

July 8, 2004



# Contract Audit Followup

Oversight Review of Naval Sea  
Systems Command Contract Audit  
Followup Process  
(D-2004-6-006)

Department of Defense  
Office of the Inspector General

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# Report Documentation Page

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### **Acronyms**

ACO	Administrative Contracting Officer
APO	Audit Policy and Oversight
ASBCA	Armed Services Board of Contract Appeals
BCM	Business Clearance Memorandum
CAFU	Contract Audit Followup
CAS	Cost Accounting Standards
DASN (ACQ)	Deputy Assistant Secretary of the Navy (Acquisition Management)
DCAA	Defense Contract Audit Agency
FAR	Federal Acquisition Regulation
NAVSEA	Naval Sea Systems Command
NNS	Newport News
SUPSHIP	Supervisor of Shipbuilding, Conversion, and Repair



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
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July 8, 2004

**MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY  
NAVAL INSPECTOR GENERAL**

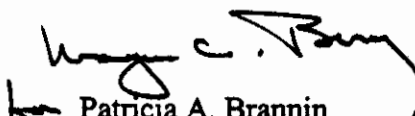
**SUBJECT: Naval Sea Systems Command Contract Audit Followup Process  
(Report No. D-2004-6-006)**

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Navy's comments are partially responsive. Based on management comments, we have deleted draft report Recommendation A.2. We request additional comments on Recommendations A.1.b, A.1.c., A.1.d., B.3. and C.1. We request that management provide comments by September 8, 2004. The Defense Contract Audit Agency comments were responsive to the recommendations and no additional response is required.

If possible, please provide management comments in electronic format (Adobe Acrobat file only). Send electronic transmission to the e-mail address cited in the last paragraph of this memorandum. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the /Signed/ symbol in place of the actual signature.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Wayne C. Berry at (703) 604-8789 (DSN 664-8789) [wberry@dodig.osd.mil](mailto:wberry@dodig.osd.mil). See Appendix D for the report distribution.

  
for Patricia A. Brannin  
Assistant Inspector General  
for Audit Policy and Oversight

## Office of the Inspector General of the Department of Defense

**Report No. D-2004-6-006**  
(Project No. D-2002-OA-0178)

**July 8, 2004**

### Naval Sea Systems Command Contract Audit Followup Process

#### Executive Summary

**Who Should Read This Report and Why?** Civil service and uniformed officers responsible for ensuring proper and timely settlement of contract audit reports should read this report. The report explains how to improve the contract audit followup process and maximize the potential savings to the Government from more effective disposition of audit findings.

**Background.** This report addresses the Naval Sea Systems Command contract audit followup process for ensuring the proper, timely resolution and disposition of contract audit reports. Resolution is achieved when the contracting officer agrees with the auditor on the actions to be taken on audit report findings or determines another course of action. Disposition of a contract audit report occurs when the contractor implements the audit recommendations or the contracting officer's decision, a settlement is reached, or the contracting officer issues a final decision under the Disputes Clause and 90 days elapse without contractor appeal to the Armed Services Board of Contract Appeals. This report discusses the Naval Sea Systems Command's monitoring and dispositioning of audit findings, collecting penalties, and submitting the status of all Naval Sea Systems Command contract audit reports semiannually to the Office of the Inspector General of the Department of Defense. The Naval Sea Systems Command's semiannual reports for the 12-month period ending March 31, 2002, included 201 audit reports with total costs questioned of \$864 million. Costs questioned are costs that are not allowable, allocable, or reasonable according to the Federal Acquisition Regulations.

**Results.** Administrative contracting officers at Naval Sea Systems Command can demonstrate and achieve more timely resolution and disposition of audit reports by correctly reporting when audit reports are resolved, withholding payments to contractors to achieve corrective action, and identifying and correcting long-standing findings. The Naval Sea Systems Command should include the contract audit followup process as an area of special interest in its FY 2004 Procurement Management Review Program. Administrative contracting officers also need to better document their determinations concerning costs questioned and waiver of penalties, and collect penalties and interest on expressly unallowable costs. Finally, administrative contracting officers should verify information from the Defense Contract Audit Agency to properly report costs questioned and other status information on their contract audit reports and the Defense Contract Audit Agency needs to ensure the accuracy of contract audit followup data.

**Management Comments and Audit Policy and Oversight Response.** The Navy generally concurred with all recommendations except those regarding withholding of payments and penalties in response to audit findings. They agreed to include Contract Audit Followup as a process in Procurement Performance Assessment Program reviews

of the Systems Commands and agreed that better documentation of decisions by contracting officials to waive penalties is required. However, they stated that penalties and interest were assessed in some instances and that administrative contracting officers have broad discretion when assessing penalties and withholdings. We agree that penalties and interest were assessed in some instances and that administrative contracting officers have broad discretion when settling audit recommendations. However, penalties and interest were neither assessed in situations where costs questioned were statutorily specified as unallowable nor was adequate justification provided for waiving penalties and interest. In addition, contracting officials must report accurately as well as resolve and disposition contract audit reports timely in accordance with DoD Directive 7640.2. Withholds should be used when contractors fail to correct longstanding deficiencies. Therefore, we request that the Navy provide additional comments on final report recommendations A.1.b, A.1.c, A.1.d, B.3. and C.1. by September 8, 2004. The Defense Contract Audit Agency concurred with the recommendation to clarify their guidance.

See Appendix C of the report for a discussion of management comments on the findings and our responses. The Management Comments section of the report contains the complete text of Management's comments.

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## Background

The Inspector General Act of 1978, as amended, section 8(c)(7), requires the Inspector General to develop policy, evaluate program performance, and monitor actions taken by all components of the Department in response to contract audits.

