



U.S. Department of Energy
Office of Inspector General
Office of Audits and Inspections

SPECIAL REPORT

Incurred Cost Audit Coverage of Non-
Management and Operating Contractors

DOE/IG-0934


February 2015



Department of Energy
Washington, DC 20585

February 3, 2015

MEMORANDUM FOR THE SECRETARY

FROM: 
Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Special Report on "Incurred Cost Audit Coverage of Non-Management and Operating Contractors"

BACKGROUND

The Department of Energy is one of the most contractor dependent civilian agencies in the Federal government. Beginning with the Manhattan Project, the Department and its predecessor agencies used Management and Operating (M&O) contracts to operate virtually all aspects of its Government-owned facilities, including the system of National Laboratories. In recent years, however, the Department has significantly expanded its use of non-M&O contractors to perform its massive site environmental cleanup effort and to manage large-scale construction projects. The Department's Office of Environmental Management (Environmental Management) has awarded the majority of the non-M&O contracts, with more than 40 prime contracts valued at more than \$90 billion and annual expenditures of about \$5 billion. In addition, the National Nuclear Security Administration (NNSA) has several significant non-M&O contracts, including the nearly \$5 billion contract to construct the Mixed Oxide Fuel Fabrication Facility at the Savannah River Site in South Carolina. These are cost reimbursable contracts and often use the services of subcontractors, which are also compensated with Federal funds.

As it has for many years, the Office of Inspector General identified contract management as a challenge area in its report on *Management Challenges at the Department of Energy – Fiscal Year 2015* (DOE/IG-0924, October 2014). A key control for improving overall contract management and reducing the risk that unallowable costs will be incurred by contractors is a risk-based incurred cost audit approach. Although the Department has generally committed to improving contract management, over the past several years we have identified a significant gap in audit coverage of non-M&O contracts and subcontracts. This report highlights audit coverage issues related to the non-M&O contracts and it identifies the associated risks to the Department.

RESULTS

Historically, the Department has met its non-M&O contract cost audit requirements through an agreement with the Defense Contract Audit Agency (DCAA). DCAA provides audit and financial advisory services to the Department of Defense and also services Federal civilian agencies responsible for acquisition and contract administration. However, over the past several

years, as responsible Department officials confirmed, DCAA has been unable to perform many of its audits on a timely basis. In fact, DCAA itself reported delays from 1 year to more than 8 years for audits of the Department's non-M&O contracts and related Department-funded subcontracts. These delays resulted in a backlog of audits of contracts and subcontracts with incurred costs valued at billions of dollars per year. To illustrate the magnitude of this problem, as of the date of our review, of the 16 largest Environmental Management non-M&O contractors:

- Seven had never had an incurred cost audit;
- Six had only received audits of costs incurred in 2010 or earlier; and,
- Only three had received relatively current audits of costs incurred in 2012 or later.

DCAA has been unable to meet the non-M&O contract audit needs of the Department and has asserted that it simply does not have the resources to meet all Department of Defense and civilian agency audit requests. As it pertains to the Department, this situation was exacerbated by the fact that the Department lacked a comprehensive strategy to ensure that non-M&O contractor costs were subjected to necessary audits. Instead, the Department employed alternative means for conducting a portion of required audits. In several instances, Environmental Management contracted with independent public accounting firms for these services. At least some effort to fill the void left by declining DCAA audit coverage had also been made by one large Environmental Management contractor that expanded its internal audit function to conduct audits of costs incurred. An Environmental Management support organization had also explored the possibility of developing its own audit capability. While laudable, these efforts were not well coordinated, in some instances did not comply with professional audit standards, and do not, in our judgment, close the significant gap in audit coverage for non-M&O contractors.

As noted previously, the Department has committed billions of dollars to the non-M&O contractor concept. Given the value of these contracts, the intricacies of contractor accounting systems, and the inherent inability of Federal contracting/reviewing officials to gain complete transaction level knowledge of contractor operations, comprehensive periodic audits are critically important. Timely incurred cost audits of non-M&O contractors and subcontractors are an essential part of the system of safeguards to: (1) identify internal control weaknesses and (2) detect and prevent Department reimbursement of contractor-claimed unallowable costs, that is claimed costs that do not comply with applicable laws, the Federal Acquisition Regulation, Cost Accounting Standards, and contract terms.

