

**A**udit



**R**eport

SETTLEMENT OF CONTRACTOR INCURRED  
INDIRECT COST AUDITS

Report Number 99-057

December 21, 1998

Office of the Inspector General  
Department of Defense

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### **Acronyms**

CAF	Contract Audit Followup
CARTS	Contract Audit Followup Report Tracking System
DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DLA	Defense Logistics Agency
FAR	Federal Acquisition Regulation
GAO	General Accounting Office
OMB	Office of Management and Budget



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202

December 21, 1998

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

SUBJECT: Audit Report on the Settlement of Contractor Incurred Indirect Cost Audits  
(Report No. 99-057)

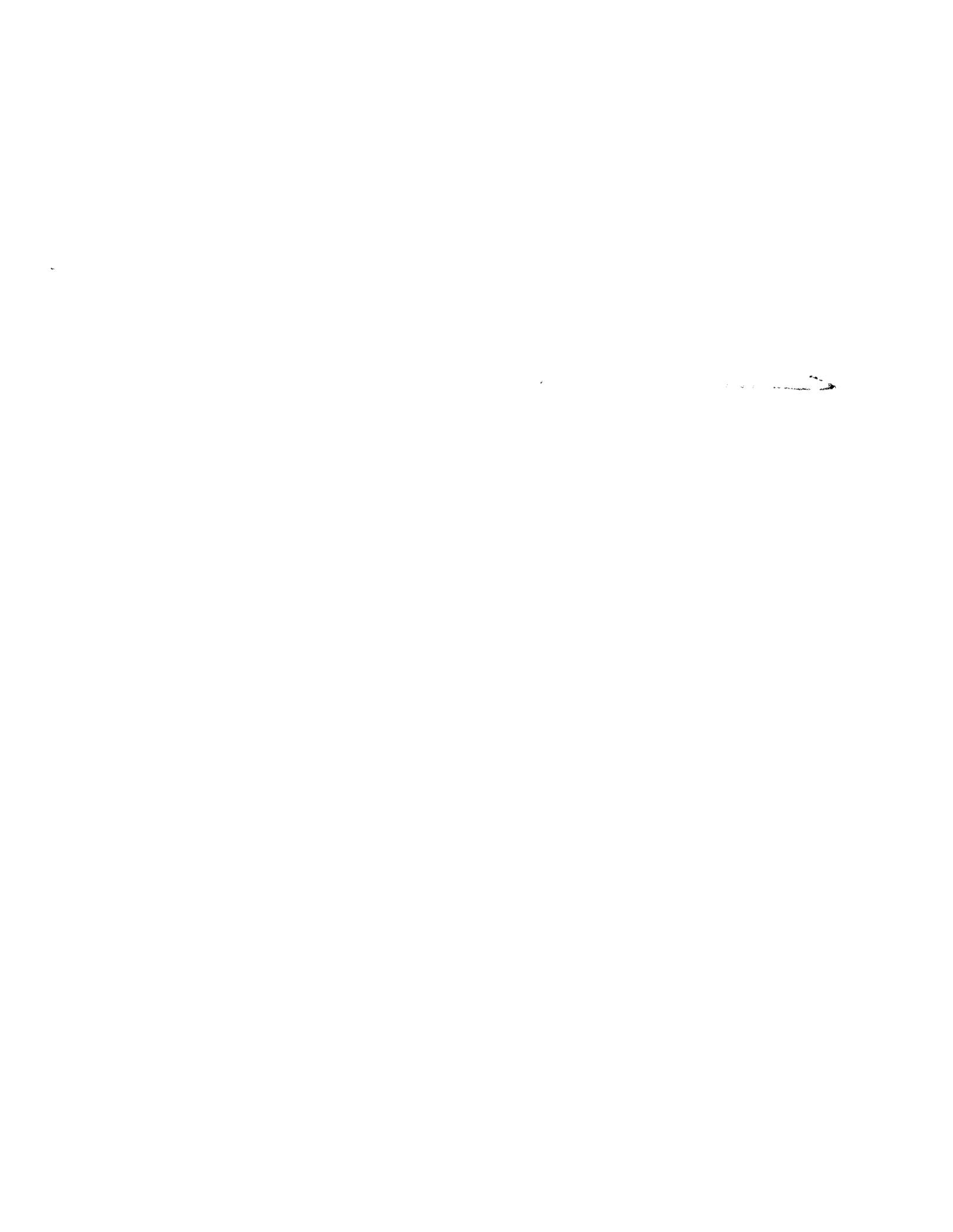
We are providing this report for information and use. We considered management comments on a draft of this report when preparing the final report. We conducted the audit as a follow-on to our evaluation of the "Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors," (Report No. PO 98-6-016).