**Contract Audit Followup.** The Office of Management and Budget Circular No. A-50 (OMB Circular A-50), “Audit Followup,” September 29, 1982, states policies and procedures for Executive agencies to establish followup systems to assure prompt and proper resolution and implementation of audit recommendations. OMB Circular A-50 requires agencies to maintain accurate records of the status of audit reports and recommendations through the entire process of resolution and disposition. Resolution is achieved when the auditor and the contracting officer agree on the actions to be taken on audit report findings, or when the contracting officer determines another course of action. Disposition of the contract audit report occurs when the contractor implements the audit recommendations or the contracting officer’s decision, a settlement is reached, or the contracting officer issues a final decision under the Disputes Clause and 90 days elapse without contractor appeal to the Armed Services Board of Contract Appeals (ASBCA).

DoD Directive 7640.2, “Policy for Followup on Contract Audit Reports,” February 12, 1988, as amended August 16, 1995, implements OMB Circular A-50 and establishes DoD policies, responsibilities, reporting requirements, and followup procedures for contract audit reports. Secretaries of the Military Departments and Directors of Defense agencies are required by DoD Directive 7640.2 to maintain adequate followup systems for the proper and timely resolution and disposition of contract audit reports. Contract audit reports should be resolved within 6 months of issuance and dispositioned, or closed, as soon as possible thereafter. Audit reports are considered overage if not dispositioned within 12 months of issuance. DoD Directive 7640.2 also requires all DoD Components to submit semiannual status reports on reportable contract audits to the Inspector General of the Department of Defense for the 6-month periods ending March 31 and September 30 and specifies what information should be reported and what format should be used. That information is included in the Inspector General’s Semiannual Report to Congress, in accordance with the Inspector General Act of 1978, as amended.

**Defense Contract Audit Agency.** The Defense Contract Audit Agency (DCAA) provides financial advisory services to all DoD Components. The DCAA audits contractor costs, identifies costs that are questionable according to the Federal

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Acquisition Regulation, and reports such costs questioned to Government contracting officers. The DCAA issues reports resulting from several types of reviews of Government contractors, such as reviews of:

- internal control (financial) systems to evaluate the adequacy of internal controls over contractor accounting and other management systems;
- cost accounting practices to assess contractor compliance with the cost accounting standards (CAS) and its disclosed accounting practices;
- operations to improve the economy and efficiency of current and planned business operations; and
- incurred costs to determine whether costs charged to Government contracts are allowable, allocable, and reasonable.

Administrative contracting officers (ACOs) are responsible for negotiating and administering contract costs, including overhead costs, and for applying penalties required by law, as appropriate.

**Naval Sea Systems Command.** The Naval Sea Systems Command (NAVSEA) is the Navy's central activity for designing, engineering, integrating, building, and procuring ships and shipboard weapons and combat systems. NAVSEA has 10 Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) offices that administer contracts to manage and deliver ships from private shipyards and oversee repairs during a ship's lifetime. Contract audit followup (CAFU) processes at five SUPSHIPS (Bath, Maine; Groton, Connecticut; Newport News, Virginia; New Orleans, Louisiana; and San Diego, California) are discussed in this report. On October 1, 2003, SUPSHIP New Orleans and SUPSHIP Pascagoula, Mississippi, were disestablished and replaced by a new command, SUPSHIP Gulf Coast.<sup>1</sup>

NAVSEA has established policies and procedures for implementing DoD Directive 7640.2 requirements in the NAVSEA Contracts Directorate Instruction 7640.2, "Followup on DCAA Contract Audit Reports," January 15, 1992. NAVSEA administers approximately 40 percent of the contract audit reports issued to the Navy and reportable under DoD Directive 7640.2. These reports comprise approximately 80 percent of the costs questioned in all of the Navy's reportable contract audit reports.

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<sup>1</sup> The Navy's comments and our responses to the findings and recommendations refer to either SUPSHIP New Orleans or SUPSHIP Gulf Coast as appropriate. All other narrative in the report refers to SUPSHIP New Orleans only.

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## **Objectives**

Our overall objective was to evaluate the NAVSEA CAFU process. Specifically, we evaluated the actions taken by administrative contracting officers to ensure the timely and proper disposition of contract audit reports and the accuracy of the NAVSEA contract audit followup data.

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## **A. Timeliness of Resolution and Disposition of Audit Reports**

Administrative contracting officers at five NAVSEA SUPSHIPs did not resolve and disposition contract audit reports within the guidelines in DoD Directive 7640.2. Of 123 reports reviewed, 67 reports exceeded the 6-month resolution guideline and 95 reports with costs questioned of \$539 million<sup>2</sup> exceeded the 12-month disposition guideline. The following actions contributed to the delays:

- Contracting officers did not recognize the distinction between resolution and disposition.
- Contracting officers were reluctant to use regulatory provisions that allow for the withholding of monies to encourage contractor correction of deficiencies.
- NAVSEA did not track the date of the original audit report on internal control system deficiencies.

Uncorrected deficiencies increase audit risk and require expanded audit effort. Because of uncorrected deficiencies, auditors issued additional audit reports that restated the deficiencies in reports on followup internal control system reviews, contractor noncompliances with cost accounting standards, and annual overhead claims. If the date a deficiency is originally reported is not tracked, the same uncorrected deficiency will appear as a new finding each time a followup report is issued.

## **Resolution and Disposition of Contract Audit Reports**

DoD Directive 7640.2 states DoD policies and procedures, including guidelines, for the resolution and disposition of contract audit reports. Resolution is achieved when the auditor and the contracting officer agree on the actions to be taken on audit report findings or when the contracting officer determines a course of action. Disposition of the contract audit report occurs when the contractor implements the audit recommendations or the contracting officer's decision, a settlement is reached, or the contracting officer issues a final decision under the Disputes Clause and 90 days elapse without contractor appeal to the ASBCA. Contract audit reports should be resolved within 6 months of issuance and dispositioned, or closed, as soon as possible thereafter. Audit reports are overage if not dispositioned within 12 months of issuance. Deviations from these

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<sup>2</sup> Amounts for costs questioned in finding A reflect adjustments for errors described in finding C.

