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United States
Department of Defense



Oversight Review

May 5, 2008

Report of Actions on Incurred Cost Audits
by the Supervisor of Shipbuilding,
Conversion and Repair Groton, Connecticut

Report No. D-2008-6-005

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Acronyms

CAFU	Contract Audit Follow-up
CFY	Contractor Fiscal Year
DCAA	Defense contract Audit Agency
FAR	Federal Acquisition Regulation
IG	Inspector General
MOA	Memorandum of Agreement
SUPSHIP	Supervisor of Shipbuilding, Conversion, and Repair



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

May 5, 2008

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (RESEARCH,
DEVELOPMENT, AND ACQUISITION)
SUPERVISOR OF SHIPBUILDING, CONVERSION AND REPAIR,
GROTON, CONNECTICUT

SUBJECT: Report of Actions on Incurred Cost Audits by the Supervisor of Shipbuilding,
Conversion and Repair Groton, Connecticut (Report No. D-2008-6-005)

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.

We request that management provide comments that conform to the requirements of DoD Directive 7650.3. Please reconsider your nonconcurrency with Recommendations A.1, A.4, B.1, B.2, C.1, C.2, E.1, E.2, and G.1. For Recommendations A.2, A.3, D, E.3, F.1, F.2, G.2, and G.3 please provide corrective action plans, including milestones, for implementing the recommendations. For us to consider management comments, we should receive them by June 30, 2008.

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 nonconcurrency 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 nonconcurrency, 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.

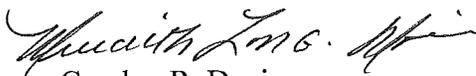

for Carolyn R. Davis
Acting Assistant Inspector General
for Audit Policy and Oversight

Table of Contents

Results in Brief	i
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Introduction

Objective	1
Background	1
DoD Directive	1

Findings

A. Premature Establishment of Indirect Cost Rates	2
Memorandum of Agreement	2
No Legal Review or Procedures	2
Actions on Costs in Memorandum of Agreement	3
Establishment of Final Indirect Cost Rates	3
Adjustment of Future Indirect Cost Rates	3
Impact on the Government	4
Management Comments and Department of Defense Inspector General Response to Finding	4
Recommendation A, Management Comments and Department of Defense Inspector General Response	6
B. Improper Use of Prior Year Sustention Rates	8
Applicable Criteria	8
Use of Prior Year Sustention Rates	8
Assessment of Penalties	9
Management Comments and Department of Defense Inspector General Response to Finding	9
Recommendation B, Management Comments and Department of Defense Inspector General Response	10
C. Failure to Obtain the Auditor's Opinion on Consultant Costs	11
Applicable Criteria	11
DCAA-Questioned Consultant Costs	11
Contracting Officer's Action	11
Management Comments and Department of Defense Inspector General Response to Finding	12
Recommendation C, Management Comments and Department of Defense Inspector General Response	12
D. Inadequate Consideration of Unallocable Costs	13
Applicable Criteria	13
DCAA-Questioned Costs	13
Contracting Officer's Action	14

Table of Contents (Con't)

Management Comments and Department of Defense Inspector General Response to Finding	14
Recommendation D, Management Comments and Department of Defense Inspector General Response	15
E. No Action Taken on Questioned Direct Costs	15
Applicable Criteria	15
DCAA-Questioned Costs	16
Contracting Officer's Action	16
Management Comments and Department of Defense Inspector General Response to Finding	16
Recommendation E, Management Comments and Department of Defense Inspector General Response	17
F. Accuracy of Reported Data	18
Applicable Criteria	18
Data Errors	18
Prior Review	19
Recommendation F, Management Comments and Department of Defense Inspector General Response	19
G. Performance Standards and Controls for Contract Audit Follow-Up	20
Performance Standards and Appraisals	20
Internal Controls	20
Prior Review	21
Management Comments and Department of Defense Inspector General Response to Finding	21
Recommendation G, Management Comments and Department of Defense Inspector General Response	22

Appendixes

A. Scope and Methodology	24
B. Inaccuracies With Reported Questioned Costs	25
C. Inaccuracies With Reported Sustained Questioned Costs	26
D. Inaccuracies With Reported Dates	27
E. Incorrect Reporting of Status	28
F. Report Distribution	29

Management Comments

Department of the Navy Comments	31
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Actions on Incurred Cost Audits by the Supervisor of Shipbuilding, Conversion and Repair Groton, Connecticut

Results In Brief

What We Did

We evaluated the actions that contracting officials at the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) Groton, Connecticut took on reportable incurred cost audits conducted by the Defense Contract Audit Agency (DCAA) for the semiannual reporting periods September 30, 2004, through March 31, 2007.

What We Found

The SUPSHIP Groton contracting officer violated Federal Acquisition Regulation and DoD Directive 7640.2 by prematurely establishing final indirect cost rates for 1997 through 2001 without taking final action on \$94 million in questioned and unresolved costs. The contracting officer improperly used prior year sustention rates to negotiate \$1.6 million in DCAA-questioned costs, allowed \$2.1 million in questioned consultant costs without obtaining the advice of the auditor, and reimbursed \$1.2 million in costs questioned as unallocable without adequate justification. SUPSHIP Groton also failed to take action on \$2.4 million in DCAA-questioned direct costs. SUPSHIP Groton does not maintain accurate data on the status of actions on incurred cost audits, hold contracting officers accountable for their actions on contract audit reports or have sufficient management focus on the internal controls over the contract audit follow-up system.

What We Recommended

SUPSHIP Groton should discontinue establishing final indirect cost rates without settling the audit findings, and using prior year sustention rates to negotiate questioned costs. The contracting officer should seek auditor advice during negotiations, ensure that all findings are addressed, and recoup the questioned direct costs. SUPSHIP Groton needs to improve the accuracy of its contract audit follow-up data, hold contracting officers accountable for their actions, and perform periodic reviews.

Management Comments

Of the 7 findings, the Navy concurred with 2 and non-concurred with 5. Of the 17 recommendations, the Navy concurred with 7, partially concurred with 3, and non-concurred with 7. The Navy said the actions on \$94 million in questioned and unresolved costs benefited the Government and complied with applicable regulations. The contracting officer did not rely solely on prior year sustention rates, and obtained audit advice on the questioned consultant costs. The Navy said that it could not reopen negotiations for the unallocable questioned costs, and that DCAA revised its opinion on the questioned direct costs. SUPSHIP Groton corrected most of the data errors and will place more management focus on the contract audit follow-up system.

Introduction

Objective

Our objective was to review the actions that the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) Groton, Connecticut took to resolve and disposition incurred cost audit reports included in its semiannual reporting for periods ending September 30, 2004 through March 31, 2007. See Appendix A for details regarding our scope and methodology and prior coverage.

Background

SUPSHIP Groton. SUPSHIP Groton is one of four SUPSHIPs under the Naval Sea Systems Command involved in procuring ships and shipboard weapons and combat systems. SUPSHIP Groton acts as the liaison between the Department of the Navy and the General Dynamics Electric Boat (GDEB) who builds and repairs nuclear powered submarines. SUPSHIP Groton is responsible for administering contracts, outfitting the ships, and assuring that quality and production schedule requirements are met. SUPSHIP Groton employs approximately 200 civilians and 27 military personnel.

Defense Contract Audit Agency. DCAA performs contract audits and provides accounting and financial advisory services to all DoD Components. DCAA issues audit reports resulting from several types of audits, such as audits of Government contractor-incurred costs. 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. DCAA issued eight incurred cost audits reports to SUPSHIP Groton covering contractor fiscal years (CFY) 1997 through 2004.

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 include most contract audits with findings and recommendations, including incurred cost audits. 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 (CAFU) systems implemented at each DoD Component for compliance with this Directive.

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. Premature Establishment of Indirect Cost Rates

SUPSHIP Groton prematurely established final indirect cost rates covering CFYs 1997 through 2001 without taking final action on \$94 million in DCAA-unresolved and questioned costs. This practice is not consistent with the Federal Acquisition Regulation (FAR), DoD Directive 7640.2, and generally accepted accounting principles. It also circumvented the primary responsibility of the SUPSHIP Groton contracting officer, which is to negotiate a fair and reasonable price on behalf of the Government. SUPSHIP Groton needs to promptly negotiate a settlement with the contractor for the remaining DCAA-unresolved and questioned costs.

Memorandum of Agreement. In a September 30, 2004 memorandum of agreement (MOA) between SUPSHIP Groton and GDEB, the contracting officer accepted \$94 million in DCAA unresolved and questioned indirect costs for CFYs 1997 through 2001 but reserved the right to negotiate the costs at a later, undetermined date. SUPSHIP Groton allowed these costs in the final indirect cost rates for CFYs 1997 through 2001. Although the MOA reserves the right to negotiate later, any costs that the contracting officer disallows from negotiations will result in an adjustment to the proposed indirect cost rates for the next open (unsettled) year, not in the year the contractor incurred, reported, and claimed the costs.

Of the \$94 million in costs addressed in the agreement, about \$78 million are costs that DCAA reported as unresolved¹ and \$16 million are costs that DCAA reported as questioned. The unresolved costs include corporate costs that the cognizant DCAA office had not yet audited at the time of report issuance. The questioned costs include costs that DCAA reported as unallowable or unreasonable, such as executive compensation, and service-center costs. SUPSHIP Groton elected not to wait for the audit results of the corporate costs or negotiate the questioned costs before establishing the final indirect cost rates for CFYs 1997 through 2001.

No Legal Review or Procedures. The SUPSHIP Groton contracting officer did not request a legal review of the agreement prior to executing it with the contractor. The contracting officer should have requested a legal review because of the unique nature of the agreement, the significance of the costs involved, and the potential for establishing precedence on future indirect cost rates. Neither the Department of the Navy nor SUPSHIP Groton has procedures governing the use of MOAs for

¹ 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.

establishing final indirect cost rates before taking final action on DCAA-unresolved and questioned costs.

Actions on Costs in the Memorandum of Agreement. Of the \$94 million in costs covered under the MOA, the SUPSHIP Groton contracting officer has only taken final action on \$4 million. Although SUPSHIP Groton can take final action on an additional \$16 million, it has no time-phased action plan for completing the actions. The remaining \$74 million includes corporate costs that cannot be settled until SUPSHIP Groton receives the results of negotiations from the Defense Contract Management Agency, Defense Corporate Executive.