We recognize that until the audits are completed, there is no reliable way of quantifying the benefits of a comprehensive audit regime. Yet, the Department's experience with its large inventory of M&O contracts may be instructive in this regard. Notably, according to the Departmental Audit Report Tracking System, as of the end of fiscal year 2014, there were more than 22 open M&O contract cost audits with a total of \$1.1 billion in questioned contractor costs. We believe that this data is useful in putting the current situation with the non-M&O contractors in perspective.

In our view, the current approach to evaluating costs incurred by its large amount of non-M&O contractors exposes the Department to an unacceptable level of financial risk. In recent discussions with DCAA officials, they stated they want to continue providing audit support to the Department and will work with the Department to develop a viable solution to reduce the backlog. DCAA's long-term intentions notwithstanding, it does not appear that any resolution of this problem is likely for a number of years.

The options for supplementing DCAA audit coverage in the interim to address the concerns highlighted in this report are not inexpensive. However, given the billions of dollars the Department invests in its non-M&O contractor and subcontractor base and the Department's experience with the prevention and identification of unallowable costs incurred by its M&O contractors, there is every reason to conclude that the benefits of a comprehensive plan for providing necessary audit capacity outweigh the costs. To help resolve the issues identified in this report, we recommended that the Department coordinate with DCAA to develop a risk-based approach for audit coverage of non-M&O contractor incurred costs. We also recommended it develop a comprehensive strategy to supplement DCAA's audit coverage to ensure necessary and required audit of incurred costs until the backlog of DCAA audits can be eliminated.

MANAGEMENT REACTION

Department and NNSA management concurred with the report's recommendations and indicated that corrective actions had been taken or were planned to address the issues identified in the report. Management's comments and our responses are summarized in the body of the report. Management's formal comments are included in Appendix 3.

Attachment

cc: Deputy Secretary
Under Secretary for Nuclear Security
Deputy Under Secretary for Science and Energy
Deputy Under Secretary for Management and Performance
Acting Assistant Secretary for Environmental Management
Chief of Staff
Director, Office of Management
Director, Office of Acquisition and Project Management
NNSA Associate Administrator for Acquisition and Project Management

**SPECIAL REPORT ON INCURRED COST AUDIT COVERAGE
OF NON-MANAGEMENT AND OPERATING CONTRACTORS**

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INCURRED COST AUDIT COVERAGE OF NON-MANAGEMENT AND OPERATING CONTRACTORS

BACKGROUND

The Department of Energy (Department) has made increasing use of non-Management and Operating (non-M&O) contracts to perform site environmental cleanup activities and to manage the development of large-scale projects. The Department's Office of Environmental Management (Environmental Management) manages the majority of the non-M&O contracts, with more than 40 prime contracts valued at more than \$90 billion and annual expenditures of about \$5 billion. In addition, the National Nuclear Security Administration (NNSA) has several non-M&O contracts as well, including the nearly \$5 billion contract to construct the Mixed Oxide Fuel Fabrication Facility at the Savannah River Site in South Carolina. A listing of the major Environmental Management non-M&O contracts and approximate values is provided in Appendix 1.

Since 1991, the Department has sought to ensure audit coverage of the non-M&O contractors' and subcontractors' incurred costs through a Memorandum of Understanding with the Defense Contract Audit Agency (DCAA). However, in recent years, DCAA has been unable to provide timely audits, resulting in a significant backlog in its non-M&O contractor audit coverage.

This report examines the non-M&O audit coverage issues and identifies associated risks to the Department.

Traditional Audit Coverage of Non-M&O Contracts

DCAA is the primary contract audit agency for the Department of Defense and also services Federal civilian agencies. Historically, the Department has met its non-M&O contract audit requirements through an agreement with DCAA. However, generally, DCAA has been unable to perform incurred cost audits in a timely manner. As a result, the Department has developed a significant backlog of incurred cost audits for non-M&O contractors. Based on our ongoing evaluation of contract audit coverage, the lack of required contract audits also extends beyond incurred cost audits. We noted that extensive delays exist in completing DCAA audits of contractor forward pricing proposals, cost accounting systems and business systems.