The Department of the Navy and the Defense Logistics Agency comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required.

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

*David K. Steensma*

David K. Steensma  
Deputy Assistant Inspector General  
for Auditing



## Office of the Inspector General, DoD

Report No. 99-057  
(Project No. 7OC-9012.01)

December 21, 1998

### Settlement of Contractor Incurred Indirect Cost Audits

#### Executive Summary

**Introduction.** This audit was performed as a follow-on to our evaluation of "Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors." The objective of that review was to determine the adequacy of Defense Contract Audit Agency (DCAA) audits of indirect cost claims at major contractors.

During the 12-month period ending March 31, 1997, DCAA questioned costs of \$1.5 billion dollars. The amount of questioned costs sustained was \$.6 billion, a sustention rate of only 40 percent. When contracting officers do not sustain costs that are expressly unallowable under the Federal Acquisition Regulation cost principles, contractors may be reimbursed for unallowable costs. In addition, the penalties and interest on the unallowable costs would not be assessed or collected.

**Audit Objectives.** Our overall objective was to evaluate whether contracting officers were effectively using contract audit reports to negotiate final indirect expense rates and assess penalties when appropriate. We also evaluated whether contracting officers were adequately documenting the basis for their rationale when they disagreed with contract audit reports on the allowability of costs or the assessment of penalties.

**Audit Results.** For the 45 audit reports we reviewed, contracting officers made effective use of DCAA audit reports and sustained the audit recommendations on expressly unallowable questioned costs when negotiating final indirect expense rates. Contracting officers adequately documented the basis for rationale when there was disagreement with contract audit reports on the allowability of costs or the assessment of penalties.

The Navy and Defense Contract Management Command did not maintain and report accurate contract audit followup data. As a result, component management was not able to effectively determine whether their contract audit followup systems were adequate and resulted in timely and appropriate disposition of audit reports. For details of the audit results, see Part I.

**Summary of Recommendations.** We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) and the Commander, Defense Contract Management Command establish controls to monitor and periodically test whether contract audits are accurately reported and remain open until all DCAA recommendations have been addressed.

**Management Comments.** The Navy stated it had implemented a new computer program to maintain the Contract Audit Followup (CAF) database that results in a centralized, uniform reporting system. The Navy also includes CAF as a special interest item during program reviews. The Defense Logistics Agency (DLA) agreed

that it needs to improve the accuracy of the data in the semiannual status report. The DLA believes that when penalty issues are involved, DoD Directive 7640.2 is not specific as to their treatment, and that further discussion regarding the status of the audit report is necessary. See Part I for a discussion of management comments and Part III for the complete text of management comments.

**Audit Response.** We consider DLA management comments to be responsive. We plan to meet with DLA representatives to clarify contract audit followup policy regarding penalty issues. Further comments are not required on this report.