Establishment of Final Indirect Cost Rates. The SUPSHIP Groton practice of establishing final indirect cost rates without negotiating all of the questioned costs violates the FAR 42.705-1, Contracting Officer Determination Procedure, and DoD Directive 7640.2.

FAR 42.705-1(b)(4) states that the contracting officer shall not resolve any questioned costs (including unresolved costs) until obtaining adequate documentation on the costs and the contract auditor's opinion on the allowability of the costs. SUPSHIP Groton allowed the costs without obtaining adequate documentation regarding their allowability.

FAR 42.705-1(b)(5)(iii)(A) requires that the contracting officer document on a post-negotiation memorandum the disposition of significant matters from the advisory audit report. Similarly, DoD Directive 7640.2, paragraph 6.5.1., states, "The memorandum shall discuss the disposition of all recommendations and questioned and/or qualified amounts, including the underlying rationale for such dispositions."

SUPSHIP Groton failed to meet the FAR and DoD Directive requirements because it did not negotiate the DCAA-questioned costs or obtain an audit opinion on the DCAA-unresolved costs before establishing the final indirect cost rates for CFYs 1997 through 2001.

Adjustment of Future Indirect Cost Rates. SUPSHIP Groton's plan to adjust future indirect cost rates for any DCAA-unresolved or questioned costs that SUPSHIP Groton disallows is not consistent with several fundamental requirements.

FAR 2.101, Definitions, defines "Indirect cost rate" as "...the percentage or dollar factor that expresses the ratio of indirect expense incurred in a *given period* to direct labor cost, manufacturing cost, or another appropriate base *for the same period*." (emphasis added)

FAR Subpart 9904.406, "Cost Accounting Standard Cost Accounting Period," provides criteria for selecting the periods to be used as the cost accounting periods for estimating accumulating and reporting. It requires that all rates (such as indirect cost

rates) used for estimating, accumulating, and reporting be based on the contractor's *cost accounting period*. (emphasis added)

The matching principle is a cornerstone of accrual accounting and generally accepted accounting principles. Accrual accounting matches revenues with expenses for a particular period using the principle of recording expenses against the revenue they helped to generate. GDEB uses the accrual method of accounting to estimate, accumulate, and report its costs from operations.

Impact on the Government. Adjusting future indirect rates for prior year disallowed costs may have a significant impact on the Government because the Government participation in any disallowed costs fluctuates from year to year. If the Government participation-rate decreases, the Government recoups a smaller share of the disallowed costs. The Government participation-rate at SUPSHIP Groton decreased from 100 percent in 1997 to 91 percent in 2004. Therefore, the Government would recoup a lower amount for any 1998 costs that are disallowed under the 2004 indirect cost rate than it would have if the costs were disallowed under the 1998 indirect cost rate.

The actions that the contracting officer took to prematurely establish final indirect cost rates, pay the unresolved and questioned costs to the contractor, and indefinitely postpone the negotiation of those costs, are not in the best interests of the Government. The contractor has no incentive to negotiate a settlement on the questioned and unresolved costs because it has already received payment for those costs. In addition, the negotiation of these costs becomes more difficult as time passes because individuals having a detailed understanding of the issues may transfer or retire, or the records become lost. Furthermore, SUPSHIP Groton used the MOA to circumvent and indefinitely delay the primary responsibility of the contracting officer, which is to negotiate a fair and reasonable price on behalf of the Government.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy did not concur with this finding. It believes that the basis used to establish indirect cost rates for CFY's 1997 through 2001 was in the best interest of the Government and did not violate any regulation, directive, or statute. The Navy said that SUPSHIP Groton's actions fall within the requirements of FAR 1.102(d) and DoD Directive 7640.2, Part 4.1.

The Navy believes its practice is consistent with the Defense Contract Management Agency (DCMA) "pay-forward" guidance. In addition, the Navy explained that establishing the final indirect cost rates in this manner enabled contract closeout and was in accordance with DCMA Quick-Closeout Procedures.

SUPSHIP Groton considered the impact on the indirect rates as relatively immaterial. The Navy believes that the practice benefited the Government by resolving over aged audit issues, moving forward on closing a number of contracts, and retaining the ability to obtain consideration from the contractor for the \$94 million set aside if at a later date it was determined that the Government was entitled to reimbursement plus interest.

DoD IG Response. We request that the Navy reconsider its position. FAR 1.102 does not give SUPSHIP Groton the authority to prematurely establish the indirect cost rates. FAR 1.102(d) states:

“The role of each member of the Acquisition Team is to exercise personal initiative and sound business judgment in providing the best value product or service to meet the customer’s needs. In exercising initiative, Government members of the Acquisition Team may assume if a specific strategy, practice, policy or procedure is in the best interests of the Government and is not addressed in the FAR, nor prohibited by law (statute or case law), Executive order or other regulation, that the strategy, practice, policy or procedure is a permissible exercise of authority.” (Emphasis added)

FAR 1.102(d) gives permission for a practice *only* if it is not addressed in the FAR or is not prohibited by law. Because the practice does not comply with several sections of the FAR and DoD Directive 7640.2, the practice is not a permissible exercise of authority under FAR 1.102(d). While we determined that the practice violates FAR 2.101, FAR 42.705-1(b)(4), FAR 42.705-1(b)(5)(iii)(A), FAR Subpart 9904.406, and DoD Directive 7640.2, the Navy did not include any specific comments on these reported violations.

Although paragraph 4.1 of DoD Directive 7640.2 recognizes the independent decision making authority of the contracting officer, the contracting officer must still act within established rules. DoD Directive 7640.2 reinforces this requirement in paragraph 4.3., which states “... the resolution and disposition of all contract audit reports shall be consistent with legal statutes, regulations, and DoD policy.” (emphasis added).

The Navy’s comparison of its practice to the DCMA “pay forward” guidance in no way justifies the premature establishment of indirect rates. We believe that both the Navy and DCMA “pay forward” practices do not comply with the FAR and DoD Directive 7640.2. In addition, the comparison is invalid because the Navy practice involves adjusting future year indirect rates for disallowed costs; whereas the DCMA “pay forward” technique involves adjusting the current-year indirect rate. The Navy practice is, however, consistent with another technique that DCMA refers to as “roll forward.” A DCMA legal counsel opinion specifically recommended against the use of the “roll forward” technique because it violates many of the same FAR and CAS standards we have cited. The Navy also needs to recognize that DCMA has never used either the “pay forward” technique or “roll forward” technique to its knowledge. Nevertheless, we will also recommend in a separate memorandum that DCMA modify its procedures to prohibit the use of both techniques.

The Navy's comparison of its practice for establishing final indirect rates to the Quick-Closeout Procedures in FAR 42.708 is also invalid. Indirect rates established under quick-closeout procedures can only be used to settle contracts having a relatively insignificant amount of indirect costs. However, the final indirect rates that SUPSHIP Groton established for 1997 through 2001 are being used by SUPSHIP Groton to settle the indirect costs for contracts, regardless of dollar value.

We vigorously dispute the Navy's determination that the \$94 million in questioned and unresolved costs are "minimal and relatively insignificant." The Navy should have recognized that the absolute dollar value of these costs alone is significant. Although the Navy calculates an impact per direct labor dollar of between \$.01 and \$.03, this is not a meaningful gauge of materiality or significance relative to the indirect rates. An example of a more meaningful measure is to determine whether the removal of the costs would cause a change to the indirect rate (In other words, would they "move" the rate). Using this measure for CFY 2000, the removal of as little as \$3,200 will cause a change to the indirect rate. Therefore, the \$94 million in questioned and unresolved costs are clearly significant to the negotiation of the indirect rates.

We also disagree with the Navy's claim that the Government has benefited from the Navy practice. The MOA between the contractor and the Navy does not identify a timeline to negotiate the costs and it does not include a provision entitling the Government to collect interest on the portion that the contracting officer eventually disallows. Therefore, the contractor is effectively receiving an interest free loan on the disallowed costs. Further, the contractor has no incentive to negotiate in good faith with the Government because it has already been paid in full for the costs. Finally, the practice gives the false impression that the Navy had timely and effectively issued final indirect rates and closed affected contracts when in fact it did so because it circumvented its responsibility of fully considering and negotiating the audit findings.

Recommendation, Management Comments and DoD IG Response

Recommendation A. We recommend that the Supervisor of Shipbuilding, Conversion and Repair at Groton, Connecticut:

- 1. Instruct the contracting officer to discontinue the practice of establishing final indirect cost rates without taking final action on DCAA-unresolved and questioned costs.**

Management Comments. The Navy did not concur with discontinuing the practice of establishing final indirect cost rates without taking final action on DCAA-unresolved and questioned costs. It stated that the FAR and applicable directives do

not prohibit this practice. Therefore, the practice is within the contracting officer's discretion. Furthermore, this practice results in quantifiable benefits to the Government by enabling prompt contract closeout.

DoD IG Response. We request that the Navy reconsider its position. We maintain that the practice does not comply with the various FAR, CAS and DoD Directive 7640.2 requirements outlined in Finding A of this report. The Navy's belief that the practice complies with DCMA guidance does not justify the use of the practice. Both the Navy and DCMA "pay forward" practices do not comply with the FAR and DoD Directive 7640.2. In addition, the Navy's practice of indefinitely delaying its action on the most controversial and significant issues makes the job of negotiating a reasonable settlement on behalf of the Government even more difficult as time passes.

- 2. Promptly negotiate any unsettled costs covered in the September 30, 2004 memorandum of agreement for which the contracting officer can take final action.**

Management Comments. The Navy concurred with this recommendation. The Navy is actively pursuing settlement of the costs under its cognizance. The Navy has dispositioned a number of these issues and has established a plan of action to resolve the remaining issues under its cognizance.

DoD IG Response. We request the Navy provide us with a copy of the plan of action, including milestones, and a current status of questioned costs that have been negotiated and are awaiting negotiation.

- 3. Implement procedures requiring that contracting officers obtain a legal review of any proposed agreements with contractors involving DCAA audit findings and recommendations.**

Management Comments. The Navy concurred with this recommendation.

DoD IG Response. We request the Navy provide anticipated dates for preparing and implementing the procedures. We also request that the Navy provide us with a draft copy of the procedures prior to implementation.

- 4. Reinstate the contractor fiscal years 1997 through 2001 incurred cost audits to open status in the contract audit follow-up system until the contracting officer takes final action on all DCAA-unresolved and questioned costs for each year.**

Management Comments. The Navy did not concur with this recommendation. The Navy believes that SUPSHIP Groton appropriately closed the audits in the contract audit follow-up system because the actions were proper and consistent with FAR and DoD guidance.

