

## Audit Requirements for Non-Management and Operating Contracts



### Guiding Principles

Obtaining audit services is often called for by regulation, policy, or prudence. The auditor can play a vital role in supporting the Contracting Officer in source selection in cost-reimbursement contracting, pricing actions, and ensuring only allowable costs are reimbursed.

## WHAT'S NEW FOR CONTRACTING OFFICERS

The Contracting Officer must obtain a waiver from the Procurement Director before electing to forgo obtaining any audit services for each proposal considered for award in a competition for a cost-reimbursement contract expected to exceed \$1,000,000. The waiver request must document explicitly how the Contracting Officer plans to perform cost realism analysis without audit support. A waiver from the Procurement Director is not required for a competition for a cost-reimbursement contract not expected to exceed \$1,000,000, but the Contracting Officer must document the contract file to explain explicitly how he or she plans to perform cost realism analysis without audit support.

## BACKGROUND

### Why The Concern Over Audits of Non-Management and Operating Contracts?

The Department of Energy's (DOE's) large dollar value contracts are predominantly cost-reimbursement contracts. In establishing the price of such contracts (that is, the estimated cost and fixed/incentive/award fee) and administering them throughout their terms the Government's risk of overpayment lies less in the original prices (estimated cost and fee) established at time of contract award than in the costs actually reimbursed over the life of the contract. The Government does not reimburse estimated cost. It reimburses actual cost (up to the cost-reimbursement contract's ceiling). The fee is small relative to the actual cost.

While selecting the offeror that will provide the best value in a competition for a cost-reimbursement contract and pricing the cost-reimbursement contract fairly and reasonably are

important (to provide equity in source selection and to avoid overpaying fee), reimbursing only costs that are allocable, allowable, and reasonable over the life of the contract is where a significant portion of the Government's financial concern lies.

Previously, the majority of DOE's contract dollars were obligated on management and operating (M&O) contracts—for which DOE's Inspector General (IG) is the auditor and DOE's Chief Financial Officer (CFO) provides abundant financial and accounting support—and the Defense DCAA's services were readily available for the few other DOE contracts, which were typically of small dollar value. Now some big dollar value contracts are no longer M&O contracts (so the IG is not the auditor and the CFO is not necessarily involved), and DCAA's services are not always readily available in a timely manner for audits of Final Indirect Cost Rate Proposals (the FAR uses the term "Final Indirect Cost Rate Proposal" and does not use the term "Incurred Cost Proposal," but DCAA's contract audit manual and other written guidance does; the terms may be considered synonyms).

This guide chapter addresses how the Contracting Officer should view the vital, sometimes required by regulation, sometimes required by Department policy, and sometimes dictated by prudence role of auditors in: source selection in cost-reimbursement contracting; pricing actions for all contract types; and ensuring the Government is reimbursing only costs that are allocable, allowable, and reasonable during cost-reimbursement contract performance.

FAR, DOE Acquisition Regulation (DEAR), and DOE Policy Other Than DEAR:  
Requirements for Auditor Assistance and Identification of Circumstances in Which  
Requesting Auditor Assistance Is Prudent

#### Responsibility Determinations

FAR 9.1 "Responsible Prospective Contractors": FAR 9.105-1(b)(2) requires the Contracting Officer to obtain from the auditor any information, when it is neither on hand nor readily available, required concerning the adequacy of prospective contractor's accounting system and the system's suitability for use in administering the proposed type of contract. There is no dollar threshold.