# Table of Contents

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<b>Executive Summary</b>	i
<b>Part I - Audit Results</b>	
Audit Background	2
Audit Objectives	2
Accuracy of Contract Audit Followup Data	3
<b>Part II - Additional Information</b>	
Appendix A. Audit Process	
Scope	8
Methodology	8
Appendix B. Summary of Prior Coverage	10
Appendix C. Application of Penalty Waiver Criteria	11
Appendix D. Report Distribution	12
<b>Part III - Management Comments</b>	
Department of the Navy Comments	14
Defense Logistics Agency Comments	16

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# Part I - Audit Results



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## **Audit Background**

The Office of Management and Budget (OMB) Circular A-50 (revised), "Audit Followup," provides policies and procedures for followup on Federal audit reports, including contract audit reports. DoD Directive 7640.2, "Policy for Followup of Contract Audit Reports," as amended August 16, 1995, implements the OMB circular and requires the Office of Inspector General, DoD (OIG, DoD), to develop contract audit followup policy and to monitor, coordinate, and evaluate contract audit followup systems maintained by DoD Components. The directive also requires that DoD Components submit semiannual reports on the status of significant postaward contract audits to OIG, DoD. Incurred cost audit reports issued by the Defense Contract Audit Agency (DCAA) fall under the purview of the directive. In accordance with the directive, the OIG, DoD, conducts comprehensive oversight reviews of significant functional areas and of major DoD Components to determine adequacy of implementation. This report summarizes our review of dispositioned incurred indirect cost audit reports at selected Defense Contract Management Command (DCMC) and Navy contracting offices.

## **Audit Objectives**

The overall audit objective was to determine whether contracting officers are effectively using contract audit reports to negotiate final indirect expense rates and assessing penalties when appropriate. We also evaluated whether contracting officers are adequately documenting the basis for their rationale when they disagree with a contract auditor on the allowability of costs or the assessment of penalties. See Appendix A for details of the audit process and Appendix B for a summary of prior coverage related to the audit objectives.

## **Contracting Officer Use of Audit Reports**

For the sample of incurred cost audit reports we reviewed, contracting officers made effective use of DCAA audit reports. They adequately addressed the allowability of questioned costs and assessment of penalties when negotiating the final indirect expense rates.

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## Accuracy of Contract Audit Followup Data

The Navy and DCMC submitted to the OIG, DoD, contract audit followup data that contained inaccurate amounts and incorrect status information on 51 of 59 incurred cost audit settlements. Also, 20 audits were reported closed prior to the settlement of \$40.4 million of unallowable costs subject to penalties. This occurred because the accuracy of the database was not monitored or tested. As a result, component management is not able to effectively determine whether their contract audit followup systems are adequate and result in timely and appropriate disposition of audit reports.

## Criteria for Maintenance and Reporting of Contract Audit Followup Data

**OMB Circular A-50 (Revised) Requirements.** The OMB Circular A-50 prescribes 11 standards that agencies must meet to establish adequate followup systems. One standard is to maintain accurate records on the status of audit reports or recommendations throughout the entire process of resolution and corrective action. Another standard requires agencies to provide semiannual reports to the agency head on the status of unresolved audit reports over 6 months old and include the amount of disallowed costs and collections and other monetary benefits resulting from audits. The circular also requires periodic analysis of audit recommendations, resolution, and corrective action to determine trends and system-wide problems.

**DoD Directive 7640.2 Requirements.** The DoD Directive 7640.2 implements OMB Circular A-50 and prescribes DoD contract audit followup policy. The directive establishes reporting requirements and responsibilities for its implementation.

The OIG, DoD, has responsibility for monitoring and evaluating program performance to ensure that the DoD Components and contract audit organizations effectively carry out their contract audit followup responsibilities. Also the OIG, DoD, is responsible for identifying cases or areas where contract audit followup procedures can be improved and recommend appropriate corrective action. The directive requires the OIG, DoD, to provide periodic reports on the status of DoD contract audit followup efforts to the Secretary of Defense.

