



ACQUISITION LETTER

This Acquisition Letter is issued under the authority of the Senior Procurement Executives of DOE and NNSA. It is intended for use by procurement professionals of DOE and NNSA, primarily Contracting Officers, and other officials of DOE and NNSA that are involved in the acquisition process. Other parties are welcome to its information, but definitive interpretations of its effect on contracts, and related procedures if any, may only be made by DOE and NNSA Contracting Officers.

Subject: Management and operating contractors' audit coverage of cost-reimbursement subcontracts

References:

DEAR 970.5203-1	Management controls
DEAR 970.5232-3	Accounts, records, and inspection
DEAR 970.5244-1	Contractor purchasing system
Acquisition Guide Chapter 70.4	Cooperative Audit Strategy

When is this Acquisition Letter (AL) effective?

This AL is effective upon issuance.

When does this AL Expire?

This AL remains in effect until superseded or canceled.

Who Is the Intended Audience For this AL?

Department of Energy (DOE), including National Nuclear Security Administration (NNSA), Contracting Officers are the audience for this AL.

Who is the Point of Contact for this AL?

Contracting Officers may contact Michael Righi of the Contracts and Financial Assistance Policy Division, Office of Policy, Office of Acquisition and Project Management by phone at (202) 287-1337 or by email at Michael.Righi@hq.doe.gov.

Need More Information on ALs?

Visit the website at <http://energy.gov/management/office-management/operational-management/procurement-and-acquisition/guidance-procurement> for information on Acquisition Letters and other policy issues.

What is the Purpose of this AL?

The purpose of this AL is to achieve greater Department-wide emphasis on auditing cost type subcontracts by providing guidance for monitoring management and operating contractors' fulfillment of their contractual obligation to provide adequate audit coverage of cost-type subcontracts.

What Types of Contracts Are Affected by this AL?

This AL applies to current and future management and operating contracts.

What is the Background of this AL?

Contractual Requirements for Subcontract Audit

Three Department of Energy Acquisition Regulation (DEAR) standard management and operating contract clauses require management and operating contractors to provide adequate audit coverage of cost-type subcontracts: DEAR 970.5203-1, Management controls; DEAR 970.5232-3, Accounts, records, and inspection; and DEAR 970.5244-1, Contractor purchasing system. Some salient features of the three clauses that are directly applicable to contractors' fulfillment of their contractual obligation to provide adequate audit coverage of cost-type subcontracts follow.

DEAR 970.5203-1 Management controls

DEAR 970.5203-1 requires the management and operating contractor to maintain effective systems of management controls for both administrative functions and programmatic functions to ensure, among other things, that costs incurred are in compliance with the clauses and intended purposes of the contract and that resources are safeguarded against waste, loss, mismanagement, or misappropriation.

Under the requirements of the clause the contractor must, among other things,

- (1) Establish and maintain systems of controls satisfactory to the Government.
- (2) Document its systems of controls.
- (3) Periodically review its systems of controls to ensure they are adequate to provide reasonable assurance that the objectives of the systems are being accomplished and they are working effectively.
- (4) Annually, or as directed by the Contracting Officer, supply the Contracting Officer copies of the reports reflecting the status of recommendations resulting from management audits performed by its internal audit activity and other audit organizations.

(5) Maintain a baseline quality assurance program that implements documented performance, quality standards, and control and assessment techniques.

DEAR 970.5232-3 Accounts, records, and inspection

DEAR 970.5232-3 requires the management and operating contractor to either conduct an audit of each cost-reimbursement subcontractor's costs or arrange for such an audit to be performed. The clause also requires the contractor to design and maintain an internal audit plan and an internal audit organization.

Under the requirements of the clause the contractor must, among other things,

(1) Within 30 days of contract award and at each 5th year of contract performance, the exercise of any contract option, or the extension of the contract, submit to the Contracting Officer for approval an Internal Audit Implementation Design to include the overall strategy for internal audits. The Audit Implementation Design must describe—

- (i) The internal audit organization's placement within the contractor's organization and its reporting requirements;
- (ii) The audit organization's size and the experience and educational standards of its staff;
- (iii) The audit organization's relationship to the corporate entities of the contractor;
- (iv) The standards to be used in conducting the internal audits;
- (v) The overall internal audit strategy of the contract, considering particularly the method of auditing costs incurred in the performance of the contract;
- (vi) The intended use of external audit resources;
- (vii) The plan for audit of subcontracts, both pre-award and post-award; and
- (viii) The schedule for peer review of internal audits by other contractor internal audit organizations, or other independent third party audit entities approved by the Contracting Officer.

(The Audit Implementation Design must discuss such matters as how the Contractor will ensure that incurred contract costs are allowable under the cost principles of the contract, the universe of payments by the Contractor, areas of high risk, the use of the Defense Contract Audit Agency (DCAA), and the process for auditing subcontracts.)