DoD IG Response. We request that the Navy reconsider its position. In accordance with DoD Directive 7640.2, Paragraphs 6.5.1. and E2.1.7.2., the audits must remain in open status until SUPSHIP Groton completes its actions on all unresolved and questioned costs. Closing the audits before the contracting officer completes the actions prevents SUPSHIP Groton management and DoD IG from effectively carrying out its monitoring and reporting responsibilities under DoD Directive 7640.2.

B. Improper Use of Prior Year Sustention Rates

The SUPSHIP Groton contracting officer improperly used prior year sustention rates as the sole basis for negotiating \$1.6 million in DCAA-questioned costs, instead of addressing the individual auditor recommendations, as FAR 42.705-1 requires. By failing to address the auditor recommendations, the contracting officer did not apply penalties or put the contractor on notice for the expressly unallowable costs.

Applicable Criteria. FAR 31.205, Selected Costs, provides specific criteria for determining the allowability of costs on Government contracts. FAR Subpart 42.7 prescribes the procedures for establishing final indirect cost rates. FAR 42.705-1 requires contracting officers to develop a negotiation position based on a proper consideration of the auditor's opinion on the allowability of the claimed costs. Contracting officers are required to explain why any of the auditor recommendations were not followed, and notify the contractor of the *individual* costs that were determined to be unallowable, including the amounts subject to penalties based on FAR 42.709 (emphasis added).

Use of Prior Year Sustention Rates. For CFYs 1997 through 2001, DCAA questioned \$1.6 million of the contractor's claimed costs for employee morale, consultants, miscellaneous (1999) expenses, and other income and credits. DCAA questioned the costs as unallowable on Government contracts based on various provisions of FAR 31.205, Selected Costs. The contracting officer sustained \$373,000 of the \$1.6 million in DCAA-questioned costs by applying prior year sustention rates to the DCAA-questioned costs. The contracting officer used a 16 percent sustention rate for the questioned consultant costs, and a 25 percent sustention rate for the other questioned costs. The sustention rates are based on the percentage of costs that the contracting officer sustained for 1994 and 1995.

Using prior year sustention rates, the contracting officer did not address the auditor recommendations applicable to the indirect cost rates being negotiated, as FAR 42.705-1 requires. In addition, there is no indication in the contract file that the contracting officer verified that the costs claimed in CFYs 1997 through 2001 were comparable with those claimed in 1994 and 1995. The negotiation memorandum also does not adequately explain why the contracting officer did not sustain the majority of DCAA-questioned costs for CFYs 1997 through 2001. Furthermore, the use of

prior year rates precludes the contracting officer from notifying the contractor of the individual costs determined to be unallowable, as FAR 42.705-1(b)(5)(v) requires.

Assessment of Penalties. The use of prior year sustention rates may affect the Government's ability to collect penalties on expressly unallowable costs. With prior year sustention rates, there is no identification of the individual unallowable costs subject to penalty. It also prevents the contracting officer from assessing a Level 2 (double) penalty as provided in FAR 42.709(a)(2), because the contractor must be notified that the costs were unallowable before submitting its indirect cost claim.

DCAA reported that \$64,000 of the \$1.6 million was expressly unallowable and subject to penalties. SUPSHIP Groton did not assess penalties even though the costs were clearly unallowable and subject to penalties. Of the \$64,000 in costs subject to penalty, \$24,000 related to lobbying activities, \$20,000 related to contributions, and \$20,000 related to public relations and advertising costs. The negotiation memorandum gives no explanation as to why the contracting officer did not assess penalties as FAR 42.705-1(b)(5)(iii)(C) requires. Therefore, the Government lost \$64,000 in penalties and the contracting officer failed to put the contractor on notice that it should not claim costs of a similar nature in the future.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy did not concur. According to the Navy, the contracting officer did not rely solely on prior year sustention rates but rather employed various negotiation strategies in settling incurred costs for CFY's 1997 through 2001 that were appropriate to the cost category and costs being negotiated.

DoD IG Response. We disagree with the management comments and we request that the Navy reconsider its position. While the Navy claims that the contracting officer used other strategies, the negotiation memorandum only reflects the use of prior year sustention rates to negotiate the \$1.6 million in questioned costs. The Navy also has not adequately explained why the use of prior year sustention rates was appropriate under the circumstances, especially considering that the Government lost \$64,000 in associated penalties. Analyzing historical sustention rates may provide helpful information, but the contracting officer should not use them as a substitute for evaluating the individual auditor recommendations.

Recommendation, Management Comments and DoD IG Response

Revised Recommendation. *We revised recommendation B.1 to clarify our intent of the recommendation.*

Recommendation B. We recommend that the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut:

- 1. Direct the contracting officer to discontinue the use of prior year sustention rates as the sole basis for negotiating DCAA-questioned costs.**

Management Comments. The Navy did not concur with this recommendation. The Navy said that DCMA recognizes the use of prior year sustention rates as an appropriate technique for establishing quick-closeout indirect cost rates. SUPSHIP Groton used this technique to resolve very limited areas of questioned costs totaling \$1.6 million.

DoD IG Response. We request that the Navy reconsider its position. The DCMA recognition of prior year sustention rates for determining quick-closeout rates is not the same as the SUPSHIP Groton use of prior year sustention rates for establishing final indirect rates. Quick-closeout rates can only be used to settle contracts having a relatively insignificant amount of indirect costs. In contrast, SUPSHIP Groton is using the final indirect rates for 1997 through 2001 to close out all contracts regardless of dollar value. In accordance with FAR 42.705-1, the contracting officer must address each auditor recommendation when establishing final indirect cost rates.

- 2. Establish and document internal controls to help ensure that contracting officers develop and document the negotiation position for indirect cost rates that is based on adequate consideration of the DCAA-questioned costs, including the DCAA-questioned costs subject to penalty.**

Management Comments. The Navy partially concurred with this recommendation. The Navy believes this is not an issue of adequate internal controls, but rather one of good documentation. SUPSHIP Groton agrees that it is essential that contracting officers adequately document the basis for their decisions.

DoD IG Response. We disagree with the management comment that this is not an issue of adequate internal controls. Adequate documentation is an integral part of a comprehensive internal control program. SUPSHIP Groton management is responsible for implementing effective internal controls which provide reasonable assurance that what should happen does happen. Effective internal controls covering the preparation and review of negotiation memorandums would have prevented the contracting officer from negotiating the questioned costs without adequate documentation of each auditor recommendation. Since the Navy agrees that adequate documentation is essential, it should also agree to implement the controls necessary to ensure that the contract file includes adequate documentation supporting the actions on the audit findings.

C. Failure to Obtain the Auditor's Opinion on Consultant Costs

The SUPSHIP contracting officer allowed \$2.1 million in DCAA-questioned consultant costs without asking DCAA to review or provide its opinion on additional information that the contractor gave the contracting officer at negotiations. In accordance with FAR 42.705-1(b)(4)(i)(B), the contracting officer should have consulted with DCAA as to whether the additional information was sufficient to justify allowing the questioned consultant costs.

Applicable Criteria. FAR 42.705-1 outlines the requirements for establishing final indirect cost rates using contracting officer determination. FAR 42.705-1(b) requires that the contractor support its indirect cost proposal with adequate supporting data. In accordance with FAR 42.705-1(b)(4), the contracting officer is responsible for not resolving any questioned costs until obtaining adequate documentation on the costs and the contract auditor's opinion on the allowability of the costs.

DCAA-Questioned Consultant Costs. For CFYs 1997 through 2001, DCAA questioned \$2.1 million in consultant costs related to an out-sourced internal audit function because the contractor failed to provide adequate supporting documentation. In accordance with FAR 31.205-33(f), consultant costs are allowable only when supported by evidence of the nature and scope of the service furnished. FAR 31.205-33(f) states:

- “...Evidence necessary to determine that work performed is proper and does not violate law or regulation shall include-
- (1) Details of all agreements...
 - (2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided; and
 - (3) Consultants' work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.”

Although the contractor provided DCAA with invoices, it did not provide DCAA with the consultant's work product and agreements needed to determine the nature of the work performed and whether it violated any law or regulation. The contractor refused to provide DCAA with the needed information despite DCAA's repeated requests for it.

Contracting Officer's Action. According to the negotiation memorandum, the contracting officer allowed the \$2.1 million in consultant costs based on her review of additional information provided by the contractor during negotiations, including “...documentation demonstrating that there is in fact an audit plan in place, that audits are being conducted and that there are results of audit for the company to use.” However, the contracting officer did not consult with DCAA or request that it review

the additional information to determine if it satisfies the FAR 31.205-33(f) allowability requirements. In accordance with FAR 42.705-1(b)(4), the contracting officer should have obtained the auditor opinion on the allowability of the costs based on the additional information.

The SUPSHIP Groton practice of reviewing and accepting additional contractor documentation at negotiations avoids getting the DCAA opinion on the allowability of the costs. The contracting officer is allowing the contractor to circumvent the audit process if the contracting officer does not consult with DCAA on additional records provided at negotiations. DCAA has the authority under the FAR 52.215-2 clause to examine contractor records, and the requisite skills and experience to provide an opinion on the allowability of claimed costs. FAR 42.705-1(b)(4)(ii) emphasizes the need to consult with the auditor and invite them to attend negotiations and other meetings involving the determination of the indirect cost rates.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy did not concur with this finding. The Navy asserts that the contracting officer made all of the additional supporting data available to DCAA and as a result, DCAA determined that these costs were in fact reasonable.

DoD IG Response. We request that the Navy reconsider its position. We disagree that the contracting officer made all the additional supporting data available to DCAA. This comment is not consistent with the negotiation memorandum which states that the contracting officer accepted the costs based on her review of supporting records that the contractor failed to provide during the DCAA audit. The negotiation memorandum does not reflect that DCAA had reviewed the supporting records or determined the costs to be reasonable. In a March 28, 2008 email, DCAA confirmed that it had not reviewed the supporting records or changed its audit opinion.

Recommendation, Management Comments and DoD IG Response

Recommendation C. We recommend that the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut:

1. **Establish and document internal controls to verify that contracting officers are obtaining the auditor opinion on the allowability of claimed costs when the contractor submits additional documentation during negotiations in accordance with FAR 42.705-1(b)(4).**

Management Comments. The Navy did not concur with this recommendation. The Navy stated that the allowability of costs must represent the contracting officer's independent judgment. While that determination is based on the advice of legal, technical, and accounting resources, requiring that third parties review every piece of information would both inhibit the contracting officer's independence and result in an unnecessarily protracted negotiations process.