DCAA Audit Coverage

In its March 24, 2014, *Report to Congress on FY 2013 Activities at the Defense Contract Audit Agency*, DCAA reported that for all of its audit clients it had 15,000 incurred cost submissions, totaling \$390 billion in costs that were pending audit at the end of fiscal year 2013. In addition, it was awaiting receipt of or had not yet made an adequacy determination on 8,000 incurred cost submissions, with a total value of \$423 billion. DCAA asserted that it had implemented corrective actions designed to improve its response rate. However, with regard to the Department's non-M&O contracts and related Department-funded subcontracts, DCAA has reported audit delays ranging from 1 year to more than 8 years. Contract audit delays are more fully described in Appendix 1.

Timely contract audits are an essential management tool. The *Federal Acquisition Streamlining Act of 1994* establishes a 6-year statute of limitations for claims filed under the *Contracts Dispute Act of 1978*, requiring that each claim be filed within 6 years after the accrual of the claim. According to the Office of Management, Procurement and Acquisition, a recent court ruling has extended this statute of limitations to audits of incurred costs, stating that "contracting parties cannot establish a statute of limitations longer than that set forth in the Contract Disputes Act, where the Government is a party." Thus, significant delays in the contract audit process, such as the delays the Department has already experienced, would likely make it impossible to recover contractor incurred costs even if they are ultimately found to be unallowable. A recent Department contracting officer decision illustrates the impact of the statute of limitation issue: the Contracting Officer for the nearly \$5 billion Shaw AREVA MOX Services, LLC (Shaw AREVA) contract recently suspended DCAA's work on the 2005 Shaw AREVA incurred cost audit because she concluded that the statute of limitations had expired, rendering it impossible to recoup any questioned costs. Although DCAA is currently working on Shaw AREVA's 2006 incurred costs, the risks associated with exceeding the statute of limitations on this and other contracts remains.

DCAA has initiated action to reduce its backlog of audits, but its actions to date have primarily targeted the Department of Defense and have not directly benefited the Department. A major step that DCAA has taken is to implement a risk-based approach for conducting incurred cost audits called the Low-Risk Incurred Cost Initiative. Under this approach, the dollar threshold that triggers automatic audits of contractor incurred cost proposal increased from \$15 million to \$250 million. In addition to the auditable dollar value, other risk factors could move an audit proposal into the high risk category, such as prior questioned costs and experience with the contractor. In addition to auditing high-risk contracts, DCAA conducts some audits of lower risk contracts on a sample basis. NNSA recently chose to participate in DCAA's Low-Risk Incurred Cost Initiative and is working out the details of their agreement. Some other agencies that participate include the National Aeronautics and Space Administration, the Department of Homeland Security, the Internal Revenue Service and the Environmental Protection Agency.

While DCAA's Low-Risk Incurred Cost Initiative has reduced the backlog of contract audits at the Department of Defense, its implementation at the Department in its current format would result in the failure to audit a majority of the Department's non-M&O contracts. Specifically, only about 20 percent of the Department's non-M&O contractors' incurred cost submissions would be subject to mandatory audit, with the other 80 percent identified as low risk and only subject to being randomly selected for audit. Thus, over time, as additional contracts are awarded, the Department's backlog of unaudited contracts would likely grow more severe. The practical impact of such action is to limit the Department's access to an important tool that helps detect and prevent contractor claims for questionable costs. In our view, this is an unacceptable risk going forward.

It should be noted that in a recent discussion between the Office of Inspector General (OIG) and DCAA, we were informed of DCAA's willingness to work with the Department to address the unresolved contract audit issues, including those related to the recently announced lower threshold for mandatory audits.

Current Audit Coverage of Non-M&O Contracts

Fundamentally, DCAA has been unable to meet the non-M&O contract audit needs of the Department due to resource constraints. This problem has been complicated by the Department's lack of a comprehensive strategy for ensuring audit coverage of non-M&O contractor costs. In the absence of DCAA performing the audit, the Department has developed alternative means for conducting some required contract audits, but these approaches have not been completely effective.