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guidelines should be fully justified and documented in the contract file. Reports that meet certain criteria are subject to semiannual status reporting requirements under the Directive.

**Timeliness of Settlements.** Of the 125 audit reports sampled, 123 covered four audit areas: financial systems, CAS, operations, and incurred costs. The two remaining audits were excluded because there were only one of each type. Table 1 summarizes the delays in months by location and audit type for each of the 123 reports that exceeded one or both of the DoD Directive 7640.2 resolution and disposition guidelines using data through March 31, 2003. For example, at SUPSHIP Bath, 4 of 11 operations audit reports exceeded the 6-month resolution guideline by a range of 1 to 12 months. Eight of the 11 reports exceeded the 12-month disposition guideline by a range of 4 to 42 months. As discussed later in this Finding, the delays shown in Table 1 represent the time taken to resolve and disposition deficiencies within all types of audit reports except financial system reports. The financial system reports may also contain deficiencies identified in prior financial system reports and restated in a followup report. When the followup report is issued, the prior report is considered closed or dispositioned, even if the deficiency still exists. Therefore, the delays shown in Table 1 for financial system reports could be significantly understated.

**Table 1. Audit Report Resolution and Disposition Delays**

<u>SUPSHIP and Audit Type</u>	<u>Total Audits</u>	<u>Resolution &gt;6 Months</u>		<u>Disposition &gt;12 Months</u>	
		<u>Reports Delayed</u>	<u>Months Delayed</u>	<u>Reports Overage</u>	<u>Months Overage</u>
<b>BATH:</b>					
Financial Systems	4			4	4-29
Cost Accounting Standards	1				
Operations	11	4	1-12	8	4-42
Incurring Costs	<u>8</u>			<u>6</u>	<u>5-27</u>
<b>Site Total and Average Delay</b>	<b>24</b>	<b>4</b>	<b>4</b>	<b>18</b>	<b>14</b>
<b>GROTON:</b>					
Financial Systems	8	2	13-49	7	2-43
Cost Accounting Standards	4			3	15-26
Operations	7	4	2-24	3	9-18
Incurring Costs	<u>9</u>	<u>8</u>	<u>2-51</u>	<u>7</u>	<u>2-45</u>
<b>Site Total and Average Delay</b>	<b>28</b>	<b>14</b>	<b>23</b>	<b>20</b>	<b>19</b>
<b>NEWPORT NEWS:</b>					
Financial Systems	9	3	3-58	6	3-69
Cost Accounting Standards	10	2	4-6	7	1-32
Operations	7	3	3-8	4	5-22
Incurring Costs	<u>11</u>	<u>11</u>	<u>12-58</u>	<u>11</u>	<u>6-57</u>
<b>Site Total and Average Delay</b>	<b>37</b>	<b>19</b>	<b>27</b>	<b>28</b>	<b>24</b>
<b>NEW ORLEANS:</b>					
Financial Systems	9	9	3-18	7	2-12
Cost Accounting Standards	3	3	8-27	3	2-21
Operations	3	1	18	3	12-21
Incurring Costs	<u>14</u>	<u>13</u>	<u>6-60</u>	<u>12</u>	<u>6-75</u>
<b>Site Total and Average Delay</b>	<b>29</b>	<b>26</b>	<b>20</b>	<b>25</b>	<b>19</b>
<b>SAN DIEGO:</b>					
Cost Accounting Standards	1	1	21	1	15
Operations	2	1	6	1	1
Incurring Costs	<u>2</u>	<u>2</u>	<u>5-9</u>	<u>2</u>	<u>3-6</u>
<b>Site Total and Average Delay</b>	<b>5</b>	<b>4</b>	<b>10</b>	<b>4</b>	<b>6</b>
<b>Total</b>	<b>123</b>	<b>67</b>	<b>21</b>	<b>95</b>	<b>19</b>

Overall, the five SUPSHIPS depicted in Table 1 had 67 reports (54 percent) that exceeded the resolution guideline by an average of 21 months, and 95 (77 percent) reports that exceeded the disposition guideline by an average of 19 months. As of March 31, 2003, 53 reports with costs questioned of \$315 million remained open, and 70 reports with costs questioned of \$375 million were

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disposed. Although the SUPSHIPs continue to reduce their open report backlog, the semiannual report for the period ending September 30, 2003, showed 72 open reports with costs questioned of \$305 million.

## **Actions Taken to Resolve Audit Reports**

The resolution of an audit report demonstrates that the ACO understands the issues in the report and has determined and documented a course of action in accordance with the DoD Component's prenegotiation documentation and review procedures. For example, audit reports on financial systems are usually resolved when the ACO requests a corrective action plan, and incurred cost audit reports are resolved when the ACO obtains approval of a pre-negotiation business clearance memorandum (BCM). After the ACO resolves an audit report, the contractor must correct the deficiencies in the audit report or justify why corrective action is unnecessary before the ACO can disposition or close the report. Proper reporting of resolution is critical in order for oversight officials to monitor ACO progress on closing each audit report and to identify if the ACO or the contractor requires increased oversight.

**Reports on Financial Systems and Incurred Costs.** ACOs at all five SUPSHIPs reviewed did not correctly identify and report resolution dates for 24 of the 30 financial system reports and 11 of the 44 reports on incurred costs. We determined that ACOs had sometimes issued timely memorandums to request corrective action plans on financial system deficiencies or prepared pre-negotiation BCMs to close incurred cost audits. However, the dates of the memorandums were not used to record the resolution in the CAFU system. Specialists who administered the reports and recorded the followup information incorrectly believed that the resolution occurred when the ACO was ready to close the audit and, therefore, delayed reporting the resolution until that time.