(2) By each January 31 of the contract performance period, submit an annual audit report, providing a summary of the audit activities undertaken during the previous fiscal year that reflects the results of the internal audits during the previous fiscal year and the actions to be taken to resolve weaknesses identified in the contractor's system of business, financial, or management controls. (The annual audit report should include a description of the allowable cost audit methodology; dollar value of the cost element or audit population; dollar value of the sample; and dollar value of the projected questioned costs.)

(3) By each June 30 of the contract performance period, submit to the Contracting Officer an annual audit plan for the activities to be undertaken by the internal audit organization

during the next fiscal year that is designed to test the costs incurred and contractor management systems described in the internal audit design. (Contractors must consider the results of prior year audits presented in the annual audit report, the status of audit activities for the current year until the issuance of the annual audit plan, and other factors such as risk assessments and emerging audit issues. This includes considering findings from the U.S. Government Accountability Office and the Office of Inspector General (IG), as well as high risk issues specified in the IG's Annual Audit Guidance Memorandum provided by February of each year.)

The clause also gives The Contracting Officer the authority to require revisions to the documents the clause requires the contractor submit, including the design plan for the internal audits, the annual report, and the annual internal audits.

Regarding remedies for unsatisfactory performance, the clause contains the following language:

“ If at any time during contract performance, the Contracting Officer determines that unallowable costs were claimed by the contractor to the extent of making the contractor's management controls suspect, or the contractor's management systems that validate costs incurred and claimed suspect, the Contracting Officer may, in his or her sole discretion, require the contractor to cease using the special financial institution account in whole or with regard to specified accounts, requiring reimbursable costs to be claimed by periodic vouchering. In addition, the Contracting Officer, where he or she deems it appropriate, may: Impose a penalty under 48 CFR 970.5242-1, Penalties for Unallowable Costs; require a refund; reduce the contractor's otherwise earned fee; and take such other action as authorized in law, regulation, or this contract.”

DEAR 970.5244-1, Contractor purchasing system

DEAR 970.5244-1 requires the management and operating contractor to provide for post-award audit of cost-reimbursement subcontracts, assigns responsibility for determining the costs allowable under each cost-reimbursement subcontract to the contractor, and emphasizes that for costs to be allowable they must be incurred per the FAR and DEAR cost principles.

How Management and Operating Contractors Meet Contractual Requirements for Subcontract Audit

Management and operating contractors may use their internal audit staff, engage contract auditors, or use the services of DCAA to perform audits of their subcontractors. The internally performed audits must, at a minimum, meet the Institute of Internal Auditors Standards.

How DOE monitors contractors' provision of adequate audit coverage of cost-type subcontracts

DOE officials from three offices--the Contracting Officer, representatives of the IG, and representatives from the Office of the Chief Financial Officer (CFO)--are primarily responsible for monitoring management and operating contractors' fulfillment of their contractual obligation to provide adequate audit coverage of cost-type subcontracts. They coordinate their oversight primarily through the execution of the cooperative audit strategy.

The cooperative audit strategy allows the Department to rely on the work of contractors' internal audit activities. Its success depends on the IG and contractors' internal auditors working closely with Contracting Offices and the CFO. Therefore, there should be frequent communication between these officials, particularly when changes occur in the Internal Audit Implementation Design and Annual Audit Plan.

The Contracting Officer, in conjunction with the IG and CFO, reviews and approves each contractor's Internal Audit Implementation Design, Annual Audit Plan, and Annual Audit Report. The Contracting Officer should coordinate the review of the Annual Audit Plan with the IG and CFO by July 15th of each year. Thereafter, each contractor will provide a copy of its approved Annual Audit Plan to the Contracting Officer, Head of Contracting Activity, the local IG audit office with cognizance over the contractor, and to the designated IG Headquarters point of contact.

The IG, the cognizant auditor for management and operating contracts, develops audit policy, provides guidance to the Contracting Officer and the CFO on the sufficiency of the design and operation of the contractor's internal audit activities, and periodically evaluates both the contractor's internal audit activities and the contractor's audits. The IG assists the Contracting Officer in reviewing and approving each contractor's Internal Audit Implementation Design, Annual Audit Plan, and Annual Audit Report.

The CFO provides expert counsel and guidance to the Contracting Officer on the adequacy of the contractor's financial management system. The CFO assists the Contracting Officer in reviewing and approving each contractor's Internal Audit Implementation Design, Annual Audit Plan, and Annual Audit Report.