Independent Public Accounting Firms

The Department has contracted with an independent public accounting firm to perform some incurred cost audits. In 2013, this firm performed 16 incurred cost audits for the Department at multiple sites. Seven of these incurred cost audits were for prior years that had not yet been audited, primarily 2008 through 2011. For example, the Hanford Site has five non-M&O contractors with outstanding audits that normally would have been performed by DCAA but are now being completed by the independent public accounting firm. The Department contracted for additional incurred cost audits with this firm for FY 2014. Similarly, NNSA is in the process of awarding a blanket purchase agreement for commercial audit services that can supplement DCAA audit coverage.

Internal Audit and Non-Audit Entities

Environmental Management has explored several approaches to address its contract audit dilemma. For example, two major Environmental Management non-M&O contractors have utilized its internal audit function to conduct audits of its incurred costs. This included incurred cost audits at two major Environmental Management sites, the Hanford Site near Richland, Washington, and the East Tennessee Technology Park in Oak Ridge, Tennessee. Further, the Environmental Management Consolidated Business Center, which provides Environmental Management customers with business and technical support services, including contracting support, has explored the possibility of standing up its own audit function or utilizing independent public accounting firms to conduct incurred costs audits.

Environmental Management's efforts, while laudable, are unlikely to provide the needed capacity for truly independent audits of non-M&O contractor incurred costs. In the case of the contractor that expanded its internal audit group, the audits conducted by that group are not subject to quality assurance regimen and independence standards to ensure that the work meets audit standards and can be relied upon; similar to what is performed under the Cooperative Audit Strategy for M&O contractors. Furthermore, although well intentioned, developing an in-house Federal capability to address the gap in DCAA audit coverage, such as that considered by the Environmental Management Consolidated Business Center, raises serious concerns about compliance with professional auditing standards. Such an audit function would be burdened by inherent conflicts of interest and a lack of audit independence. To illustrate this concern, the group would be responsible for establishing contracts, processing contract billings and administering the contracts, as well as auditing the contract invoices.

Invoice Reviews

In addition to the alternative means the Department has used, some organizations told us that they had reduced the risk associated with not performing required audits by utilizing invoice reviews to identify unallowable costs. Such reviews are an important component of a strong internal control system, but they do not supplant the need for required incurred cost audits. This is especially true in a Department where the scope and complexity of contractor billings are so significant.

Office of Inspector General

The OIG provides limited, indirect coverage of costs incurred by non-M&O contractors through performance audits of projects and periodic audits of functional areas. For example, our audit report on *The Department of Energy's \$12.2 Billion Waste Treatment and Immobilization Plant – Quality Assurance Issues – Black Cell Vessels* (DOE/IG-0863, April 2012), found that a \$15 million fee was paid to the non-M&O contractor constructing the Waste Treatment and Immobilization Plant at Hanford that did not conform to contract requirements. Our audit report on *Cost Transfers at the Department's Sodium Bearing Waste Treatment Facility Construction Project* (OAS-M-13-03, August 2013), identified \$7.9 million in direct project costs for the Sodium Bearing Waste Treatment Facility construction project that was inappropriately transferred. The transfer was significant in that this construction project has a cost cap making the contractor responsible for all costs above a specified ceiling.

Additionally, our audit report on *The Use of Staff Augmentation Subcontracts at the National Nuclear Security Administration's Mixed Oxide Fuel Fabrication Facility* (DOE/IG-0887, May 2013), identified \$3.7 million in inappropriate temporary living expenses for 2007 through 2011 that were paid to the non-M&O contractor constructing the \$5 billion Mixed Oxide Fuel Fabrication Facility. In our audit report on *The Department of Energy's K Basins Sludge Treatment Project at the Hanford Site* (DOE/IG-0848, February 2011), we questioned approximately \$1 million in costs that the non-M&O contractor paid to a subcontractor that was not in accordance with the Federal Acquisition Regulation.

While the OIG's audits are important to identify internal control issues, they are not a substitute for incurred cost audits. Audits of costs incurred under a cost reimbursable contract are the responsibility of Department management.

Risks of Not Performing Timely Incurred Cost Audits

Given the Department's experience with its large inventory of M&O contracts, we believe that many of the same problems we have identified may exist on non-M&O contracts. For example, the Departmental Audit Report Tracking System showed that as of the end of FY 2013, there were more than 20 open M&O contract cost audits that had identified \$1.1 billion in questioned contractor costs. Furthermore, our special report on *Management and Operating Contractors' Subcontractor Audit Coverage* (DOE/IG-0885, April 2013), reported that between 2010 and 2012, the OIG identified subcontract audit weaknesses with nine M&O contractors. Subcontracts valued in excess of \$906 million had not been audited or were

reviewed in a manner that did not meet audit standards. Similar issues may exist with non-M&O contractors.