If an ACO determined that deficiencies in an audit report did not warrant any action, that determination should have been documented in a timely manner in order to resolve and close the audit report. For example, the ACO at SUPSHIP New Orleans suspended action on three open and overage financial system reports because he believed the deficiencies did not merit corrective action or could become irrelevant after the contractor's implementation of a new business system. However, SUPSHIP official files contained neither a determination that the deficiencies were insignificant nor a letter from the contractor stating that the deficiencies would be addressed and corrected as part of the planned business system.

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## Regulatory Provisions for Correcting Deficiencies

All five SUPSHIPs had overage internal control system or CAS noncompliance reports citing long-standing deficiencies. Some deficiencies were identified in prior reports or unnecessarily increased the number of reports issued by DCAA. The ACOs at these locations had not used regulatory provisions to encourage contractor corrective action.

**Disposition of Financial System Reports.** Defense Federal Acquisition Regulation Supplement Subpart 242.7503, “Procedures,” states that the ACO, upon receipt of an audit report identifying significant accounting system or related internal control deficiencies, will take the following actions:

- (1) Provide a copy of the report to the contractor and allow 30 days, or a reasonable extension, for the contractor to respond.
- (2) If the contractor agrees with the report, the contractor has 60 days from the date of initial notification to correct any identified deficiencies or submit a corrective action plan showing milestones and actions to eliminate the deficiencies.
- (3) If the contractor disagrees, the contractor should provide rationale in its written response.
- (4) The ACO will consider whether it is appropriate to suspend a percentage of progress payments or reimbursement of costs proportionate to the estimated cost risk to the Government, considering audit reports or other relevant input, until the contractor submits a corrective action plan acceptable to the ACO and corrects the deficiencies.

Federal Acquisition Regulation (FAR) Subpart 32.503-6, “Suspension or Reduction of Payments,” provides the Government the right to reduce or suspend progress payments under specified conditions, including contractor noncompliance with material requirements of the contract. Accordingly, the contractor must maintain an efficient and reliable accounting system and controls in order to ensure the administration of progress payments.

**Withholding Payments to the Contractor to Correct System Deficiencies.** We reviewed 30 reports on internal control systems including 13 followup reports—12 of which identified uncorrected system deficiencies addressed in a prior report of the same subject area. ACOs had not used the regulatory provisions on withholding payments to encourage contractor corrective actions. As a result of those uncorrected deficiencies, auditors also issued reports on contractor noncompliance with CAS and incurred costs that restated the uncorrected deficiencies in the internal control system reports. For example:

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- A June 25, 1996, report issued to SUPSHIP NNS on Newport News and Dry Dock Company's indirect cost system stated that the contractor had inadequate policies and procedures for identifying and excluding unallowable costs from claims and billings to the Government. DCAA initially reported at least one deficiency as early as March 1992. Although the ACO resolved the report in October 1996, the contractor never implemented corrective actions. The ACO dispositioned the report in March 2003, after awaiting completion of the DCAA review of a new financial system that replaced the existing system in June 1999. The uncorrected deficiencies caused DCAA to expand its audit efforts to identify and report on the expressly unallowable costs that the contractor continued to claim in its incurred cost submissions. The contractor claimed expressly unallowable costs of \$19 million in FY 1998 and \$15 million in FY 1999. Because the system deficiencies remained uncorrected, DCAA issued separate CAS noncompliance reports on Newport News and Dry Dock Company and Naptheon, Incorporated, a subsidiary with the same deficiency.
  - A November 25, 1997, report issued to SUPSHIP Groton on the Electric Boat Corporation initially cited the contractor with partial noncompliance with a material management and accounting system standard because the contractor refused to provide the ACO with its internal audit results. The ACO did not adequately document when the audit was resolved prior to its disposition, but the ACO discussed options for corrective action with DCAA and the contractor. On November 3, 2000, DCAA provided the ACO with a cost impact of \$381,000 for that deficiency. In June 2002, a followup report restated the same deficiency.

The ACOs at SUPSHIP Newport News and Groton did not withhold payments to the contractors in those two cases, as of the date of our site visit to SUPSHIPs NNS and Groton on August 12, 2002 and November 12, 2002, respectively. The failure to correct financial system deficiencies forces the auditors to expend additional efforts by reporting restated deficiencies. Correcting the deficiencies ensures that a contractor's financial system can be relied on by the Government and the contractor.

**Corrective Actions for CAS Noncompliances.** We reviewed 13 reports on contractor CAS noncompliance—11 of which were overage by up to 32 months. FAR Subpart 30.6, "CAS Administration," provides procedures for timely resolution and disposition of CAS noncompliances. When the contractor does not submit an accounting change description, a general dollar magnitude of the

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change, or a cost impact proposal, as required, the ACO, with assistance from the auditor, shall estimate the general dollar magnitude of the cost impact on CAS-covered contracts and subcontracts. The ACO may then withhold up to 10 percent of the amount billed by the contractor on progress payments or public vouchers until the submission is furnished. The ACO may disposition the noncompliance report after receipt of the submission. None of the 11 overage reports had withholding provisions applied to them.

## **Reporting the Original Date of a System Deficiency**

The ACO may disposition an audit report citing accounting or management system deficiencies when the auditors issue a followup audit report on the same system. However, if the followup report states that the same deficiency exists, DoD Directive 7640.2 requires the agency to track the date the deficiency was originally reported in its CAFU system until the deficiency is corrected. Unless the original report date is provided, the same deficiency may appear to be a new finding each time a followup report is issued, thus masking how long the deficiency has remained uncorrected. However, the original report is considered closed and the measure of timeliness begins over with the followup report.

**Navy Tracking Procedures.** The Navy did not track original report dates because it used an outdated 1993 data input model for collecting and reporting semiannual CAFU information. The model did not include the requirement to record original report dates. That requirement was established in the August 16, 1995, revision of DoD Directive 7640.2. Therefore, the delays in settling some of the NAVSEA system deficiencies exceed the delays shown in Table 1 for reports on financial systems. Tracking the date a finding is originally reported is essential in order to ensure that management and other oversight activities have visibility of long-standing, uncorrected issues that require increased efforts to achieve corrective action.