#### Proposal Analysis

FAR 15.404-1 "Proposal analysis techniques" and FAR 15.404-2 "Information to support proposal analysis": Audits may, but are not required to, be requested for pricing of contract actions. The Contracting Officer should request audit support when the information available to him or her is inadequate to determine a fair and reasonable price and audit support can provide the information. Many of the cost analysis techniques and procedures (FAR 15.404-1 (c) (2)) typically require a complete proposal audit or some other type of audit service. DCAA provides

different types of audit services of varying scopes and resulting in different types of report statements. For source selection for award of a cost-reimbursement contract, for example, cost realism analysis must be performed on each proposal considered for award ((FAR 15.404-1 (d)) and in almost all cases this requires obtaining audit services. (DOE requires the Contracting Officer—see the WHAT’S NEW FOR CONTRACTING OFFICERS section and the GUIDANCE section of this Guide chapter—to obtain a waiver from the Procurement Director before electing to forgo obtaining any audit services for each proposal considered for award in a competition for a cost-reimbursement contract expected to exceed \$1,000,000.)

DEAR 915.404-2-70 “Audit as an aid in proposal analysis”: When a pricing action will be based on cost or pricing data, the Contracting Officer must obtain a review by the cognizant audit activity if the action meets certain criteria. If it is a firm-fixed-price or firm-fixed-price with economic price adjustment action, the Contracting Officer must obtain a review by the cognizant audit activity if the action exceeds the threshold for cost or pricing data (\$700,000 as of February 2013). If it is not a firm-fixed-price or firm-fixed-price with economic price adjustment action, the Contracting Officer must obtain a review by the cognizant audit activity if the action exceeds twice the threshold for cost or pricing data (\$1,400,000 as of February 2013). The requirements of DEAR 915.404-2-70 may be waived at one level above the Contracting Officer, but only if: the reasonableness of the price can be determined from the information available; the contract file is documented reflecting the reason; and an independent Government estimate is not the sole justification.

Office of Contract Management memorandum of Aug. 20, 2001 “Contract Audits”: This memo reiterates and affirms the requirements of DEAR 915.404-2-70 and adds: audits are necessary when significant incurred costs are involved or actual cost data on previous contracts exists and is relevant to the current contract pricing action; audits should not be waived unless the data used to support determining the reasonableness of the price has been audited within the past year; and cost/pricing reports from DOE pricing support personnel or Department of Defense contract management offices do not satisfy the audit requirement of DEAR 915.404-2-70.

### Cost Accounting Standards

FAR 30.202-7 “Determinations”: For Cost Accounting Standards (CAS) covered contracts, FAR requires the auditor to conduct a review of the contractor’s CAS Disclosure Statement, if one is required, to ascertain whether it is current, accurate, and complete and to report the results to the cognizant Federal agency official (FAR 32.202-7(a) “Adequacy determination”).

(The cognizant Federal agency appoints the cognizant Federal agency official. The cognizant Federal agency will normally be the agency with the largest dollar amount of negotiated contracts. It is responsible, on behalf of all Federal agencies, for establishing final indirect costs rates and administering CAS for all contracts in a business unit. The cognizant Federal agency official is responsible for determining the contractor’s disclosure statement adequately describes

its cost accounting practices. After determining the contractor's disclosure statement is adequate, the cognizant Federal agency official is responsible for determining if the contractor's disclosed cost accounting practices comply with CAS and FAR Part 31.)

After the cognizant Federal agency official has determined the contractor's CAS Disclosure Statement adequate, the auditor will conduct a detailed compliance review to ascertain whether or not the disclosed practices comply with CAS and FAR Part 31 and advise the cognizant Federal agency official of the results (FAR 32.202-7(b) "Compliance determination").

The Contracting Officer may not award a CAS-covered contract until the cognizant Federal agency official has made a written determination that any required CAS Disclosure Statement is adequate.

### Contract Audit Services

FAR 42.1 "Contract Audit Services": Regarding proposed and incurred costs, the auditor is responsible for submitting advice to the Contracting Officer based on analysis of contractor's financial and accounting records, reviewing financial and accounting aspects of the contractor's cost control systems, and other analyses and reviews that require access to the contractor's financial and accounting records. There is no dollar threshold.