Results of Recent DOE Office of Inspector General Audits

Summary of Audit Results

DOE Office of Inspector General audits over the past several years of management and operating contractors' audit coverage of cost-type subcontracts (for a summary of those audits' results see Special Report--Management and Operating Contractors' Subcontract Audit Coverage, DOE/IG-0885, April 2013) have revealed subcontract audit issues and indicate the need for a top-down approach to resolve those issues, which have occurred at multiple sites. The audits discovered significant subcontract costs that either had not been audited or had not been reviewed in a manner that met the Institute of Internal Auditors Standards. Clearly, as the Inspector General and the Senior Procurement Executives agreed, these issues could only have arisen because management and

operating contractors failed to develop and implement effective subcontract audit policies, and the issues' existence substantially increases the risk that unallowable costs will be incurred and billed without being detected in a timely manner. To resolve these issues, it is imperative Contracting Officers ensure contractors both: adopt a documented risk based approach for conducting audits with a reasonable threshold for selecting subcontracts; and perform or obtain audits that meet the requirements of the Institute of Internal Auditors standards. The following section lists some of the more serious issues identified in the recent DOE Office of Inspector General audits.

Specific Serious Issues Identified By the Audits

DOE Office of Inspector General audits over the past several years of management and operating contractors' audit coverage of cost-type subcontracts have revealed significant subcontract audit issues. Some specific issues were

- Lack of procedures requiring subcontract audit
- Procedures requiring subcontract audit were not based on a reasonable risk-based approach, which resulted in inadequate coverage of the universe of subcontracts
 - thresholds set that excluded virtually all cost-reimbursements subcontracts
 - no thresholds set
 - no acceptable criteria for determining subcontracts to be audited set
 - time-and-materials subcontracts were not included in the audit universe
 - (note: a benchmark for a reasonable risk-based approach is found in the Defense Contract Audit Agency Contract Audit Manual, which calls for subcontracts over \$15 million to be audited annually and low-risk subcontracts below \$15 million to be audited once every three years)
- Procedures requiring subcontract audit did not require audits meet required professional standards (the standards set by the Institute of Internal Auditors)
 - audit entity lacked independence
 - work papers not prepared adequately
 - entity performing audit not qualified
- Procedures were adequate for both how audit coverage was determined and professional standards being required but the procedures were not followed
 - audits were not performed or requested
 - analysis to determine which subcontracts should be audited not performed.

What Guidance is included in this AL?

1. What's new for Contracting Officers?

While the following requirements for the Contracting Officer are not new, they do demand he or she meet his or her existing responsibility to monitor a key aspect of a management and operating contractor's cost-type subcontract management, specifically the management and operating contractor's provision of adequate audit coverage of their cost-type subcontracts.

Each Contracting Officer is to ensure, using the tools and processes of the Cooperative Audit Strategy and taking any other contract administration actions appropriate, that management and operating contractors: adopt a documented approach for conducting audits with a reasonable threshold for selecting subcontracts; and perform or obtain audits that meet the requirements of the Institute of Internal Auditors standards. Specifically, each Contracting Officer, at a minimum, must

- demand the contractor submit all required documents on time
- in reviewing and approving the contractor's Internal Audit Implementation Design, Annual Audit Plan, and Annual Audit Report
 - consult with the IG and the CFO and jointly determine whether or not the contractor's planning and its execution of its planning have resulted in, and will continue to result in, provision of adequate audit coverage of its cost-type subcontracts
 - ensure all of the specific subcontract audit issues identified in the recent DOE Office of Inspector General's audits either do not exist for the contractor or if they do exist they are explicitly addressed and appropriately resolved, paying particular attention to the following possible issues
 - the contractor's failing to develop and implement procedures
 - thresholds that do not reflect a reasonable risk-based approach
 - audits not performed per standards set by the Institute of Internal Auditors
 - require the contractor to correct any inadequacies in its systems of management controls related to subcontract audit before granting related approvals
- employ any contractual remedy appropriate if the contractor fails to provide adequate audit coverage of its cost-type subcontracts, including, among other

things, requiring the contractor to cease using the special financial institution account, requiring reimbursable costs to be claimed by periodic vouchering, and reducing the contractor's otherwise earned fee.

2. What's new for Other Officials Involved in the Acquisition Process?

While the requirements for other officials involved in the acquisition process of this AL are not new, they do remind those officials of their existing responsibility to monitor, jointly with the Contracting Officer, a key aspect of a management and operating contractor's cost-type subcontract management, specifically the management and operating contractor's provision of adequate audit coverage of their cost-type subcontracts.

3. Who has what responsibility for implementing this AL's guidance?

The Contracting Officer has the responsibility for implementing this AL's guidance.

4. What changes implemented by this AL's guidance affect current contracts, future contracts, or both?

This AL's guidance affects both current and future management and operating contracts. It requires contracting officers to ensure they (and the other government participants involved in the contract administration function covering contractors' audit of subcontracts) monitor management and operating contractors' fulfillment of a contractual obligation. That obligation is the contractors provide adequate audit coverage of cost-type subcontracts by ensuring they: adopt a documented approach for conducting audits with a reasonable threshold for selecting subcontracts; and perform or obtain audits that meet the requirements of the Institute of Internal Auditors standards.