DoD IG Response. We request that the Navy reconsider its position. We do not agree that obtaining the DCAA advice would have inhibited the contracting officer's independent judgment or protracted the negotiation process. The dollar value of the questioned costs alone (\$2.1 million) justified a DCAA review of the supporting records. Moreover, FAR 42.705-1(b)(4) requires the contracting officer to obtain the auditor's opinion before rendering a final determination on the allowability of the costs. In addition, we believe that the contracting officer actions effectively allowed the contractor to circumvent the audit process.

2. Request that the contracting officer invite the auditor to attend negotiations and serve as an advisor for determining the contractor's final indirect cost rates.

Management Comments. The Navy partially concurs to this recommendation. The Navy concurs that inviting the auditor to attend negotiation is useful, and it does so when appropriate. However, the determination of final indirect costs remains the responsibility of the contracting officer.

DoD IG Response. The management comments are partially responsive. We request that SUPSHIP Groton submit a specific action plan for utilizing DCAA at the next indirect rate negotiations. In accordance with FAR 42.705-1(b)(4)(ii), SUPSHIP Groton should invite the DCAA auditor to participate in future indirect rate negotiations due to the complexity and significance of the DCAA audit findings in this area.

D. Inadequate Consideration of Unallocable Costs

The SUPSHIP contracting officer reimbursed \$1.2 million in costs that DCAA questioned due to allocability. The contracting officer accepted the costs without fully considering the audit recommendation.

Applicable Criteria. FAR 42.705-1(b)(4)(i)(B) requires that the contracting officer obtain the contract auditor opinion on the allowability of the costs. FAR 42.705-1(b)(5)(iii)(C) states that the contracting officer is required to document on the negotiation memorandum the "reasons why any recommendations of the auditor or other Government advisors were not followed."

DCAA-Questioned Costs. In the supplemental audit report for CFYs 1997 through 2001, DCAA reported that \$1.2 million of the claimed Booz Allen Hamilton

consultant costs was not allocable to GDEB and therefore unallowable in accordance with FAR 31.201-4, Determining Allocability. DCAA determined that the resulting questioned costs were allocable to the General Dynamics Marine Group, not to GDEB.

Contracting Officer's Action. The negotiation memorandum states, "The auditor cites FAR 31.205-33 as the basis for questioning the costs....We reviewed this issue extensively and find no basis for supporting the amounts questioned by the DCAA." However, DCAA questioned the costs because they were not allocable in accordance with FAR 31.201-4, Determining Allocability. The negotiation memorandum fails to adequately explain the rationale for not supporting the audit conclusion that the costs were unallocable. The contracting officer stated that she may have misunderstood or overlooked this DCAA finding in the supplemental report. As a result, SUPSHIP Groton paid \$1.2 million in costs that may be unallocable and cannot be recouped by the Government.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy does not concur with the finding. According to the Navy, the \$1.2 million addressed in Finding D is part of the \$2.1 million addressed in Finding C. In addition, the Navy points out that DCAA initially questioned the costs as unreasonable, but later questioned them as unallocable in a revised opinion. The contracting officer received the revised opinion after she had reached agreement with the contractor on this issue, but before she executed the final indirect rate agreement.

According to the Navy, the contracting officer could not consider the issue under the circumstances. The contracting officer determined that it would be unproductive to reopen negotiations because of concerns she had with the DCAA rationale for determining the amount of unallocable costs.

DoD IG Response. We request that the Navy reconsider its position. The questioned costs addressed in Finding D are not part of the questioned costs addressed in Finding C. Finding D involves \$1.2 million in consultant fees that Booz Allen billed, whereas Finding C addresses \$2.1 million in internal audit fees that Arthur Anderson and other firms billed.

We reject the contracting officer's view that it would have been unproductive to reopen negotiations and potentially recoup \$1.2 million in unallocable costs. The negotiation memorandum does not document any concerns that the contracting officer had with the DCAA rationale for determining the unallocable costs. The contracting officer told us that she had simply overlooked these questioned costs during negotiations. Assuming the contracting officer had any concerns with the DCAA

findings, she should have discussed them with DCAA and fully explained her determination in the negotiation memorandum.

Recommendation, Management Comments and DoD IG Response

Recommendation D. We recommend that the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut establish a quality assurance process to verify that contracting officers adequately document their consideration of all Defense Contract Audit Agency audit findings and recommendations in accordance with FAR Subpart 42.705, Final Indirect Cost Rates.

Management Comments. The Navy concurred with this recommendation. The Navy will remind contracting officers to document the resolution of all DCAA audit findings and recommendations in the negotiation memorandum.

DoD IG Response. The planned action is not responsive. Simply issuing a reminder will not provide reasonable assurance that contracting officers are adequately documenting their actions. SUPSHIP Groton needs to take more substantive actions, such as providing comprehensive training and/or implementing procedures to require a review by a level above the contracting officer. We request that SUPSHIP Groton evaluate its procedures and training requirements to determine the most appropriate quality assurance process for ensuring that SUPSHIP contracting officers adequately document their actions.

E. No Action Taken on Questioned Direct Costs

Revised Finding. As a result of management comments, we no longer take exception to the contracting officer actions on \$2.1 million of the \$2.4 million in questioned direct costs discussed below. For additional details, refer to the “Management Comments and Department of Defense Inspector General Response to Finding” below.

SUPSHIP Groton took no action on \$2.4 million in DCAA-questioned direct costs for CFYs 1997, 1998, and 2000, even though it reported in the CAFU system that all actions were completed. The contractor will have free use of Government funds until the contracting officer settles the questioned costs.

Applicable Criteria. FAR 42.705-1(b)(5)(iii)(B) requires that the negotiation memorandum include a reconciliation of all costs questioned, with identification of items and amounts allowed or disallowed in the final settlement.

DCAA-Questioned Costs. For CFYs 1997, 1998, and 2000, DCAA questioned \$2.4 million in direct costs, including \$300,000 in subcontractor travel costs and \$2.1 million in subcontractor gains on the sale of a building. DCAA questioned the travel and subcontractor losses in accordance with FAR 31.205-46, Travel Costs, and FAR 31.205-16, Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets.

Contracting Officer's Action. SUPSHIP Groton took no action on the questioned direct costs, and the negotiation memorandum fails to address the SUPSHIP Groton determination of those costs. However, SUPSHIP Groton reported that the actions on the audit reports were completed (disposed) in accordance with DoD Directive 7640.2 which requires that "contracting officers take timely and proper actions in response to *all* audit findings." (emphasis added) The SUPSHIP Groton contracting officer stated that she may have overlooked the questioned direct costs during negotiations. The failure of the contracting officer to take prompt action on the questioned costs allows the contractor to have free use of the Government funds until the costs are settled.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy did not concur with this finding. The Navy claims that DCAA reported \$2.4 million in questioned direct costs "for information purposes only." Regarding the \$2.1 million portion related to the sale of the building, the Navy also said that DCAA later accepted the costs after agreeing with the contractor that the building was worthless. Regarding the \$300,000 portion in direct travel costs, the Navy said that the contracting officer did not negotiate these costs because DCAA did not include them in the incurred cost audit reports.

DoD IG Response. Based on additional information that SUPSHIP Groton provided after issuance of our draft report, we agree with the action that the contracting officer took on the \$2.1 million related to the sale of the building.

However, we still find that the contracting officer actions on the remaining \$300,000 in questioned direct costs were inadequate. The audit report does not provide any indication that DCAA had questioned the costs for "information purposes only." Although the Navy claims otherwise, DCAA did question the costs in the incurred cost audit reports for 1997 and 1998. DCAA reported a portion of the questioned costs on Page 4 of Audit Report No. 2361-1999R10150001, and the remainder on Page 3 of Audit Report No. 2361-1998B1010016. The negotiation memorandum is silent with respect to these questioned costs, and SUPSHIP Groton has not provided any evidence to support the adequacy of the contracting officer actions or lack thereof.

Recommendation, Management Comments and DoD IG Response

Revised Recommendation. As a result of management comments, we revised Recommendations E.1. and E.2., to only address the questioned direct travel costs of \$300,000.

Recommendation E. We recommend that the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut, instruct the contracting officer to take the following steps immediately:

1. Negotiate the questioned direct costs of \$300,000.

Management Comments. The Navy said that SUPSHIP Groton will negotiate the \$300,000 in direct travel costs as part of its closeout of the applicable contracts.

DoD IG Response. The Navy's proposed action is not fully responsive. The contractor will have free use of Government funds if the contracting officer delays the negotiation of the questioned direct costs until contract completion (which could take several years). The contracting officer should promptly negotiate the costs and require that the contractor remove the sustained portion of the questioned costs from current billings. We request that the Navy provide to the DoD IG documentation that confirms the prompt resolution of the questioned costs.

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

Management Comments. The Navy did not concur. The contracting officer did not report the questioned direct travel costs in the CAFU system because DCAA did not include them in the audit reports.

DoD IG Response. We request that the Navy reconsider its position. DCAA did include the questioned direct travel costs in the incurred cost reports. The audits should remain open in the contract audit follow-up system until the contracting officer negotiates the questioned direct costs. Including the audits in the contract audit follow-up system will enable Navy management and the DoD Inspector General to monitor the contracting officer actions and report the negotiation results in the DoD IG Semiannual Report to Congress, as DoD Directive 7640.2 requires.

3. Require that the contracting officer include a reconciliation and determination of all questioned costs, including questioned direct costs, in the negotiation memorandum.

Management Comments. The Navy concurred in principle to this recommendation. Inclusion of a reconciliation and determination regarding all questioned costs is part of the current process for documenting negotiations.

DoD IG Response. The Navy comments are responsive. We request that SUPSHIP Groton provide the DoD IG with a copy of the negotiation memorandum for the latest negotiated indirect rates to confirm that the contracting officer reconciled the questioned costs as part of documenting negotiations.

F. Accuracy of Reported Data

SUPSHIP Groton did not maintain accurate records of reportable incurred cost audits in the CAFU system. As a result, the semiannual CAFU data that SUPSHIP Groton reported to the DoD IG for the periods September 30, 2004 through March 31, 2007 contained several data errors.