Acquisition Letter (AL) 2008-02 "Audit Management": This AL provides guidance to contracting officers on planning audits for other than M&O contracts, and it provides factors to consider when determining the extent of audit support to request

### Indirect Cost Rates

FAR 42.7 "Indirect Cost Rates" (covers both billing rates and final indirect cost rates):

FAR 42.705 states that for each indirect cost rate proposal for each fiscal year of the contract the auditor will: (1) review the proposal for adequacy (for guidance on constitutes an adequate proposal, FAR 42.705-1(b)(1) references DCAA Pamphlet No. 7641.90); (2) provide a written description of any inadequacies to the contractor and Contracting Officer; (3) resolve the inadequacies with the contractor or elevate them to the Contracting Officer; (4) then audit the proposal after it has been determined adequate; (5) submit an advisory report to the Contracting Officer; (6) recommend to the Contracting Officer which costs may be unallowable and subject to penalties (FAR 42.709), provide rationale and supporting documentation for each recommendation, and refer the matter to the appropriate criminal investigative organization if there is evidence the contractor knowingly submitted unallowable costs; (7) be included in the Government negotiating team as required; and (8) be invited to serve as an advisor at any negotiation or meeting with the contractor whenever possible.

The Contracting Officer may not resolve any questioned costs without obtaining the auditor's opinion on the allowability of the costs and must include in the negotiation memorandum the reasons why any recommendation of the auditor was not followed.

FAR 52.216-7 "Allowable Cost and Payment": Requires the contractor for a cost-reimbursement contract or a time-and-materials contract (other than a contract for a commercial item) to submit an adequate final indirect cost rate proposal to both the contracting officer and the auditor within six months of the end of each of its fiscal years. There is no dollar threshold.

Acquisition Guide Chapter 42.1 "Indirect Cost Rate Administration": Discusses the Department's procedures for the administration of indirect cost rates for contracts and financial assistance instruments. The guide chapter states when DOE has responsibility for negotiating rates that the Contracting Officer will request advisory audit services when warranted and that the audit requests will flow through the Cognizant Federal audit agency (the Defense Contract Audit Agency (DCAA) or the Department of Health and Human Services (HSS).

#### What Mechanisms Do Auditors Use To Ensure Claimed Costs Are Allowable

The amount of audit work required to verify that the Government is reimbursing only costs that are allocable, allowable, and reasonable for a particular effort depends on a number of factors, including, among other things, whether the contractor's accounting system has ever been determined adequate, the size, quality, and independence of the contractor's internal control staff, the complexity of the contract, how recently the contractor has been audited and what was audited, and the results of past audits. So, for the exact same job, you should expect less audit effort to be required to perform audits of an established Government contractor with a large number of cost-reimbursement contracts and a good record of keeping its accounting system effective and its billings and cost incurred submissions accurate than you expect to be required of a new Government contractor. Auditors have less work if they enjoy the advantage of being able to rely on ongoing system audits, frequent invoice reviews, recent Final Indirect Cost Rate Proposal audits, and a robust contractor internal control organization that has proven to be reliable. There are other factors than those mentioned above that could influence the amount of audit work required. Auditors include all factors in the risk assessment performed for each audit assignment.

#### **GUIDANCE**

##### Audit Requirements for Non-M&O Contracts

###### FAR Requirements

Under the FAR, the Contracting Officer must obtain the services of an auditor for: (1) help in determining the adequacy of a prospective contractor's accounting system (when the information is neither on hand nor readily available), that is, for any information required

concerning the adequacy of a prospective contractor's accounting system and the system's suitability for use in administering the proposed type of contract; (2) help in determining whether a required CAS Disclosure Statement is adequate and compliant; and (3) reviewing each indirect cost rate proposal for adequacy for each fiscal year of the contractor, auditing each such indirect cost rate proposal, and providing an advisory report to the Contracting Officer on each such indirect cost rate proposal.

Under the FAR, there is no other regulatory requirement to obtain audit assistance. There are many situations (some were discussed in the BACKGROUND section) in which the FAR indicates and prudence dictates audit assistance is appropriate.