The Defense Contract Management Agency is developing a DoD-wide CAFU data system that will be available to all Military Departments and DoD Agencies with CAFU responsibilities. The new system, once implemented, will comply with DoD Directive 7640.2 reporting requirements and should enhance the accuracy, completeness, consistency, and sharing of information. The Navy is participating in the development of the new data system to ensure that it will meet the Navy's CAFU requirements.

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## **Management Controls Related to the CAFU Function**

We interviewed officials at the NAVSEA Headquarters and the four SUPSHIP contracting offices we visited to determine what management control procedures were in place and whether management had reviewed compliance with those procedures periodically. The SUPSHIP offices at Bath and Groton performed internal oversight reviews of the CAFU function. SUPSHIP New Orleans did not specifically identify CAFU as a separate functional area within their overall contracting function and SUPSHIP NNS did not test to determine whether contracting officers followed CAFU policies and procedures.

When the CAFU function is identified as an assessable function within an activity and reviewed as part of the overall Management Control Program, the resolution and disposition of audit issues is more visible, trackable, and therefore more of a priority. An example of the priority of the CAFU function was demonstrated at SUPSHIP Bath. The ACO at SUPSHIP Bath was pro-active in settling audit reports by having bi-weekly meetings with contractor representatives and DCAA resident auditors to resolve issues on ongoing and open audits. The ACO is a member of a joint integrated process team at SUPSHIP Bath and attends DCAA entrance and exit conferences. The ACO also communicates regularly with other SUPSHIP contracting officers and NAVSEA headquarters officials on CAFU issues.

The Deputy Assistant Secretary of the Navy, Acquisition & Business Management Office has oversight responsibility for the CAFU program. That office last reported on the CAFU program in "Procurement Performance Management Assessment Program of NAVSEA," July 23, 1998, which concluded that the program was well managed. The report stated that the NAVSEA program for tracking contract audits allowed visibility of aged audits and alerted contracting officers for possible followup. It did not test whether contracting officers actually used the program.

To facilitate management oversight of followup issues that require attention and to improve the accuracy of CAFU data in semiannual reports to Congress, the Deputy Assistant Secretary of the Navy, Acquisition & Business Management Office should include the CAFU function as a special interest item in its "FY 2004 Procurement Performance Management Assessment." The assessment should include control tests of the performance of contracting officers and other personnel responsible for the proper implementation of contract audit followup policies and procedures and include the audit followup area as an area of special interest in the future procurement management review program.

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## Summary

Contracting officials need to be more aggressive in resolving and dispositioning audit reports. The difference between when resolution and disposition occurs needs to be understood, implemented, and reported properly for all types of reportable audits. Long-standing deficiencies need to be identified and assessed from the time of their original reporting to determine if withholding of payments to contractors should be used to achieve corrective action.

## Navy Comments on the Finding and Audit Policy and Oversight Response

Summaries of Navy comments on the finding and the Audit Policy and Oversight (APO) response are in Appendix C.

## Recommendations, Navy Comments, and APO Response

**Deleted and Renumbered Recommendations.** As a result of management comments, we deleted draft Recommendation A.2. and renumbered draft Recommendation A.3. as A.2. We recommended in draft Recommendation A.2. that NAVSEA establish performance measures for the timely resolution and disposition of reportable contract audit reports. The need to establish performance measures will be assessed as part of NAVSEA's FY 2004 Procurement Management Review Program.

**A. We recommend that the Commander for Contracts, Naval Sea Systems Command:**

**1. Instruct administrative contracting officers and their staff at Supervisor of Shipbuilding, Conversion, and Repair offices to:**

**a. Properly identify, document, and report the resolution of financial system and incurred cost audit reports.**

**Navy Comments.** NAVSEA partially concurred, stating that sufficient guidance on the resolution of financial system and incurred cost audit reports already exists. The NAVSEA Contracts Directorate will review existing resolution procedures with its SUPSHIPs by July 30, 2004.

**APO Response.** We consider NAVSEA's actions to review resolution procedures with its SUPSHIPs as meeting the intent of our recommendation.

**b. Withhold payments to contractors on overage audits to encourage contractor correction of accounting and management system internal control deficiencies in accordance with Defense Federal Acquisition**

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**Regulation Supplement Subpart 242.7503, “Procedures,” Federal Acquisition Regulation Subpart 32.503-6, “Suspension or Reduction of Payments,” and Federal Acquisition Regulation Subpart 30.6, “CAS Administration,” for noncompliances with the cost accounting standards, or document reasons why withholding is not appropriate.**

**Navy Comments.** NAVSEA partially concurred. NAVSEA stated that the decision to withhold payments on overage audits is a business decision and each circumstance must be reviewed and judged on its own merits and not against a formulaic or automatic approach. Contractors are allowed a reasonable amount of time to respond to audit findings, and the ACO is obligated to provide DCAA the opportunity to perform a followup audit. ACOs have wide latitude to execute their duties and responsibilities in this area once they have fully assessed the impact and appropriateness of the actions and all parties have had the opportunity to respond. SUPSHIP ACOs withhold amounts as prudent.

**APO Response.** The NAVSEA comments are nonresponsive. We agree that ACOs should implement withholding only after fully assessing the circumstances of each audit, allowing contractors a reasonable time to respond to audit findings, and consulting with other parties as necessary. However, we believe that 12 months is a reasonable period to disposition financial system and CAS reports, rather than 12 months plus delays of up to 69 and 32 months, respectively, as shown in Table 1 for these types of audits.