The Secretaries of the Military Departments and the Directors of Defense agencies are responsible for maintaining timely and complete information on all applicable contract audit reports from receipt through disposition. They are required to ensure that a semiannual contract audit followup status report is prepared and submitted to the OIG, DoD, in accordance with the directive. They must perform periodic reviews of their component's followup system to determine whether the systems are adequate and result in timely, appropriate

## Accuracy of Contract Audit Followup Data

resolution and disposition of audit reports. Also, DoD Components must ensure that acquisition personnel in their components are adequately trained in the requirements of the contract audit followup program.

DoD Directive 7640.2 requires components to maintain records on all applicable contract audit reports through disposition. Incurred cost audits are considered dispositioned when the contracting officer has settled all issues in the audit report or the report is superseded by a more recent report. When an audit is reported closed, the contracting officer is required to report the amount sustained. The amount sustained is the portion of costs questioned by the auditor that were upheld as a result of actions taken by either the contractor or the contracting officer. Costs questioned and sustained shall be reported as zero when a report is superseded, replaced, or incorporated into a new report.

### Reporting Accuracy of Audit Recommendations

**Reporting of Cost Questioned/Sustained.** We judgmentally reviewed 59 audit reports for reporting accuracy. Contracting officials incorrectly reported the amount questioned or sustained in 51 of those 59 cases. Twenty-seven of those audits contained obvious reporting errors with the amount reported as sustained greater than the amount questioned. The other 32 audits were reported closed with over \$5 million questioned costs and either zero or 100 percent reported sustained. Contracting officials incorrectly reported settlements in 25 of those of 32 cases. For example, one office reported four audits with \$32.7 million costs questioned and 100 percent sustained when the contracting officer never negotiated final rates with the contractor because of significant contract overruns. Another office reported two audits with \$58.8 million costs questioned and zero dollars sustained where the contracting officer actually sustained \$34.3 million. A superseded audit was reported with \$45.1 million questioned and zero sustained. The amount questioned should have been reported as zero since the audit was superseded and the amount questioned was incorporated in another audit. Table 1 summarizes the reporting errors.

<u>Reporting Error</u>	<u>Number of Cases</u>
Incorrect Costs Questioned	25
Incorrect Costs Sustained	13
Incorrect Costs Questioned and Sustained	7
Information Pending	<u>6</u>
<b>Total</b>	<b>51</b>

**Reporting the Status of Audit Recommendations.** In 33 audits where DCAA identified \$40.4 million of unallowable costs subject to penalties, Navy and DCMC contracting officers reported 20 of the audits closed prior to settlement of penalty issues. Six of those audits were reported closed as far back as 1996

and the penalty issues still have not been settled. The contracting officers negotiated the final overhead rates, executed the rate agreements, and closed the audits in the contract audit followup tracking systems before addressing the penalties. The contracting officers handled the penalty issues as separate administrative actions. The audit reports should remain open in the followup system until the contracting officers have settled the penalty issues. Table 2 lists the audits closed prior to settlement of the penalties.

**Table 2. Audit Reports Closed Prior to the Settlement of Penalties** ➔

Audit Report No.	Office	Contractor	Date Closed
2360-94G14010-002	SUPSHIP Groton	GD Corp., EB Division	08/09/96
2360-95B10150-001	SUPSHIP Groton	GD Corp., EB Division	08/09/96
2360-95B10160-031	SUPSHIP Groton	GD Corp., EB Division	10/01/96
2461-94A16990-003	DCMC Pratt Whitney	UTC P&W Group	04/10/96
2641-94A16990-001-S1	DCMC Pratt Whitney	UTC P&W Group	10/16/96
2641-95C12050-501-S1	DCMC Pratt Whitney	UTC P&W CEB	11/14/96
3541-93M14010-002	DCMC Twin Cities	3M Company	08/09/96
3541-94M16990-101	DCMC Twin Cities	3M Company	08/09/96
3541-96M10250-002	DCMC Twin Cities	3M Company	10/11/96
3711-93A14010-001	DCMC GD Lockheed FW	Lockheed Martin TAS	03/29/96
3711-94A14010-001	DCMC GD Lockheed FW	Lockheed Martin TAS	07/31/96
3711-94B14010-001	DCMC GD Lockheed FW	GD, Data Systems Div.	06/28/96
4141-95S10250-009	SUPSHIP San Francisco	SECO	11/29/96
4141-95S10250-017	SUPSHIP San Francisco	SECO	11/29/96
4141-95S10250-018	SUPSHIP San Francisco	SECO	11/29/96
4141-95S10520-010	SUPSHIP San Francisco	SECO	11/29/96
4291-93B16990-003	DCMC Santa Ana	Loral Aerospace Holdings	07/22/96
4341-89F14010-061-S1	DCMC Baltimore	Lockheed Corp.	07/24/95
4341-90F14010-007-S1	DCMC Baltimore	Lockheed Corp.	01/06/97
6121-95R10250-001	DCMC Baltimore	EER Systems Corp.	05/06/96