Applicable Criteria. DoD Directive 7640.2 includes the following data accuracy requirements:

- Paragraph 5.2.5 requires that DoD Components establish procedures for maintenance of up-to-date records on all reportable contract audits from receipt through disposition; and
- Paragraph 6.3 requires that DoD acquisition and contract administration organizations maintain accurate and complete information regarding the status of reportable audit reports from the time reports are received through final disposition.

Data Errors. Our review of the SUPSHIP Groton reporting of actions on incurred cost audit reports disclosed the following errors:

- missing records for the two reportable audit reports (Audit Report 2361-2002B10100001S1 and 2361-2003B10100001);
- inaccurate questioned costs for six of eight audits, resulting in SUPSHIP Groton overstating the questioned costs by \$27 million (see Appendix B);
- inaccurate sustained questioned costs for five of eight audits, resulting in SUPSHIP Groton overstating the sustained questioned costs by \$3.8 million (see Appendix C);
- incorrect dates for two audit reports and three audit resolutions (see Appendix D); and
- incorrect status of actions on six of eight audits (see Appendix E).

Most of the errors resulted from SUPSHIP Groton failing to verify the accuracy of the data entered by DCAA in the CAFU automated system or misunderstanding the reporting requirements of DoD Directive 7640.2. Although DCAA provides a monthly electronic listing of data on reportable audits, the SUPSHIP Groton

contracting officer is ultimately responsible for data accuracy. The contracting officer needs to verify the DCAA-provided questioned costs against the DCAA audit reports and make any necessary adjustments.

Without accurate data, SUPSHIP Groton management, the DoD Inspector General, and Congress do not have accurate information on contracting officer actions taken in response to contract audit reports.

Prior Review. DOD IG Report No. D-2004-6-006, “Oversight Review of Naval Sea Systems Command Contract Audit Follow-up Process,” July 8, 2004, reported that the semiannual reports for periods ending September 30, 2001, and March 31, 2002, contained incorrect CAFU information for 29 of the 45 incurred cost audits. Thirteen of the 45 incurred cost audits were assigned to SUPSHIP Groton. SUPSHIP Groton had incorrectly reported 5 of the 13 audits in its semiannual reporting to the DoD IG. SUPSHIP Groton has not demonstrated any significant improvement in the accuracy of the CAFU data since the prior review.

Recommendation, Management Comments and DoD IG Response

Recommendation F. We recommend that the Supervisor of Shipbuilding and Repair, Groton, Connecticut:

- 1. Establish quality assurance processes to ensure the accuracy of the data reported in the contract audit follow-up system.**

Management Comments. The Navy partially concurred. The Navy agreed that there were inaccurate records of reportable incurred cost audits in the CAFU system. However, the Navy believes the issue of maintaining accurate records to be indicative of the need for additional training, not a quality assurance issue.

DoD IG Response. The Navy comments are partially responsive. We agree that the Navy should provide CAFU training to SUPSHIP Groton acquisition personnel, as DoD Directive 7640.2, section 5.2.8, requires. Training is an essential component of any quality assurance program. The Navy should also consider other types of quality assurance processes that will improve CAFU system data accuracy, such as periodic data accuracy checks by the designated CAFU monitor. In its response to the final report, we request that the Navy provide its time-phased action plan for providing the CAFU training and for considering the need to implement any additional quality assurance processes.

- 2. Correct the errors in the contract audit follow-up system identified in this review.**

Management Comments. The Navy concurred and stated that SUPSHIP Groton corrected the errors in the contract audit follow-up system.

DoD IG Response. SUPSHIP Groton only corrected those errors that it agreed to during the review. SUPSHIP Groton has yet to make all of the required corrections. The CAFU system still includes the following errors:

- understated questioned cost for audit report 23612004B10100001 (see Appendix B);
- inaccurate audit report date for 2361-1999R10100001S1 (see Appendix D); and
- incorrect status of actions on five of eight audits (see Appendix E).

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

SUPSHIP Groton 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 CAFU, and
- including the CAFU function as a regular part of SUPSHIP Groton’s internal control review program.

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 four SUPSHIP Groton contracting officials responsible for taking action on DCAA audit reports. None of the standards or appraisals had comments that addressed CAFU effectiveness. DoD Directive 7640.2, paragraph 5.2.4, requires agencies to “ensure that performance appraisals of appropriate acquisition officials reflect their effectiveness in the resolution and disposition of audit findings and recommendations in a timely manner, while fully protecting the Government’s interests.” The number of exceptions we identified demonstrates the need for SUPSHIP Groton contracting officers to be held accountable for timely and proper resolution and disposition of contract audit reports.

Internal Controls. Management processes and procedures (internal controls) provide reasonable assurance that what needs to happen does happen. Our review identified deficiencies with SUPSHIP Groton’s CAFU actions and we have recommended that SUPSHIP Groton establish specific procedures to improve its

CAFU 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, and DoD Instruction 5010.40, "Managers' Internal Control (MIC) Program Procedures", January 4, 2006. DoD Directive 7640.2, paragraph 5.2.3, also requires periodic evaluations of the CAFU 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."

SUPSHIP Groton has not performed an internal control review of the CAFU function. The lack of management attention and oversight of the CAFU function may have contributed to the serious weaknesses in the contract audit resolution and disposition program we identified at SUPSHIP Groton. When the CAFU 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.

Prior Review. DoD IG Report No. D-2004-6-006, "Oversight Review of Naval Sea Systems Command Contract Audit Follow-up Process," July 8, 2004, recommended that the Commander for Contracts, Naval Sea Systems Command, include the contract audit follow-up function as an area of special interest in its "FY 2004 Procurement Management Review Program." Although the Naval Sea Systems Command agreed to the recommendation, our review disclosed no indication that the CAFU process was tested or included as an area of special interest in FY 2004.

Management Comments and Department of Defense Inspector General Response to Finding

Management Comments. The Navy concurred in principle. The Navy explained that it maintains an environment that recognizes the importance of adequately and timely resolving and completing the disposition of contract audit reports. Every contracting officer responsible for resolving audits has an evaluation element that requires "timely completion of and/or resolution" of audit findings.

As part of the NAVSEA contracting competency, SUPHIP Groton maintains a robust internal control system based on guidance contained in the FAR, DFARS, Navy/Marine Corps Acquisition Regulation Supplement, NAVSEA Contracting

Handbook and numerous supplemental regulations and directions from Headquarters that provide adequate control of all contracting actions.

NAVSEA followed up on the DOD IG report issued in 2004 regarding the CAFU process through the Procurement Performance Management Assessment Program (PPMAP). In its September 2007 review of SUPSHIP Groton, the NAVSEA PPMAP team identified the CAFU process as a special interest item that was extensively reviewed.

DoD IG Response. We request that the Navy reconsider its comments. The evaluation element that the Navy identifies, actually states “*AUDIT FOLLOW UP: Acceptable: Ensure positive and timely completion of and/or resolution of MCR, IG, GAO, and other findings*”. As written, this element does not satisfy the DoD Directive 7640.2, paragraph 5.2.4., requirement because the element does not address the effectiveness of the contracting official actions related to *contract* audit follow-up. SUPSHIP Groton must hold their contracting officers accountable for contract audit follow-up related actions to help prevent similar deficiencies identified in this report from occurring in the future.

During our review, SUPSHIP Groton stated that no internal/management review of the CAFU system had been performed in the last 3 years. Although the Navy states that it reviewed the CAFU process in September 2007, we have not received documentation we requested to confirm the performance of the review or its results. We request that the Navy provide the requested documentation in its response to the final report.

Recommendation, Management Comments and DoD IG Response

Recommendation G. We recommend that the Supervisor of Shipbuilding, Conversion and Repair Groton, Connecticut, 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 Navy did not concur. As discussed above, timely resolution of audits is currently in the performance standards of the appropriate acquisition officials.

DoD IG Response. We request that the Navy reconsider its position. The current appraisal is not specific enough to satisfy the DoD Directive 7640.2 requirement. To satisfy the Directive, the appraisal must evaluate contracting officials on their actions regarding contract audit follow-up.

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- 2. Perform an internal control review of contract audit follow-up actions in FY 2008 to ensure compliance with DoD Directive 7640.2.**

Management Comments. The Navy concurred.

- 3. Make the review of contract audit follow-up actions a regular part of the SUPSHIP Groton internal review program.**

Management Comments. The Navy concurred.

Appendix A. Scope and Methodology

We evaluated the actions that SUPSHIP Groton took on eight incurred cost audits reported during the semiannual reporting periods September 30, 2004, through March 31, 2007. In its semiannual reporting, SUPSHIP Groton reported that the contracting officer completed the actions on five of the eight audits, and in the process of taking actions on the remaining three audits. We reviewed the eight audits to determine whether:

- CAFU 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 sound rationale for not sustaining DCAA-questioned costs;
- contracting officials assessed penalties on expressly unallowable costs;
- disposition actions were adequately documented in accordance with FAR, DoD Directive 7640.2 and SUPSHIP Groton procedures;
- contracting officials are evaluated on their effectiveness in resolving and completing the disposition of audit findings on time; and
- periodic evaluations of the CAFU program are conducted to ascertain CAFU program effectiveness.

We performed this review from August 2005 through August 2007. We suspended the project for 19 months within this timeframe to address other projects.

Use of Computer-Processed Data. SUPSHIP Groton uses a Web-based eTools contract audit follow-up database to maintain and report 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 other report to SUPSHIP Groton on the CAFU process. DoD IG Report No. D-2004-6-006, "Oversight Review of Naval Sea Systems Command Contract Audit Follow-up Process," July 8, 2004. We reported several inadequacies with the CAFU process, including inaccuracies with the SUPSHIP Groton semiannual reporting of CAFU data. SUPSHIP Groton has not made significant improvements to its CAFU data accuracy since the prior review.

Appendix B. Inaccuracies With Reported Questioned Costs

Revised Appendix B. We revised Appendix B to identify the items that still need to be corrected at the time of final report issuance.

Audit Report Number	Actual Questioned Cost in DCAA Report	Questioned Cost in CAFU* System	Difference	Note
23611999R10150001S1	\$3,268,469	\$14,207,133	\$10,938,664	1
23611998B10100016S1	4,975,319	4,058,077	(917,242)	1
23611999R10100001S1	3,405,684	14,919,482	11,513,798	1
23612000R10100001S1	4,773,332	7,625,104	2,851,772	1
23612001B10100001S1	5,329,000	8,382,588	3,053,588	1
23612004B10100001	2,617,358	2,633,844	16,486	1,2
Total	\$28,204,294	\$55,661,360	\$27,457,066	

Note:

1. SUPSHIP Groton reported inaccurate questioned costs in the eTools CAFU system. The contracting officer should have compared the amounts in the DCAA audit report with the amounts stated in the eTools CAFU system for accuracy.
2. SUPSHIP Groton is still reporting incorrectly the question cost in the eTools CAFU system.