The regulations cited in this recommendation provide the ACO with the discretion on whether to use withholding. However, we disagree that the SUPSHIP ACOs have withheld amounts as appropriate on the overage financial system and CAS audits in our sample. Except for the SUPSHIP Groton example cited in the report, we found no evidence that any of the SUPSHIP ACOs were assessing whether withholding was appropriate, documenting their determination, or actually using withholding on overage reports. We also identified many financial system and CAS reports in which the time allowed to the contractor by the ACO to adequately respond to audit findings had substantially exceeded regulatory timeframes.

We also disagree that the ACO is obligated to provide DCAA the opportunity to perform a followup audit before closing the prior audit. ACOs must close an audit when it meets the disposition requirements of DoD Directive 7640.2. For example, financial system audits can be closed when the contractor either implements, or agrees to implement, corrective action. The ACO may request a followup audit if the original audit was not timely dispositioned or to evaluate implementation of the contractor’s corrective action. We request NAVSEA reconsider their comments in responding to the final report.

**c. Track and report the date an audit report first identifies an accounting and management system deficiency that is restated in a followon report in accordance with DoD Directive 7640.2, paragraph 6.3.4.1, “Policy for Followup on Contract Audit Reports.”**

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**Navy Comments.** NAVSEA partially concurred. The Navy CAFU report program is the responsibility of the Deputy Assistant Secretary of the Navy (Acquisition Management) (DASN (ACQ)). Since NAVSEA cannot modify the tracking and reporting mechanism of this program, NAVSEA suggested that the recommendation be redirected to the DASN (ACQ). The DASN (ACQ) stated that it would begin to adjust the dates of supplemental audits to those of the original audits.

**APO Response.** We request that the DASN (ACQ) and NAVSEA reconsider their comments in responding to the final report because the current Navy CAFU report program can accommodate the tracking of original report dates. Neither DASN (ACQ) nor NAVSEA should adjust the report dates of supplemental reports to those of the original audits. The report date of each supplemental report is a critical field and must be accurately maintained. NAVSEA should instead begin tracking the original issue date using either the Remarks or Narrative fields for each report until the Navy is fully participating in the new CAFU system.

**d. Prepare an action plan for the timely and proper resolution and disposition for each audit report addressed in this report and that is still open.**

**Navy Comments.** NAVSEA partially concurred, stating that NAVSEAINST 7640.2 already includes a requirement to maintain a milestone schedule of all reportable audits. ACOs identify and report these milestones for each open audit in their CAFU reports.

**APO Response.** The NAVSEA comments are not responsive. As of March 31, 2004, 26 sampled audit reports with total costs questioned of \$163 million were still open. These reports were issued between July 1999 and March 2002. Each of these overage reports requires an aggressive action plan to expedite resolution and disposition. Each plan must include the ACO's determination on whether withholding or notification of intent to disallow costs should be used. We request that NAVSEA reconsider its position on the recommendation and provide comments on the final report.

**2. Include the contract audit followup function as an area of special interest in "FY 2004 Procurement Management Review Program."**

**Navy Comments.** NAVSEA concurred.

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## **B. Collection of Penalties on Unallowable Costs**

Although required by Title 10, United States Code, Section 2324(b), “Penalty for Violation of Cost Principle,” ACOs at three SUPSHIP offices did not appropriately assess penalties or justify waivers of penalties for expressly unallowable costs. Eleven of 14 audits had penalties recommended but penalties were not assessed. The ACOs improperly waived penalties and interest on expressly unallowable costs in excess of \$5.6 million.

### **Requirements for Assessing Penalties**

In 10 U.S.C. 2324(b), it is stipulated that a penalty shall be assessed if a contractor submits costs that are expressly unallowable according to the FAR in a proposal for settlement of indirect costs. The penalty shall be equal to the amount disallowed and allocated to contracts covered by the provision, including interest. The contracting officer may apply double penalties if a contractor submits the same type of unallowable costs in subsequent overhead claims. The head of an agency may issue a waiver from penalties if one of three conditions exists:

1. The contractor withdraws the proposal before the formal initiation of an audit and resubmits a new proposal;
2. The contractor demonstrates, to the satisfaction of the ACO, that it has established appropriate policies that preclude unallowable costs subject to penalties from being included in indirect cost proposals; or
3. The ACO is satisfied that the unallowable costs subject to penalties were inadvertently incorporated into the proposal.

The FAR Subpart 42.7, “Indirect Cost Rates,” implements 10 U.S.C. 2324(a) through (d) and covers the assessment of penalties against contractors that include unallowable costs in final indirect cost rate proposals. If unallowable costs exceed \$10,000, the cognizant contracting officer shall issue a final decision, including a demand for payment of any penalty assessed unless a waiver is obtained in accordance with the regulations. The contracting officer’s final decision to the contractor shall state that the determination is a final decision under the Disputes clause of the contract. It is not necessary for unallowable costs to have been paid to the contractor in order to assess the penalty, and

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demanding payment of the penalty is separate from demanding repayment of any paid portion of the disallowed costs.

## **Assessment of Penalties**

The SUPSHIP ACOs did not enforce the statute to apply penalties on expressly unallowable costs.

**SUPSHIP New Orleans.** The ACO waived penalties and interest of more than \$1.7 million for expressly unallowable depreciation costs. The DCAA reports for FY 1996 through FY 1999 questioned the excess depreciation and recommended penalties and interest. The ACO received legal advice that supported the audit position. The BCM documenting the settlement showed that the ACO had calculated the penalty and interest applicable to the expressly unallowable depreciation costs (\$476,605) for FY 1997 through FY 1999, but the ACO used the following factors in deciding not to assess the penalties and interest:

- Since January 1998, the contractor had asserted disagreement with the DCAA interpretation of the FAR;
- An ASBCA case was open on a similar case (Kearfott Guidance and Navigation Corporation versus Donald H. Rumsfeld, Secretary of Defense) from March 1998 until June 29, 2001; and
- Litigation costs would probably exceed \$476,605.