## Implementation of Contract Audit Followup Procedures

**Management of Contract Audit Followup Procedures.** The Navy and DCMC did not effectively monitor their contract audit followup systems to ensure accurate reporting in accordance with DoD Directive 7640.2. They did not implement system controls to identify reporting errors, especially obvious errors such as reporting sustained costs in excess of questioned costs.

**Understanding of Contract Audit Followup Reporting Requirements.** Contracting officials did not fully understand the DoD Directive 7640.2

## Accuracy of Contract Audit Followup Data

reporting requirements for audits of contractors' incurred costs. They were unclear about the proper reporting procedures for superseded audits, disposition requirements for reporting audits closed, and the amount of questioned costs to be reported sustained.

## **Adequacy of Contract Audit Followup Systems**

The Navy and DCMC were not able to effectively determine whether the settlements of incurred cost audit recommendations were timely and appropriate because contracting offices reported inaccurate data. Reports that were closed before settlement of all issues lacked visibility to ensure penalties were assessed and collected when appropriate. Also, information on the settlement of audit recommendations reported to the OIG, DoD, and periodically to the Secretary of Defense was inaccurate.

## **Recommendation, Management Comments, and Audit Response**

**We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) and the Commander, Defense Contract Management Command establish controls to monitor and periodically test whether contract audits are accurately reported and remain open until all recommendations have been addressed.**

**Navy Comments.** The Navy concurred and has implemented a new computer program to maintain the CAF database that results in a centralized, uniform reporting systems for submission of more accurate semiannual data. The Assistant Secretary of the Navy (Research Development & Acquisition) also includes CAF as one the of the special interest items during Procurement Performance Management Assessment Program reviews.

**Defense Logistics Agency Comments.** The DLA partially concurred and agreed that they needed to improve their performance with regard to the accuracy of the data in the semiannual status report. The DLA will issue a letter to the Contract Audit Followup monitors addressing this concern. Also, DLA believes that the penalty issue area requires further discussion and evaluation because current guidance is unclear.

**Audit Response.** The comments by the Navy and the Defense Logistics Agency are responsive to the intent of the recommendation.

The DLA response indicated that since DoD Directive 7640.2 is not specific on the treatment of penalty issues, this is an area for further consideration. We believe that an audit report should remain open in the followup system until the contracting officer has settled all the issues related to that specific report. We will meet with DLA representatives to clarify followup policy in this area.

## **Part II - Additional Information**

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# Appendix A. Audit Process

## Scope

**Work Performed.** We conducted an audit of closed incurred indirect cost audits selected from the contract audit followup status reports submitted by DoD Components for the semiannual reporting periods ended September 30, 1996 and March 31, 1997.

**Limitations to Audit Scope.** A review of the Management Control Program was not an announced objective.

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

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

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

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Contract Management high-risk area.