*Contract Audit Follow-up

Appendix C. Inaccuracies With Reported Sustained Questioned Costs

Revised Appendix C. We revised Appendix C to identify the items that still need to be corrected at the time of final report issuance.

Audit Report Number	Actual Sustained Cost According to Negotiation Files	Sustained Cost Reported by NAVY in CAFU* System	Difference	Note
2361-1999R10150001S1	\$751,066	\$3,688,423	\$2,937,357	1
2361-1998B10100016S1	901,093	1,171,845	270,752	1
2361-1999R10100001S1	3,688,243	751,066	(2,937,177)	1
2361-2000R10100001S1	1,171,845	901,093	(270,752)	1
2361-2002B10100001	0	3,835,132	3,835,132	2
Total	\$7,457,990	\$11,293,302	\$3,835,312	

Notes:

1. The contracting officer prematurely entered the sustained questioned costs in the incorrect years. SUPSHIP Groton corrected the error during our review by removing the sustained questioned costs.
2. The contracting officer did not revise the sustained cost in the eTools CAFU system to zero when the audit report was superseded or replaced, as required by DoD Directive 7640.2, paragraph 6.3.4.2. SUPSHIP Groton corrected the sustained costs during our review.

*Contract Audit Follow-up

Appendix D. Inaccuracies With Reported Dates

Revised Appendix D. We revised Appendix D to identify the items that still need to be corrected at the time of final report issuance.

Audit Report Number	Actual Report Date	Report Date Reported in CAFU* System	Actual Resolution Date	Resolution Date Reported in CAFU* System	Note
2361-1998B10100016S1			03/12/04	04/28/04	1
2361-1999R10100001S1	04/28/04	04/02/04			2, 5
2361-2000R10100001	09/25/02	09/25/03			2, 6
2361-2002B10100001S1			03/30/07	N/A	3, 6
2361-2004B10100001			N/A	02/07/07	4

Notes:

1. The audit was resolved one month after the contracting officer reported it as resolved in the eTools CAFU system. SUPSHIP Groton corrected this inaccuracy during our review.
2. The CAFU system did not have accurate audit report dates. The contracting officer did not verify the date in the eTools CAFU system against the audit report.
3. This reportable audit was not in the eTools CAFU system at the start of our review. Therefore, the contracting officer did not report a resolution date for this audit.
4. Although the contracting officer reported the status of Audit Report Number 2361-2004B10100001 as resolved, the audit is not resolved. SUPSHIP Groton corrected the inaccuracy during our review.
5. SUPSHIP Groton is still reporting the date incorrectly.
6. These date inconsistencies no longer require correction because DCAA issued a supplemental audit report that replaced this audit.

*Contract Audit Follow-up

Appendix E. Incorrect Reporting of Status

Revised Appendix E. We revised Appendix E to identify the items that still need to be corrected at the time of final report issuance.

Audit Report Number	Actual Status of Audit	Status Reported in CAFU* System	Note
2361-1999R10150001S1	Unresolved	Dispositioned	1
2361-1998B10100016S1	Unresolved	Dispositioned	1
2361-1999R10100001S1	Unresolved	Dispositioned	1
2361-2000R10100001S1	Unresolved	Dispositioned	1
2361-2001B10100001S1	Unresolved	Dispositioned	1
2361-2004B10100001	Unresolved	Resolved	2

Notes:

1. SUPSHIP Groton inaccurately reported the status as complete through disposition. However, the contracting officer has not developed an action plan for taking final actions on the costs included in the memorandum of agreement (see finding A). Therefore, SUPSHIP Groton should report these audits as unresolved. SUPSHIP Groton is still reporting the status incorrectly.
2. SUPSHIP Groton inaccurately reported the status as resolved when the audit was unresolved. SUPSHIP Groton corrected the inaccuracy during our review.

*Contract Audit Follow-up

Appendix F. 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

Assistant Secretary of the Navy (Research, Development, and Acquisition)
Director, Program Analysis and Business Transformation
Assistant Secretary of the Navy, (Manpower and Reserve Affairs)
Naval Audit Service
Naval Inspector General
Supervisor of Shipbuilding and Repair, Groton Connecticut

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Policy Quality Assurance Division Chief, Policy and Plans Directorate
Director, Defense Contract Management Agency

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
House Subcommittee on Government Management, Organization, and Procurement,
Committee on Oversight and Government Reform
House Subcommittee on National Security and Foreign Affairs,
Committee on Oversight and Government Reform



Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
RESEARCH, DEVELOPMENT AND ACQUISITION
1000 NAVY PENTAGON
WASHINGTON DC 20350-1000

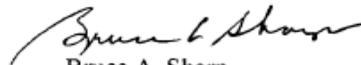
December 26, 2007

MEMORANDUM FOR DEPARTMENT OF DEFENSE - INSPECTOR GENERAL
ARLINGTON, VIRGINIA

SUBJECT: Department Of Defense Inspector General Draft Report - Actions on
Incurred Cost Audits by Supervisor of Shipbuilding Conversion and Repair
Groton, Connecticut (Project No. D20005-DIP0AI-0280.000)

The Department of the Navy (DON) hereby submits its response to subject draft audit report. The response delineates detailed comments to the findings contained in the subject draft report. The Navy's response is to be incorporated into the final DODIG report on Supervisor of Shipbuilding Conversion and Repair Groton, Connecticut SOSG incurred cost audit report (Project No. D20005-DIP0AI-0280.000).

If you have any questions pertaining to this memo or its attachments, please refer them to Ms. Robbin Bruce at Robbin.Bruce@navy.mil or at 703-693-3998.


Bruce A. Sharp

Attachments:
As stated



DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
1333 ISAAC HULL AVE SE
WASHINGTON NAVY YARD DC 20376-0001

IN REPLY TO:

7500
Ser 00N3E/250
21 Dec 07

From: Commander, Naval Sea Systems Command
To: Assistant Secretary of the Navy, (RDA) A&LM

Subj: DODIG DRAFT REPORT - ACTIONS ON INCURRED COST AUDITS BY
THE SUPERVISOR OF SHIPBUILDING, CONVERSION AND REPAIR
GROTON, CONNECTICUT (D2005-DIP0AI-0280.)

Encl: (1) Proposed DoN Response to DoDIG Draft Report

1. Enclosure (1) is NAVSEA's response to the subject draft audit report prepared in the required DON format.
2. For additional information please contact Ms. Yvonne Cameron on COM 202-781-3329 or by email at yvonne.cameron@navy.mil.

P. E. SULLIVAN

Copy to:
OASN (RDA) A&LM
OASN (FMC-1)
SUPSHIP Groton (Code 400) (Code 1071)

**SUSHIP Groton, CT comments on Department of Defense Inspector General
Draft Report of Review of the Actions taken on Incurred Cost Audits
(Project No. D20005-DIP0AI-0280.000)**

Introduction

The Department of Defense Inspector General (DODIG) performed a review of the actions taken on incurred cost audits by the Supervisor of Shipbuilding, Groton CT (SOSG) under Project No. D2005-DIP0AI-0280.000 and provided SOSG with a draft report on 26 September 2007. The following comments are provided in accordance with DoD Directive 7650.3.

Background

1. In early 2004, the SOSG Administrative Contracting Officer (ACO) was attempting to negotiate the settlement of 33 outstanding contracting and financial issues valued at approximately \$134 million with the Electric Boat Corporation (EBC). Included in this proposed negotiation were the proposed indirect costs for EBC's Fiscal Years (CFYs) 1997 through 2001. The claimed indirect expense for these five years totaled approximately \$ (Redacted). The basis for attempting this negotiation related to negotiating settlement of aging audit issues, and establishing final indirect cost rates to reduce the backlog of contracts to be closed out.

2. The issues on the table had been the subject of extensive and sometimes contentious negotiations between the contractor and the government, with little real progress. EBC was experiencing significant key personnel turnover, including the departure of the manager of accounting and the pending retirement of the Director of Contracts. The EBC Director of Contracts had long been involved in the negotiations process and possessed significant and valuable knowledge on most of the issues. In addition, he had been empowered by the corporation to resolve all major issues during his tenure. Given the effort already invested by both the contractor and the government, both parties agreed that it would be prudent to make one last effort at settling as many of the open issues as possible before his retirement.

Enclosure (1)

The Contracting Officer evaluated the efforts that had been invested and the movement that had been made to date and determined that if new contractor personnel were brought into the negotiation much of the progress that had been made would be lost.

3. Both parties were concerned that the negotiation might result in a less than an equitable outcome for either or both parties. To preclude this possibility the parties agreed that they would proceed with the understanding that if either party did not have sufficient time or information to make an informed decision on specific issues, those issues would be set-aside with a reservation of rights for later negotiations.

4. The essence of the negotiation involved addressing and settling 33 Contract and financial issues with an estimated value of \$134 million.

5. The negotiation resulted in:

a. Settling 16 Contracting or Financial issues valued at \$38 Million.

b. Setting aside 17 issues with a value of \$96 million and establishing a reservation of rights for future negotiations. The amount set aside included \$94 million of DCAA-unresolved or questioned costs that SOSG either did not have cognizance over or which could not be settled because of other restraints. An additional \$2 Million was set aside relating to Computer Sciences Corporation incurred cost issues.

c. Of the \$94 Million set aside for DCAA-unresolved or questioned cost, \$77 Million related to GD Corporate costs under the cognizance of the Defense Corporate Executive (GDDCE) that had not been settled at the time of our negotiation. The residual \$17 Million related to costs under our cognizance that could not be settled at the time of our negotiation consisting of:

(1) \$4 Million related to the Graving Dock #3

(Redacted)

(2) \$7.5 Million related to Excess Compensation issues that SOSG was awaiting audit results.

(3) \$5 Million related to Shared Resources Incorporated (SRI) costs that had not been audited by the DCAA at the time of our negotiation.

d. Of the total \$134 million involved in this negotiation \$77 million of corporate cost was not under our cognizance and could not be negotiated. Of the \$57 Million that SOSG had cognizance of, this negotiation resolved \$38 million or 66.67% of that amount.