In addition to issues arising from the failure to conduct incurred cost audits, the timeliness of such audits is also critical. DCAA's backlog of incurred cost audits has resulted in some incurred costs not being audited in more than 7 years. In light of the *Federal Acquisition Streamlining Act's* 6-year statute of limitations that potentially restricts recovery of unallowable costs beyond that time frame, it is likely that unallowable costs that are identified based on incurred cost audits that are more than 6 years old will not be recoverable. Also, the relevance of internal control findings in delayed audits is often reduced due to changed management practices and staff, which significantly reduces the value of such audit work.

Further, there is only a 3-year retention requirement for contractors to maintain cost data upon the end of the contract for certain records. Auditors in these cases frequently encounter significant problems with locating relevant records and sometimes must resort to time-consuming searches for records. In addition, contractor staff attrition often makes it impossible to obtain needed information when misplaced records or data are not available. As such, there is a real risk that a lack of documentation may handicap the audit process.

RECOMMENDATIONS

To the Department and NNSA's credit, they have initiated discussions with DCAA to implement a strategy for reducing the backlog of unaudited non-M&O incurred costs. In fact, NNSA has chosen to participate in DCAA's Low-Risk Incurred Cost Initiative and is in the process of negotiating with DCAA. However, the Department and NNSA, along with other stakeholders, should coordinate on further actions to reduce the backlog of unaudited non-M&O contractor incurred costs. Accordingly, in recognition that DCAA cannot provide all of the audit services necessary to fulfill the Department's requirements, we recommend that both the Department's Office of Acquisition and Project Management and NNSA's Associate Administrator for Acquisition and Project Management:

1. Coordinate with DCAA to develop a risk-based approach to conducting non-M&O incurred cost audits that will reduce the backlog of unaudited incurred costs; and
2. Develop a comprehensive strategy to supplement DCAA's audit coverage and ensure necessary and required audit of non-M&O incurred costs until the backlog of DCAA audits can be eliminated.

MANAGEMENT RESPONSE

Department and NNSA management concurred with each of the report's recommendations and indicated that corrective actions had been taken or were planned to address the identified issues. Specifically, Department management noted that it has stated its expectation that required audits must be obtained, whether from DCAA or KPMG; has issued guidance to that effect; has put a contract in place for audit services to ensure Contracting Officers have an alternative to DCAA to obtain quality audits; is coordinating closely with DCAA on its audits; and is following up with contracting activities to ensure they understand what is expected and have the appropriate support. Department management also noted that they believe it is important to recognize that whatever good intentions DCAA has, its track record makes it prudent to avoid assuming a marked change in DCAA's support. Additionally, they stated that all stakeholders, not just the report's addressees, have a role in ensuring required audit support is obtained.

NNSA stated it had already initiated steps to mitigate the risk posed by DCAA's limited ability to meet the non-M&O contract audit needs of the Department. Specifically, NNSA has chosen to participate in DCAA's Low-Risk Incurred Cost Initiative. To address its audit service needs in the absence of support from DCAA, NNSA is in the process of awarding multiple blanket purchase agreements. Additionally, NNSA awarded a contract to conduct an audit of the Mixed Oxide Fuel Fabrication Facility estimating system and internal controls over cost proposals.

AUDITOR COMMENTS

Department and NNSA management's comments and planned corrective actions were responsive to our recommendations. Their comments are included in Appendix 3.