## Methodology

**Use of Computer-Processed Data.** To determine the audit sample, we relied on computer-processed data contained in the OIG, DoD, Contract Audit Reporting Tracking System (CARTS). The CARTS is a database comprised of reportable audits submitted semiannually by DoD Components to the OIG, DoD. The system contains error checks, developed by the Contract Audit Followup staff, that are run on the data prior to inclusion in the database. In addition to those checks, we performed a limited review of the universe of incurred cost audits. We found some basic reporting errors and adjusted the universe prior to sample selection. As a result of the error checks and adjustments, we determined that the computer-processed data are sufficiently reliable to be used in meeting the audit objectives.

**Statistical Sampling Methodology.** The Analysis, Planning and Technical Support Directorate of the OIG, DoD, selected a limited scope sample using geographic cluster selection and census stratum. The sample was selected from a universe of 724 closed incurred cost audits from the semiannual reporting periods ending September 30, 1996 and March 31, 1997. The sampling plan resulted in a sample size of 79 reports.

We concluded the audit after reviewing the settlement actions of 45 audit reports. Because we curtailed the statistical sampling, we made no projections from that data. To accomplish our audit objectives we reviewed:

- existing statutory provisions, regulations, and guidance on incurred costs;
- DCAA contract audit report recommendations;
- contract file documentation such as prenegotiation objectives, post negotiation memorandums, and memorandums for record; and
- documentation related to the assessment and collection of penalties on unallowable incurred costs.

**Audit Type, Dates, and Standards.** We conducted this program audit from December 1997 through August 1998 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the OIG, DoD.

**Contacts During the Audit.** We contacted individuals and organizations within the DoD. Further details are available on request.

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## **Appendix B. Summary of Prior Coverage**

The General Accounting Office (GAO) and the OIG, DoD, has issued audit reports that discussed unallowable incurred indirect costs.

### **General Accounting Office**

GAO Report No. NSIAD-94-204R (OSD Case No. 9709), "Unallowable Costs and Penalties," July 6, 1994.

GAO Report No. NSIAD-93-79 (OSD Case No. 9252), "Unallowable Costs Charged to Defense Contracts," November 1992.

### **Inspector General, DoD**

Inspector General, DoD, Report No. 98-6-016, "Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors," August 6, 1998.

Inspector General, DoD, Report No. 95-001, "Oversight of the Defense Contract Audit Agency Reporting of Cost Questioned Subject to Penalties," October 18, 1994.

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## Appendix C. Application of Penalty Waiver Criteria

**Regulatory Guidance on the Waiver of Penalties.** Federal Acquisition Regulation (FAR) 42.709-5, prescribes policies and procedures for waiving penalties. The guidance states that the contracting officer shall waive penalties when the contractor demonstrates the following to the cognizant contracting officer's satisfaction.

- The contractor has established appropriate policies, personnel training, and an internal control and review system that provides assurance that unallowable costs subject to penalties are precluded from inclusion in the contractor's final indirect cost rate proposals. This should include the types of controls required for satisfactory participation in the DoD sponsored self-governance programs, specific accounting controls over indirect costs, compliance tests which demonstrate that the controls are effective, and Government audits that have not disclosed recurring instances of expressly unallowable costs.
- The unallowable costs subject to the penalty were inadvertently incorporated into the proposal; for example, their inclusion resulted from an unintentional error, notwithstanding the exercise of due care.

**Application of Waiver Criteria.** Of the 33 cases where DCAA identified unallowable costs subject to penalties, the contracting officers waived penalties in 10 cases. Contracting officers did not apply the correct FAR waiver criteria in 3 of the 10 cases because they did not follow, or did not understand the FAR penalty waiver provisions. For example, in one case, a contracting officer waived penalties because he believed that assessment of penalties would hinder settlement of final indirect rates and that they were not warranted. The FAR does not permit waiving penalties for these reasons. In the two other cases, contracting officers waived penalties because of unintentional error without documenting whether the contractors had also satisfied the other required FAR waiver criteria for establishing policies and personnel training, and an internal control and review system to assure that unallowable costs subject to penalties are not included in final indirect cost rate proposals.

Information on those three cases was provided to DCMC representatives who will provide guidance to the two cognizant offices on the application of the FAR penalty waiver provisions.