6. Typical of the issues settled were:

- (a) Incurred Cost Audits
- (b) Prior Year Interest and Penalty Settlement
- (c) Cost Accounting Changes

7. The issues set aside involved:

- (a) Corporate Home Office Allocations for CFY's 1997-2001
- (b) Accounting Changes
- (c) Litigation Issues (Graving Dock #3)
- (d) Electric Boat Legal Costs Associated with Discrimination Cases
- (e) Computer Science Corporation incurred Cost audits

PART 1 - COMMENTS TO DODIG FINDINGS

Finding A. Premature Establishment of Indirect Cost Rates

SUPSHIP Groton prematurely established final indirect cost rates covering CFY's 1997 through 2001 without taking final action on \$94 million in DCAA-unresolved and questioned costs.

SOSG Response To Finding A: Non-concur.

A review of FAR Part 42 and the applicable DOD Directives and guidance do not reveal any violations. FAR 1.102(d) specifically states that if a particular strategy or practice is in the best interests of the government and is not prohibited then the practice is a permissible exercise of authority. In addition DOD Directive 7640.2 in Part 4 states, "The responsibility for reaching agreement with the contractor is the Contracting Officer's, and he or she has wide latitude and discretion in that regard."

SOSG finds that the basis used to establish indirect cost rates for CY's 1997 through 2001 is an acceptable practice that is consistent with Defense Contract Management Agency (DCMA) guidance on treatment of unresolved costs. The "pay-forward" technique used by SOSG is consistent with DCMA guidance for situations where there is a disagreement about the allowability of certain costs and it is unclear whether the ACO will ultimately find those costs to be allowable. The "pay-forward" technique does not resolve the issue but defers it by paying the cost provisionally while retaining the ability to recoup it at a later date.

In order to comply with CAS requirements and based on DCMA guidance, the ACO used the "pay-forward" technique to pay the costs as claimed by the contractor. The ACO then established a reservation of rights on these costs in the event that the costs were subsequently determined to be unallowable. The reservation of rights was documented in an advanced agreement in accordance with FAR 31.109.

As discussed at FAR 42.703-1, final indirect cost rates are established to enable contract closeout and to establish the final contract price of fixed price incentive and fixed price re-determinable contracts. Open contracts remain a liability to the customer and to the government.

Prompt action to establish final indirect cost rates eliminates the need to obtain replacement funds when contract funds are cancelled prior to closeout. Furthermore, excess funding cannot be returned to the customer until the contract is closed.

The Defense Contract Management Agency (DCMA), which settles the majority of indirect costs on DOD contracts and closes almost all DOD contracts, has issued a series of Class Deviations to FAR 42.708, which addresses Quick Closeout Procedures. The most recent class deviation, which is valid through 30 September 2009, allows DCMA ACO's to close contracts prior to establishing final indirect cost rates regardless of dollar value or the percent of unsettled indirect costs allocable to those contracts.

In the SOSG case, the Contracting Officer's decision to establish final rates while setting aside \$94M to a later date was based on the following considerations:

(a) Establishing final rates while setting aside certain undisposed questioned costs is not prohibited.

(b) Ability to settle sixteen audit/financial issues not related to the \$94M in reserved costs.

(c) The Government's interest is protected by provisions in the agreement providing for recovery of costs later found unallowable. The decision to pay the amounts reserved while leaving the costs in the overhead years is compliant with the requirements of CAS which mandates that costs be charged to the period in which they are incurred.

(d) Contracting Officer had no authority to dispose of all the questioned/unresolved costs because they were either under the cognizance of the DCMA Defense Corporate Executive (DCE) or were the subject of litigation, such as the issue of Graving Dock Three and corporate costs of defending against discrimination complaints.

(e) The ability to close contracts about 2 years earlier than would have been possible if this office had waited for the DCE to dispose of the questioned cost under their cognizance thereby reducing the Government's potential risk.

As shown in the following table, the maximum impact on the indirect rates in the unlikely event that the government had sustained all DCAA-unresolved or questioned cost that was paid to the contractor and left in overhead expense for each of the affected years would have been minimal and relatively immaterial.

(For IG consideration only)

(Redacted)

For CFY's 1997 and 1998 the impact would have been less than \$.01 per direct labor dollar. For CFY 1999, the impact was approximately \$.01 per direct labor dollar and for CFY 2000 the impact was approximately \$.03 per direct labor dollar. It should be noted that the amount reserved in CY 2001 represents the entire corporate allocation to EBC for the year and not the amount questioned by the DCAA. The audit had not been completed on these costs at the time of our negotiation. After adjusting the reserved amount for CFY 2001 to reflect the amounts subsequently questioned, the monetized impact on the indirect rate for the year was approximately \$.02 per direct labor dollar.

In summary, the negotiation benefited the government by (1) resolving the overage audit issues referred to in the previous section that carried a potential liability to the government, (2) moving forward on closing a number of contracts that had been physically complete for years, thereby returning money to the treasury and reducing the government's potential liabilities, and (3) most importantly retaining the ability to obtain consideration from the contractor for the \$94 million set aside if at a

later date it was determined that the government was entitled to additional reimbursement plus interest from the contractor.

Finding B. Improper Use of Prior Year Sustention Rates

The SUPSHIP Contracting Officer improperly used prior year sustention rates as the sole basis for negotiating \$1.6 million in DCAA-questioned costs, instead of addressing the individual auditor recommendations as FAR 42.705-1 requires.

SOSG Response To Finding B: Non-concur. The SOSG Contracting Officer did not rely solely on prior year sustention rates but rather employed various negotiation strategies in settling incurred costs for CFY's 1997 through 2001 that were appropriate to the cost category and cost being negotiated. For costs settled using historical cost information, the Contracting Officer:

(a) First reviewed the prior four years (1993-1996) of incurred cost audits (1) to determine if the DCAA was questioning the same category of costs from year to year, (2) to determine whether the DCAA's basis for questioning costs remained the same and (3) to determine whether the contractor's position on the allowability of these costs remained unchanged. That review determined that the auditor's and the contractor's positions were the same for the cost categories of Employee Morale, Consultants, Other Income and Credits, and Miscellaneous Expenses in each year for the entire period from 1993-2001.

(b) Secondly, screened all of costs questioned in the above categories by the DCAA for CFY's 1997 through 2001 for the inclusion of expressly or directly associated unallowable and removed them in their entirety. SOSG acknowledges DCAA reported that \$64,000 was expressly unallowable. However a review of the documentation available to the SOSG Contracting Officer at the time of negotiations failed to uncover evidence that the identified costs were expressly unallowable. From a contracting perspective, the remaining cost pool was identical with costs that had been negotiated on an annual basis in the four years from 1993 through 1996 with little change in outcome.

(c) After reviewing DCAA's argument, the contractor's responses and the results of previous negotiations, the parties concluded that it was unlikely that continued discussion would result in a significantly different outcome. Consequently, the parties decided to resolve the issues identified above for the period from 1997-2001 using the average percentage reduction from the period from 1993 through 1996.

(d) Based on the unallowable costs identified during the screening described above, the SOSG Contracting Officer assessed \$224,760 in FAR penalties and recovered \$90,240 of interest associated with the time value of money. A check was forwarded to the US Treasury in the amount of \$315,000.

Finding C. Failure To Obtain Auditor's Opinion On Consultant Costs

The SUPSHIP Contracting Officer allowed \$2.1 million in DCAA-questioned consultant costs without asking DCAA to review or provide its opinion on additional information that the contractor gave the Contracting Officer at negotiations.

SOSG Response To Finding C: Non-concur.

The issue of the \$2.1M in consulting costs dates back to 1993. In 1993, DCAA questioned all costs claimed by EBC for this particular consultant based on an audit that determined that the costs claimed were unreasonable. This determination was based on the fact that EBC did not provide DCAA with sufficient evidentiary matter for DCAA to render an opinion. From 1993 through 2001 all costs associated with this consultant were questioned by the DCAA as being unreasonable in nature on the basis of insufficient supporting documentation. Based on this long series of audit reports on this issue, the Contracting Officer was well aware of the auditor's opinion and considered that opinion in establishing the government position.

The Contracting Officer has the ultimate responsibility for determining reasonableness, allowability and allocability. The Contracting Officer determined that the supporting documentation received from the contractor during negotiations was sufficient to support a

determination of cost reasonableness. This decision was based on the fact that recommendations made by this consultant were being implemented by the contractor, overhead costs were being reduced and that work product was being provided to support the amounts claimed. Subsequently, DCAA determined that these costs were in fact reasonable.

Section 6.4 of DoD Directive 7640.2 states, "For most contract audit reports, the Contracting Officer should obtain contractor comments, and such technical advice deemed necessary, prior to formulating a pre-negotiation position. The additional information shall be shared with the auditor, as appropriate." The Contracting Officer deemed the additional information to be sufficient to make a determination of the cost reasonableness. The Contracting Officer made all of the supporting data available to the auditors.

Finding D. Inadequate Consideration of Unallocable Costs

The SUPSHIP Contracting Officer reimbursed \$1.2 million in costs that DCAA questioned due to allocability. The Contracting Officer accepted the costs without fully considering the audit recommendation.

SOSG Response To Finding D: Non-concur. The \$1.2 million referenced in this finding is included in the \$2.1M cost referenced in Finding C. The DCAA revised their audit opinion in Finding C and determined the costs to be reasonable and hence allowable, but questioned the allocability of a portion of the costs in Finding C.

As discussed in the preceding section, DCAA originally questioned \$2.1 million in consultant costs on the basis of reasonableness. The Contracting Officer examined supporting documentation and found these costs to be reasonable in nature. Subsequent to the agreement, but before the execution of the final settlement on 22 March 2004, DCAA advised the Contracting Officer on 11 March 2004 of the information that would be contained in its supplemental audit memorandum for Calendar Years 1997 through 2001 to be issued on 28 April 2004, which revised the audit position on all costs associated with this consultant.

While the supplemental report accepted the consulting costs as reasonable, it questioned \$1.2 million of the \$2.1 million on the basis of allocability. The information of the supplemental audit report was provided after the contractor and the SOSG Contracting Officer reached agreement on the issue of the reasonableness of the questioned consulting costs. Since this information was received after the SOSG Contracting Officer made the determination of allowability, the Contracting Officer could not have considered the issues of allocability prior to reaching an agreement with the contractor on this specific issue.