For FY 1996, which was the first year that penalties could be applied, the ACO did not address the \$1,208,503 that DCAA recommended for penalties and interest.

**Justification for Waiver.** Although the BCM explained why the ACO had waived penalties, the explanations did not address specific conditions under which a waiver may be granted according to the statute.

We do not consider the reasons listed to be appropriate. The ASBCA case mentioned was decided prior to the May 2003 settlement. In that case, Kearfott Guidance and Navigation Corporation versus Donald H. Rumsfeld, Secretary of Defense, No. 02-1039, the U.S. Court of Appeals Federal Circuit ruled on February 25, 2003, that the Government had properly applied the FAR cost principle when disallowing the increased depreciation costs resulting from asset write-ups. Although the SUPSHIP New Orleans BCM cited the decisions by the Court of Appeals and the ASBCA, the memorandum did not explain why the case would not uphold the assessment of penalties because the case was decided in favor of the Government.

The consideration of litigation costs was also inappropriate. NAVSEA legal council had previously advised that penalties were appropriate. The memorandum recommended that penalties be imposed in amounts calculated by DCAA and that a demand letter be issued to the contractor. The litigation costs should not have been considered because of the legal position and because the court decision supported the auditor recommendation.

None of the reasons the ACO used for waiving the penalties were in accordance with the statute—that the contractor withdraws the proposal before formal initiation, that the contractor demonstrates it has established policies that preclude unallowable costs in proposals, or that the ACO is satisfied that unallowable costs were inadvertently incorporated into the proposal.

**SUPSHIP NNS.** At SUPSHIP NNS, the BCMs for five audit reports did not adequately explain the negotiated treatment of expressly unallowable costs and the audit recommendations of penalties related to those costs. The BCMs that settled FY 1994 through FY 1997 contractor overhead expenses closed four reports covering NNS Shipbuilding & Dry Dock Company and one report on its home office, the Tenneco Corporation. The expressly unallowable costs for NNS Shipbuilding & Dry Dock Company for the four FYs totaled approximately \$3.9 million, as shown in Table 2. A breakdown of those costs is listed in Appendix B. Those cost elements were identified by the SUPSHIP office as unallowable costs subject to penalties in FY 1996 and FY 1997.

<b><u>FY 1994</u></b>	<b><u>FY 1995</u></b>	<b><u>FY 1996</u></b>	<b><u>FY 1997</u></b>	<b><u>Total</u></b>
\$75,596	\$274,986	\$1,657,592	\$1,888,100	\$3,896,274

**Assessment of Penalties.** The BCMs for FY 1994 through FY 1996 included the general statement that costs questioned had been sustained and had been settled 50-50 as part of a lump sum amount, which was considered immaterial and which represented contractor unintentional errors. The memorandum explained that the penalties were waived due to the difficulties in negotiating old contractor overhead expenses with the contractor and the need to expedite the closeout of old contracts. Although the FY 1997 BCM, which was completed in August 2003, included explanations on expressly unallowable costs, the BCM did not adequately explain the waiver of penalties.

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We do not believe a determination to waive penalties should be made when the contractor has long-standing uncorrected deficiencies for incomplete submissions and inadequate policies and procedures in the accounting system.

**Documentation Requirements.** FAR Subpart 42.705-1, “Contracting Officer Determination Procedure,” requires the contracting officer to prepare a BCM covering:

- the disposition of significant matters in the advisory audit report,
- reconciliation of all costs questioned with identification of items and amounts allowed or disallowed in the final settlement,
- reasons why any recommendations of the auditor or other Government advisors were not followed, and
- identification of cost or pricing data submitted during the negotiations and relied upon in reaching a settlement.

The ACO failed to properly address the audit recommendations for expressly unallowable costs and the assessment of penalties and interest. The contracting officer should also have notified the contractor of the individual costs that were considered unallowable and the respective amounts of the disallowance. FAR Subpart 42.801, “Notice of Intent to Disallow Costs,” states that the contracting officer may issue the notice as early as possible during the monitoring of contractor costs related to cost-type and flexibly priced contracts. Early notice to the contractor provides for timely resolution of any resulting disagreement.

The failure of the SUPSHIP NNS ACO to collect penalties on expressly unallowable costs has been previously reported. In our report, IG DoD Report No. PO 97-056 “Defense Hotline Allegations Concerning Contract Audit Recommendations,” September 29, 1997, we stated that an ACO had no justification to waive \$7.8 million in penalties that DCAA recommended he assess on unallowable costs included by NNS in its FY 1989 and FY 1990 incurred costs submissions. We recommended that SUPSHIP NNS contracting officials receive training in negotiation principles and procedures. NAVSEA concurred.

**SUPSHIP Groton.** The ACO did not adequately explain a waiver of recommended penalties on unallowable costs of \$18,105 in its FY 1995 BCM. According to FAR Subpart 42.801, if unallowable costs exceed \$10,000, the cognizant contracting officer shall issue a final decision, including a demand for

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payment of any penalties assessed, unless waived. There was no documentation for waiving the penalty. By not addressing the cost, future overhead submissions containing the same expressly unallowable costs cannot result in double penalties.

**Summary.** The failure by the ACO to properly assess contractor penalties resulted in the Government losing more than \$5.6 million. That failure also precluded the Government from applying double penalties to future incurred cost submissions that contained the same unallowable costs because the ACO had not put the contractor on notice for those costs. 10 U.S.C. 2324(b) was enacted to make contractors diligent in excluding expressly unallowable costs. Contractors may continue to claim expressly unallowable costs until the ACOs adhere to the statute for assessing penalties. The ACOs should notify the contractors that previously claimed unallowable costs would not be accepted in future submissions and that penalties will be applied if included.

## **Navy Comments on the Finding and APO Response**

Summaries of Navy comments on the finding and the APO response are in Appendix C.