#### DEAR Requirements

There are no DEAR requirements in addition to what the FAR requires regarding obtaining audits or audit services for determining the adequacy of a prospective contractor's accounting system, determining a required CAS Disclosure Statement is adequate and compliant, review of each indirect cost rate proposal, audit of each such indirect cost rate proposal, and an advisory report.

There is a DEAR requirement (that is, a requirement in addition to what the FAR requires) that the Contracting Officer obtain a review by the cognizant audit activity if a pricing action will be based on cost or pricing data and meets certain criteria.

#### DOE Policy Other Than DEAR Requirements

**Pricing:** When a price will be based on cost or pricing data the Contracting Officer must obtain a review by the cognizant audit activity for any: firm-fixed-price or firm-fixed-price with economic price adjustment pricing action that exceeds the cost or pricing data threshold; or other pricing action that exceeds twice the cost or pricing data threshold. This requirement may be waived at a level above the Contracting Officer if: the reasonableness of the price can be determined from the information available; the contract file is documented reflecting the reason; an independent Government estimate is not the sole justification; significant incurred costs are not involved; actual cost data on previous contracts does not exist or is not relevant to the current contract pricing action; and the data used to support determining the reasonableness of the price has been audited within the past year.

**Source Selection:** The Contracting Officer must obtain a waiver from the Procurement Director before electing to forgo obtaining any audit services for each proposal considered for award in a competition for a cost-reimbursement contract expected to exceed \$1,000,000. The waiver request must document explicitly how the Contracting Officer plans to perform cost realism analysis without audit support. A waiver from the Procurement Director is not required for a competition for a cost-reimbursement contract not expected to exceed \$1,000,000, but the Contracting Officer must document the contract file to explain explicitly how he or she plans to

perform cost realism analysis without audit support. A complete proposal audit is not required to meet this requirement to obtain audit services. DCAA provides different types of audit services of varying scopes and resulting in different types of report statements. In the case of supporting a Contracting Officer conducting a competition for a cost-reimbursement contract, DCAA categorizes (on its website under “Frequently Asked Questions: Contracting Officer”) the type of service it provides as “Cost Realism Analysis,” the scope of the service as “Evaluation to ascertain potential cost understatement,” and the resulting report statement as “Disclaimer.”

### The Role of the Contracting Officer

DOE Contracting Officers are responsible for ensuring performance of all necessary actions for effective contracting and safeguarding the interests of the United States in its contractual relationships. In fulfilling these responsibilities they are allowed wide latitude to exercise their business judgment, yet are required to request and consider the advice of specialists in other fields, such as auditors, as appropriate. They are members of the Acquisition Team, which consists of all participants in the Government acquisition, and as such are to exercise personal initiative and sound business judgment in providing the best value product or service to meet the customers’ needs, while maintaining the public’s trust and fulfilling public policy objectives. A fundamental guiding principle for the Acquisition Team members, articulated explicitly in the FAR, is they work together as a team and are empowered to make decisions within their area of responsibility.

DOE Contracting Officers generally must request and rely upon the advice of auditors, such as DCAA or private sector audit firms, in making a number of determinations under their non-M&O contracts. As good stewards of the taxpayers’ dollar, they are obligated to maximize the return on the entire spectrum of the Department’s resources devoted to audits and audit related efforts.

Consequently, in their striving to utilize the services of outside audit entities efficiently, Contracting Officers should consider consulting with their Offices of Chief Financial Officer, which typically possess significant knowledge and experience in financial management and controls. Contracting Officers should also consider consulting with the Office of the Inspector General, which possesses significant knowledge and experience in auditing, especially in maximizing the effectiveness of contractors’ internal control systems in supporting audit work and consequently reducing the need for and cost of audits.

(When DCAA cannot provide required audit support, Contracting Officers may be able to obtain audit services from DOE’s private sector provider of audit services, which is currently KPMG LLP. See Policy Flash 2010-57 “Supplemental Audit Services” and October 3, 2012, email to Field Office Procurement Directors “Supplemental Audit Service—New Ordering process for Audits Performed By KPMG.”)