**OFFICE OF ENVIRONMENTAL MANAGEMENT'S HIGHEST VALUE
NON-MANAGEMENT AND OPERATING CONTRACTS¹**

Contractor	Location	Value	Auditor/Last Year Costs Audited/Current Cost Audit Status
Bechtel National Inc.	Richland, WA	\$11.30B	DCAA/2007/Auditing 2008-10
Washington River Protection Co.	Richland, WA	\$7.40B	DCAA/Planning 2013
CH2MHill Plateau Remediation Co.	Richland, WA	\$7.0B	KPMG/Auditing 2008-11
Savannah River Remediation, LLC	Savannah River Site, SC	\$4.70B	DCAA/Auditing 2010-11
CH2M-WG Idaho, LLC	Idaho Falls ID	\$3.81B	KPMG/Planning 2013
Mission Support Alliance, LLC	Richland, WA	\$3.34B	KPMG/None/Auditing 2009-11
Washington Closure, LLC	Richland, WA	\$2.50B	DCAA/Auditing 2008
Fluor-B&W Portsmouth, LLC	Portsmouth, OH	\$2.47B	DCAA/None
Parsons Infrastructure & Technology Group	Savannah River Site, SC	\$1.35B	DCAA/Auditing 2008-10
Wackenhut, Services, Inc.	Savannah River Site, SC	\$989M	DCAA/No audits planned
Babcock & Wilcox Conversion Svcs, LLC	Portsmouth, OH/Paducah, KY	\$511.5M	KPMG/Auditing 2011-12
Idaho Treatment Group	Idaho Falls, ID	\$461.7M	KPMG/Auditing 2013
Isotek Systems, LLC	Oak Ridge, TN	\$435.0M	DCAA/Auditing 2007-08
LATA/Environmental Services of KY, LLC	Paducah, KY	\$408.M	DCAA/None/To audit 2010 in 2015
CH2MHill B&W West Valley, LLC	West Valley, NY	\$366.7M	KPMG/Auditing 2013
Wastren Advantage, Inc.	Oak Ridge, TN	\$297.5M	DCAA/Auditing 2010-12

¹ NNSA also has several non-Management and Operating contracts, most notably, Shaw AREVA MOX Services, contract to construct the Mixed Oxide Fuel Fabrication Facility at the Savannah River Site, South Carolina. The Defense Contract Audit Agency is the cognizant auditor and is currently auditing the 2006 costs incurred by the contractor.

PRIOR REPORTS

- Special Report on [*Management Challenges at the Department of Energy - Fiscal Year 2015*](#) (DOE/IG-0924, October 2014). Based on the results of the Office of Inspector General's (OIG) body of work over the past year, the management challenges list for fiscal year 2014 remains largely consistent with that of the previous year. These challenges include contract and financial assistance award management, cybersecurity, environmental cleanup, nuclear waste disposal, safeguards and security, and stockpile stewardship.
- Audit Report on [*Cost Transfers at the Department's Sodium Bearing Waste Treatment Facility Construction Project*](#) (OAS-M-13-03, August 2013). Among other things, the OIG found that three of seven cost transfers totaling \$7.9 million represented direct costs of the project, specifically, \$3.8 million for a waste transfer line and tie-in, \$4 million for mineralization testing, and \$107,000 for portable bathrooms. As such, these costs were not appropriately charged to the project because the contractor did not consider all pertinent facts, and we concluded that the costs should not have been transferred. Additionally, four of the seven cost transfers, valued at \$5.2 million, were for activities that were not direct project costs or had been appropriately shared pro rata with other projects in accordance with Department of Energy (Department) and contractor accounting and project management principles. Management concurred with the report's recommendations and identified actions it had taken to address the issues reported.
- Audit Report on [*The Use of Staff Augmentation Subcontracts at the National Nuclear Security Administration's Mixed Oxide Fuel Fabrication Facility*](#) (DOE/IG-0887, May 2013). Shaw AREVA MOX Services, LLC (MOX Services) used staff augmentation subcontracts to fill professional, technical and administrative support service positions on an as-needed basis on the Mixed Oxide Fuel Fabrication Facility Project. The OIG received a complaint alleging a variety of problems involving temporary living expenses, overtime hours, as well as the appropriateness of staff augmentation labor rates. Among other things, the audit substantiated the allegation that MOX Services billed, and the National Nuclear Security Administration (NNSA) reimbursed, payments to subcontractors for excessive temporary living expenses. Specifically, since January 2007, MOX Services was reimbursed about \$3.7 million for inappropriate temporary living expenses for staff augmentation employment. In response, NNSA management concurred with the report's recommendations and identified actions it had taken or planned to improve management of the temporary living expense component of staff augmentation subcontracts at the Mixed Oxide Fuel Fabrication Facility Project.
- Special Report on [*Management and Operating Contractors' Subcontract Audit Coverage*](#) (DOE/IG-0885, April 2013). Between 2010 and 2012, the OIG reported subcontract audit weaknesses with nine Management and Operating contractors. Subcontracts valued in excess of \$906 million had not been audited or were reviewed in a manner that did not meet audit standards. The report noted that while some sites had taken action in

response to the audit reports, a greater Department-wide emphasis on auditing cost-type subcontracts was needed. In response to the report, management concurred with the findings and recommendations and agreed to take corrective actions.