The auditor discussed the basis for questioning \$1.2 million with regard to allocability with the SOSG Contracting Officer. The DCAA determined that \$1.2 million of the \$2.1 million in consulting costs were not allocable to Electric Boat but rather to the General Dynamics Marine Group (GDMG). DCAA auditors developed a methodology to calculate the impact of the unallocable costs based on use of a cost per page analysis and identification of pages with reference to potential unallowable or unallocable activity. SOSG personnel examined the basis on which the amounts questioned were calculated and determined that these questioned amounts could not be sustained in negotiations. Specifically, they could not determine the reliability of the correlation between the number of pages of material provided by the consultant as work product and the benefiting segment of General Dynamics. GDMG was, at the time, made up of two divisions, Bath Iron Works and Electric Boat. Electric Boat was the predominant division representing approximately 75% of the Marine Group. Based on the spuriousness of the audit finding and the relative weight of Electric Boat's share, the SOSG Contracting Officer determined that it would be unproductive to reopen negotiations on this issue prior to executing the final settlement.

Finding E. No Action Taken on Questioned Direct Costs

SUPSHIP Groton took no action on \$2.4 million in DCAA-questioned direct cost for CFY's 1997, 1998 and 2000, even though it reported in the CAFU system that all actions were completed.

SOSG Response To Finding E: Non-concur. The \$2.4 million in DCAA questioned costs is comprised of \$2.1 million in cost related to the sale of a General Dynamics facility located in New Jersey (General Dynamics Electro Dynamics Division) and \$300K relating to direct business travel. The costs related to the sale of the New Jersey facility were questioned in a separate audit report, and were reported in the CFY 1997, 1998 and 2000 incurred cost audits for informational purposes only. The DCAA auditors initially stated that the government should have shared in the gain on the sale of the New Jersey-facility. In the negotiations process between SOSG Contracting Officer and EBC, the contractor continually insisted that the buildings were worthless and possessed no value. In support of that position SOSG was provided with appraisals and professional testimony concerning the "value" of the buildings. SOSG requested that the DCAA visit the site in New Jersey and determine if the contractor's assertion had validity. Based on DCAA's visit to the New Jersey site, DCAA revised its audit opinion on the "value" of the buildings and agreed with EBC that the buildings were worthless. This opinion was contained in a DCAA memorandum issued in March 2004. This audit file was provided to the DODIG audit team prior to their visit in August 2007. This issue was among the issues resolved in the SOSG settlement with the contractor in March 2004.

The remaining \$300K relates to Direct Travel costs incurred by the contractor in CFY's 1997 and 1998. These costs were identified to the SOSG Contracting Officer in the incurred cost audit report for informational purposes only, and relate to direct travel costs incurred under specific contracts. Because these costs were not part of the costs questioned in the incurred cost audit reports for 1997 and 1998, they were not included in the 2004 settlement.

Finding F. Accuracy of Reported Data

SUPSHIP Groton did not maintain accurate records of reportable audits in the CAFU system.

SOSG Response To Finding F: Concur.

Finding G. Performance Standards and Controls For Contract Follow-Up

SUPSHIP Groton 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 CAFU, and include the CAFU function as a regular part of SUPSHIP Groton's internal control review program.

SOSG Response To Finding G: Concur in principle, with comment. SOSG maintains an environment that recognizes the importance of adequately and timely resolving and completing the disposition of contract audit reports.

Every Contracting Officer responsible for resolving audits has an evaluation element that requires "timely completion of and/or resolution" of audit findings.

As part of the NAVSEA contracting competency, SOSG maintains a robust internal control system based on guidance contained in the FAR, DFARS, Navy/Marine Corps Acquisition Regulation Supplement, NAVSEA Contracting Handbook and numerous supplemental regulations and directions from Headquarters that provide adequate control of all contracting actions. NAVSEA followed up on the DOD IG report issued in 2004 regarding the CAFU process through the Procurement Performance Management Assessment Program (PPMAP). In its September 2007 review of SUPSHIP Groton, the NAVSEA PPMAP team identified the CAFU process as a special interest item that was extensively reviewed.

**PART II - COMMENTS TO DODIG RECOMMENDATIONS FOR
CORRECTIVE ACTION**

DoDIG Recommendations For Finding A.

1. Instruct the Contracting Officer to discontinue the practice of establishing final indirect cost rates without taking final action on DCAA-unresolved and questioned costs.

SOSG Response: Non-concur. The FAR and applicable directives do not prohibit this practice and it is within the Contracting Officer's discretion. Furthermore, as discussed above, this practice results in quantifiable benefits to the government by enabling prompt contract closeout. DCMA guidance provides that the "pay-forward" technique used by SOSG is an appropriate method for dealing with disputed or questioned overhead costs in certain situations, stating that:

"The so-called "pay-forward" option may be desirable when a disagreement arises about the allowability of the cost and it is unclear whether the ACO may ultimately find it allowable. Like a "roll forward", "pay-forward" does not resolve the issue but defers it. The significant difference is that in a "pay-forward", the costs by default remains charged to the correct accounting period. An ACO is not authorized to pay unallowable costs, but is authorized to make reasonable judgment calls on the subject."

2. Promptly negotiate any unsettled costs covered in the September 30, 2004 memorandum of agreement for which the Contracting Officer can take final action.

SOSG Response: Concur. SOSG is actively pursuing settlement of the costs under our cognizance. To date we have dispositioned a number of these issues and have established a plan of action to resolve the remaining issues under our cognizance.

3. Implement procedures requiring that Contracting Officers obtain a legal review of any proposed agreements with contractors involving DCAA audit findings and recommendations.

SOS Response: Concur.

4. Reinstate the contractor fiscal years 1997 through 2001 incurred cost audits to open status in the contract audit follow-up system until the Contracting Officer takes final action on all DCAA-unresolved and questioned costs for each year.

SOSG Response: Non-concur. As discussed in the response to recommendation 1, SOSG believes its actions were proper and consistent with FAR and DOD guidance, and the audits have been appropriately dispositioned in the contract audit follow-up system.

DoDIG Recommendations For Finding B.

1. Direct the Contracting Officer to discontinue the use of prior year sustention rates for negotiating DCAA-questioned costs.

SOSG Response: Non-concur. Use of prior year sustention rates is recognized by DCMA as an appropriate technique for establishing quick closeout indirect cost rates. SOSG used this technique to resolve very limited areas of questioned costs totaling \$1.6M.

2. Establish and document internal controls to help ensure that Contracting Officers develop and document the negotiation position for indirect cost rates that is based on adequate consideration of the DCAA-questioned costs, including the DCAA-questioned cost subject to penalty.

SOSG Response: Partially Concur. It is the position of SOSG that this is not an issue of adequate internal controls, but rather one of good documentation. SOSG agrees that it is essential that Contracting Officers adequately document the basis for their decisions.

DoDIG Recommendations For Finding C.

1. Establish and document internal controls to verify that Contracting Officers are obtaining the auditor opinion on the allowability of claimed costs when the contractor submits additional documentation during negotiations in accordance with FAR 42.705-1(b)(4).

SOSG Response: Non-concur. There are sufficient internal controls already in place relative to this issue. As with all Contracting Officer determinations, the allowability of cost must represent the Contracting Officer's independent judgment. While that determination is based on the advice of legal, technical and accounting resources, requiring that every piece of information be reviewed by third parties would both inhibit the Contracting Officer's independence and result in an unnecessarily protracted negotiations process.

2. **Request that the Contracting Officer invite the auditor to attend negotiations and serve as an advisor for determining the contractor's final indirect rates.**

SOSG Response: Partially Concur. SOSG concurs that inviting the auditor to attend negotiation is useful, and SOSG does so when appropriate. However, the determination of final indirect costs remains the responsibility of the Contracting Officer.

DoDIG Recommendation For Finding D.

1. **We recommend that the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut establish a quality assurance process to verify that Contracting Officers adequately document their consideration of all Defense Contracting Audit Agency audit findings and recommendations in accordance with FAR Subpart 42.705, Final Indirect Cost Rates.**

SOSG Response: Concur. SOSG concurs that a quality assurance process is essential for verifying that Contracting Officers adequately document the basis for their decisions. While the decision described herein was within the latitude and discretion of the Contracting Officer, more detailed file documentation was needed to detail the reasons for that decision. Consequently, SOSG will remind Contracting Officers to document resolution of all DCAA audit findings and recommendations in the Business Clearance.

DoDIG Recommendations For Finding E.

1. **Negotiate the questioned direct costs of \$2.4 million.**

SOSG Response: Non-concur. The \$2.1 million in questioned costs related to the New Jersey facility was disposed of by the settlement of the CFY 2000 incurred cost audit. The SOSG Contracting Officer will dispose of the \$300K in direct travel costs as part of the closeout of the applicable contracts.

2. **Reinstate the 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.**

SOSG Response: Non-concur. The SOSG Contracting Officer properly disposed of the \$2.1 million in questioned costs related to the sale of the New Jersey facility as described above. The direct travel costs were appropriately not reported in the Contract Audit Follow-up (CAFU) system for the audits under review.

3. **Require that the Contracting Officer include a reconciliation and determination of all questioned costs, including questioned direct costs, in the negotiations memorandum.**

SOSG Response: Concur in principle, with comment. Inclusion of a reconciliation and determination regarding all questioned costs is part of the current process for documenting negotiations. The direct costs in question were not included in the incurred cost audit being reviewed. The negotiation memorandum reconciliation was therefore correct as written.

DoDIG Recommendations For Finding F.

1. **Establish quality assurance processes to ensure the accuracy of the data reported in the contract audit follow-up system.**

SOSG Response: Partially concur. SOSG concurs with the DODIG finding that there were inaccurate records of reportable incurred cost audits in the CAFU system. All necessary corrections have been made in the CAFU System. However, SOSG finds the issue of maintaining accurate records to be indicative of the need for additional

training for all CAFU monitors in the DCMA web database and is not a quality assurance issue.

2. **Correct the errors in the contract audit follow-up system identified in this review.**

SOSG Response: Concur. Completed.

DoDIG Recommendations For Finding G.

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.**

SOSG Response: Non-concur. As discussed above, timely resolution of audits is currently in the performance standards of the appropriate acquisition officials

2. **Perform an internal control review of contract audit follow-up actions in FY 2008 to ensure compliance with DoD Directive 7640.2.**

SOSG Response: Concur.

3. **Make the review of contract audit follow-up actions a regular part of the SUPSHIP Groton internal control program.**

SOSG Response: Concur.



Inspector General Department of Defense