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## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology  
  Director, Defense Procurement  
  Director, Defense Logistics Studies Information Exchange  
Under Secretary of Defense (Comptroller)  
  Deputy Chief Financial Officer  
  Deputy Comptroller  
Assistant Secretary of Defense (Public Affairs)  
Deputy Under Secretary of Defense (Acquisition Reform)

### **Department of the Navy**

Assistant Secretary of the Navy (Financial Management and Comptroller)  
Assistant Secretary of the Navy (Research, Development, and Acquisition)  
Auditor General, Department of the Navy  
Commander, Naval Sea Systems Command  
Chief, Office of Naval Research

### **Other Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Logistics Agency  
  Commander, Defense Contract Management Command

### **Non-Defense Federal Organizations and Individuals**

Technical Information Center, National Security and International Affairs Division,  
  General Accounting Office  
Chairman and ranking minority member of each of the following congressional  
committees and subcommittees:

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on National Security, Committee on Appropriations  
House Committee on Government Reform and Oversight  
House Subcommittee on Government Management, Information, and Technology,  
  Committee on Government Reform and Oversight  
House Subcommittee on National Security, International Affairs, and Criminal  
  Justice, Committee on Government Reform and Oversight  
House Committee on National Security

**Part III – Management Comments**

# Department of the Navy Comments



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

19 November 1998

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR  
GENERAL FOR AUDITING

SUBJECT: DODIG DRAFT AUDIT REPORT ON SETTLEMENT OF  
CONTRACTOR INCURRED INDIRECT COST AUDITS (PROJECT  
NO. 70C-9012.01) - Information Memorandum

REFERENCE: (a) Draft DODIG Report 70C-9012.01 Dated 8 Sept  
98

Enclosure: (1) Department of the Navy Response

The Department of the Navy response to reference (a) is provided at enclosure (1). We concur with the recommendation and have already implemented a Contract Audit Follow-Up Access database which is now in use by all the Navy reporting commands.

A handwritten signature in cursive script, appearing to read "William J. Schaefer".

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

Copy to:

FMO (31)  
DASN (ABM)

Department of the Navy Response  
To  
DODIG Draft Audit Report of 8 September 1998  
On  
Settlement of Contractor Incurred Indirect Cost Audits  
(Project NO. 70C-9012.01)

Ref: (a) Draft DODIG Report 70C-9012.01 Dated 8 Sept 98

**Recommendations for Corrective Action:**

**We recommend that the Assistant Secretary of the Navy (Research, Development and Acquisition) and the Commander, Defense Contract Management Command establish controls to monitor and periodically test whether contract audits are accurately reported and remain open until all DCAA recommendations have been addressed.**

**Department of the Navy Response: Concur with the recommendation.**

1. ASN(R&DA) has already implemented a Contract Audit Follow-Up Access database which is now in use by all of the Navy reporting commands. The database is a centralized, uniform database with many more edit checks than the previous version that was developed by the Army. This database will not allow costs sustained to be greater than costs questioned. In addition, one of the special interest items that ASN(RD&A) reviews during the Procurement Performance Management Assessment Program (PPMAP) is Contract Audit Follow-Up.
2. It should be noted that the Navy only had 7 incurred cost audits on Table 2 of your report (the DODIG and this office agreed that the ONR report was listed in error). Of these 7 audits, there were costs questioned in the amount of \$24,478,636 with costs sustained of \$17,416,715 - equating to a sustention rate of 71.12%. We believe this new database coupled with the PPMAP reviews ensures appropriate monitoring and management attention.

Enclosure (1)

# Defense Logistics Agency Comments



IN REPLY  
REFER TO DDAI

**DEFENSE LOGISTICS AGENCY**  
**HEADQUARTERS**  
8725 JOHN J. KINGMAN ROAD, SUITE 2533  
FT. BELVOIR, VIRGINIA 22060-6221

4 NOV 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,  
DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report on the Settlement of Contractor  
Incurred Indirect Cost Audits (Project No. 70C-9012.01)

This is in response to your September 8, 1998, subject draft report. If you have any questions, please contact Zora Henderson, (703)767-6272.