- Audit Report on [*The Department of Energy's \\$12.2 Billion Waste Treatment and Immobilization Plant - Quality Assurance Issues - Black Cell Vessels*](#) (DOE/IG-0863, April 2012). The OIG received allegations concerning aspects of the quality assurance program at the Department's \$12.2 billion Waste Treatment and Immobilization Plant (WTP) project in Hanford, Washington. The review substantiated the allegation. In short, the audit found that the Department had procured and installed vessels in the WTP that did not always meet quality assurance and/or contract requirements. For the vessels reviewed, the audit identified multiple instances where quality assurance records were either missing or were not traceable to the specific area or part of the vessel. We also found that the Department paid the WTP contractor a \$15 million incentive fee for production of a vessel that was later determined to be defective. Although the Department demanded return of the fee, it did not follow up on the matter and the fee was never reimbursed.
- Audit Report on [*The Department of Energy's K Basins Sludge Treatment Project at the Hanford Site*](#) (DOE/IG-0848, February 2011). The audit found that the Department's administration of the Fluor Hanford, Inc., contract was ineffective and both the contractor and its subcontractor failed to apply key project management principles as the project progressed. The audit also found that, among other things, the contractor paid a \$1 million fee to a subcontractor that was not tied to any performance objectives but appeared to be for contract closeout. Since the costs were not approved, as required, the audit questioned the allowability of the entire \$1 million payment.

MANAGEMENT COMMENTS



Department of Energy

Washington, DC 20585

December 19, 2014

MEMORANDUM FOR RICKEY R. HASS

DEPUTY INSPECTOR GENERAL
FOR AUDITS AND INSPECTIONS

FROM:

PAUL BOSCO *PBos*
DIRECTOR
OFFICE OF ACQUISITION
AND PROJECT MANAGEMENT

SUBJECT:

Draft Special Report on "Incurred Cost Audit Coverage of Non-Management and Operating Contractors"

The Office of Acquisition and Project Management (APM) has reviewed the subject draft report and has the following comments:

General Comment: The report recognizes some, but not all, of the actions the Department has taken to address the issues created by DCAA's inability to provide the audit services necessary to meet the Department's requirements. We fundamentally agree with the report's recommendations, and the comments that accompany our concurrences with the recommendations reflect nuances not significant disagreement. As our comments imply, however, it is important to recognize that whatever good intentions DCAA has, its track record makes it prudent to avoid assuming a marked change in DCAA's support. It is also important to note that the Department has: stated its expectation that required audits must be obtained, whether from DCAA or KPMG; has issued guidance to that effect; has put a contract in place for audit services to ensure Contracting Officers have an alternative to DCAA to obtain quality audits; is coordinating closely with DCAA on its audits; and is following up with contracting activities to ensure they understand what is expected and have the appropriate support. Lastly, all stakeholders, not just the report's addressees, have a role in ensuring required audit support is obtained.

Recommendation 1: Coordinate with DCAA to develop a risk-based approach to conducting non-M&O incurred cost audits that will reduce the backlog of unaudited incurred costs.



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Management Response: Concur with comment

APM concurs with the recommendation and fully supports working with DCAA. We have been coordinating with DCAA and will continue to do so. DCAA has, in fact, been more receptive lately to our complaints about its lack of response to our requests for audit support. DCAA in the recent past, however, has not been able to meet the entirety of the Department's audit needs. It is unlikely it will be able to do so in the foreseeable future. Under DCAA's risk-based approach, few of the Office of Environmental Management's contracts would be audited because few would meet the threshold DCAA has set. Consequently, we will use a tailored approach in coordinating with DCAA and provide input to DCAA on all risk-based auditing decisions. We have obtained from the Heads of Contracting Activity a prioritized list of contracts and subcontracts, which we provided to DCAA. We expect DCAA to use the list to track our most important audit requests, provide our Heads of Contracting Activity monthly status, and alert its Field Audit Offices of our priorities. DCAA has identified a liaison to work with us, including discussing, on a case-by-case basis, its application of its risk-based auditing methodology to the Department's contracts. We have provided DCAA a list of points of contact at each program office. Our actions will reduce the backlog of unaudited incurred costs, to the extent DCAA can provide audit services, while ensuring our contracts are subject to full audits where appropriate.

Recommendation 2: Develop a comprehensive strategy to supplement DCAA's audit coverage and ensure necessary and required audit of non-M&O incurred costs until the backlog of DCAA audits can be eliminated.

Management Response: Partially Concur

APM partially concurs with the recommendation and will work with the Heads of Contracting Activity, who are the officials responsible for ensuring appropriate audit coverage, to continue developing, implementing, and revising as necessary a comprehensive strategy to supplement DCAA's audit coverage. APM partially concurs because we have already taken extraordinary measures to supplement DCAA's audit coverage. We have put an audit services contract in place (with KPMG) to supplement DCAA's audit coverage and are using it extensively. We have issued Department-wide detailed guidance on Contracting Officers' responsibilities for obtaining audits. The guidance identified audit requirements for all types of contracting actions, both pre- and post- contract award. We do not view DCAA, for the foreseeable future, as the only answer. We view them as the preferred audit option, but one that we cannot rely upon to meet all of the Department's audit needs. Heads of Contracting Activity are responsible for ensuring appropriate audit coverage. We will continue to emphasize to our contracting activities that their Contracting Officers are responsible for ensuring appropriate audits are being conducted when required (or when advisable, in some instances).

APM will put an internal control in place, as part of its Procurement Management Reviews, to ensure every Contracting Officer is obtaining required audits. If internal reviews find instances where a Contracting Officer is not, and lack of funds was not the reason, APM will coordinate with the Head of Contracting Activity to correct the problem. If lack of funds was the reason for a Contracting Officer failing to obtain required audits, APM will coordinate with the office responsible for providing funds (the Office of the Head of the Contracting Activity, the Program Office, or the Secretarial Office) to correct the problem.



Department of Energy
 Under Secretary for Nuclear Security
 Administrator, National Nuclear Security Administration
 Washington, DC 20585



February 3, 2015

MEMORANDUM FOR GREGORY H. FRIEDMAN
 INSPECTOR GENERAL

FROM: FRANK G. KLOTZ *FK 2/3/15*

SUBJECT: Comments on the Office of Inspector General Draft Report Titled
"Incurred Cost Audit Coverage of Non-Management and Operating Contractors" (A14OA054 / 2014-02311)

Thank you for the opportunity to review and comment on the subject draft report. The National Nuclear Security Administration (NNSA) concurs with the report recommendations which focus on coordinating a risk-based approach to non-Management & Operating Contract (non-M&O) audits with the Defense Contract Audit Agency (DCAA) and developing a comprehensive interim audit strategy pending the resolution of the audit backlog.

As the report indicates, NNSA pro-actively initiated action to mitigate the risks posed by the DCAA resource challenges that have limited their ability to meet the non-M&O contract audit needs of the Department. Specifically, NNSA has chosen to participate in DCAA's Low-Risk Incurred Cost Initiative, which implements a risk based approach for evaluation of final indirect rate proposals and ensures limited audit resources are applied to proposals with the highest risk.

To address our audit service needs in the absence of support from DCAA, NNSA is in the process of awarding multiple Blanket Purchase Agreements by March 2015. Additionally, NNSA awarded a contract in Fiscal Year 2014 to conduct an audit of the MOX Services' estimating system and internal procedures to ensure prospective cost proposals are consistent with applicable contract law and regulations.

NNSA appreciates the auditors' efforts and recognition of the actions NNSA has already taken or initiated to address the inherent challenges created by the DCAA resource constraints. We believe the actions noted above will provide a reliable solution for NNSA's immediate needs, while we continue to work with the Department of Energy on a broader and more sustainable long term strategy. If you have any questions regarding this response, please contact Dean Childs, Director, Audit Coordination and Internal Affairs, at (301) 903-1341.



FEEDBACK

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