Encl

*Sheila P. Raines*

SHEILA P. RAINES  
Team Leader, Liaison and Policy  
Internal Review Office

**SUBJECT:** Settlement of Contractor Incurred Indirect Cost Audits (Project No. 70C-9012.01)

**FINDING:** Accuracy of Contract Audit Followup Data.

The Navy and DCMC submitted to the OIG, DoD, contract audit followup data that contained inaccurate amounts and incorrect status information on 51 of 59 incurred cost audit settlements. Also, 21 audits were reported closed prior to the settlement of \$40.4 million of unallowable costs subject to penalties. This occurred because the accuracy of the database was not monitored or tested. As a result, component management is not able to effectively determine whether their contract audit followup systems are adequate and result in timely and appropriate disposition of audit reports.

**DLA COMMENTS:** We have reviewed the draft report and partially concur with the findings. We concur with the findings relative to inaccurate amounts and status information on 30 of the 47 reports under DCMC cognizance. While we disagree with the findings on the remaining 17 reports, we have not provided the details on each report due to the immaterial impact on the contract audit followup system. Our differences were in the areas of reportable, our records indicating the correct cost questioned was in the semiannual report, and additional costs were questioned during fact-finding.

While we agree that we need to do a better job of monitoring and testing the system, we do not agree with the finding that DCMC is not able to assure the timely and appropriate disposition of reportable audits. The majority of the errors found in the system related to items such as not zeroing out the costs questioned on the original audit report when there is a supplemental report and whether or not a report was reportable. Per your audit results in the executive section of the report, contracting officers make effective use of audit reports and adequately document when there is a disagreement with the audit report. In addition, we note that the errors in the reporting made our sustention rate of the costs questioned lower than what it actually was.

Our review of the penalty issue found the following: The penalty issue for the 3M Company, Lockheed Martin TAS, General Dynamics Data Systems Division, and Loral Aerospace Holding were resolved in the disposition of the audit report. The remaining penalty issues have subsequently been resolved. DoD Directive 7640.2 is not specific on how to treat penalty issues with respect to followup on contract audit reports. It can be argued that the penalty issue is a separate action. Currently, our contracting officers track penalty information in our Automated Metrics System (AMS). Therefore, there is visibility that appropriate action is being taken on the penalty recommendations.

**ACTION OFFICER:** Glenn Gulden, DCMDI-RO, (703) 767-3406

**REVIEW/APPROVAL:** Thomas E. Brunk, DCMC

**COORDINATION:** Zora Henderson, DDAT

**DLA APPROVAL:**



E.R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

NOV - 4 1998

## Defense Logistics Agency Comments

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**SUBJECT:** Settlement of Contractor Incurred Indirect Cost Audits

**RECOMMENDATION:** We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) and the Commander, Defense Contract Management Command establish controls to monitor and periodically test whether contract audits are accurately reported and remain open until all recommendations have been addressed.

**DLA COMMENTS:** Partially concur. While DCMC currently has a system to monitor the database, we need to improve our performance. We will issue a letter to our Contract Audit Followup Monitors addressing this concern. Since DoD Directive 7640.2 is not specific on how to treat the penalty issues, and it can be argued that they are separate issues and should be treated as such, we believe this is an area for further discussion and evaluation. Currently we have a system to monitor the penalty issues to ensure proper action is being taken on penalty issues.

**DISPOSITION:**

Action is considered complete.

**ACTION OFFICER:** Glenn Gulden, DCMDI-RO, (703) 767-3406

**REVIEW/APPROVAL:** Thomas E. Brunk, DCMC

**COORDINATION:** Zora Henderson, DDAI

**DLA APPROVAL:**



J.M. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

NOV - 4 1998

## **Audit Team Members**

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