## **Recommendation, Navy Comments, and APO Response**

**B. We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officers to:**

**1. Enforce the requirements of Title 10, United States Code, Section 2324(b), “Penalty for Violation of Cost Principle,” for assessing penalties and interest on unallowable costs. If waivers are granted, they should be documented to reflect compliance with 10 U.S.C. paragraph 2324(c) as implemented by Federal Acquisition Regulation Part 42.709-5, “Waiver of the Penalty.”**

**Navy Comments.** NAVSEA partially concurred. The Contracts Directorate will review issued guidance with the SUPSHIPS concerning the requirements for assessing penalties and interest on unallowable cost and properly documenting the file. The estimated completion for this is 30 July 2004.

**APO Response.** NAVSEA comments and planned actions meet the intent of the recommendation.

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**2. Comply with Federal Acquisition Regulation Part 42.705-1, “Contracting Officer Determination Procedure,” on documenting determinations concerning costs questioned and auditor-recommended penalties in order to ensure the consistent application of cost principles and cost accounting standards.**

**Navy Comments.** NAVSEA concurred. The Contracts Directorate will remind NAVSEA ACOs to ensure files and business clearance memoranda contain adequate documentation regarding the ACO determinations concerning costs questioned and auditor recommended penalties. Estimated completion date is July 30, 2004.

**3. Issue a notice of intent to disallow costs on expressly unallowable costs previously claimed in proposals in accordance with Federal Acquisition Regulation Part 42.801, “Notice of Intent to Disallow Cost.”**

**Navy Comments.** NAVSEA partially concurred. NAVSEA stated that ACOs have broad discretion in determining and interpreting FAR and DFARS regulations. Mere allegation of unallowable costs should not result in an automatic notice to disallow such costs. DCAA initial findings may not be accurate and are revised upon rebuttal by the contractor or the ACO. Such discretion should be permitted for the ACO to exercise the authority delegated. However, NAVSEA will issue guidance to remind NAVSEA ACOs of the guidance regarding the determination of notices to disallow costs to contractors on unallowable costs by July 30, 2004.

**APO Response.** We agree that ACOs have broad discretion in applying the regulations applicable to unallowable costs after fully assessing the circumstances of each audit. However, the statute specifically lists the expressly unallowable costs that should not be claimed by the contractor.

We concur with NAVSEA’s plans to issue guidance on the responsibilities of NAVSEA ACOs to use notices of intent to disallow costs to contractors. However, we believe that the SUPSHIP NNS ACO must issue a notice to Newport News Shipbuilding & Dry Dock Company of his intent to disallow previously claimed expressly unallowable costs if included in subsequent claims. We believe the notice is required due to the significant amounts of expressly unallowable costs included in prior year submissions by Newport News Shipbuilding & Dry Dock Company as well as the SUPSHIP NNS ACO’s failure to assess penalties in all instances. Although the SUPSHIP NNS ACO is currently pursuing assessment of penalties as part of its FY 1998 incurred cost settlement, the notice is needed to encourage prompt corrective action by Newport News Shipbuilding & Dry Dock Company and reduce the risk of future disputes. We request NAVSEA and SUPSHIP NNS reconsider their comments in responding to the final report.

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## C. Accuracy of Contract Audit Followup Information

The Navy's semiannual reports for the periods ending September 30, 2001, and March 31, 2002, contained incorrect costs questioned amounts for 29 of 45 NAVSEA incurred cost audits, excluded 8 reportable audits that should have been included, and included 13 nonreportable audits. Incorrect costs questioned and improperly reported data resulted from contracting officials:

- relying on DCAA adjusted amounts instead of verifying the costs questioned amounts with the audit reports, and
- failing to understand the reporting requirements of DoD Directive 7640.2 by including amounts for corporate allocations not under their cognizance, by failing to adjust costs questioned based on supplemental audit reports, and by incorrectly identifying reportable audits.

The lack of adequate management controls resulted in significant errors in the data in the NAVSEA followup system. Therefore, Congress and the Navy do not have accurate data to determine whether audit findings are sustained.

### Reporting of Questioned Incurred Costs

The DoD Directive 7640.2, "Contract Audit Followup," defines incurred cost audits that have \$100,000 or more in costs questioned as reportable. Costs questioned are the total amount questioned in the audit report, regardless of contract mix or percentage of commercial business that the reporting contracting official has responsibility and authority to disposition.

DCAA audit reports generally contain an exhibit that shows the costs questioned. DCAA also provides contracting officials with a monthly electronic transmission of reports issued during the month that includes the amount of costs questioned for each report. Although DCAA provides the information, the contracting official is responsible for determining the amount that is reported in the CAFU system.

**Costs Questioned Understated in the Followup System.** Four of the five SUPSHIP offices recorded incorrect costs questioned for 29 of 45 incurred cost

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audit reports reviewed. Two of the four offices, NNS and New Orleans, relied on incorrect costs questioned data obtained from the auditors, which was incorrectly recorded in the Navy followup system. At SUPSHIP New Orleans, 15 audit reports understated costs questioned by \$11.5 million (36 percent) because the contracting officials incorrectly relied on the auditor's adjusted costs questioned for Government participation<sup>3</sup>. At SUPSHIP NNS, the contracting officials understated costs questioned for six audit reports by approximately \$20 million<sup>4</sup> (29 percent) because the contracting officials used the costs questioned provided by DCAA, which had been reduced for government participation and adjusted for negotiation results and other improper exclusions.

Although the costs questioned submitted to SUPSHIPS Bath and Groton were not reduced for Government participation, those offices also had incorrect amounts in the followup system. SUPSHIP Bath included costs questioned from corporate audit reports, which resulted in overstated costs questioned. An audit report on divisional overhead may include the results of a corporate audit; however, each divisional or corporate ACO should only track and report the amount questioned that he or she is responsible for negotiating at the division or corporate level. SUPSHIP Groton did not recognize the costs questioned in five reports, thus incorrectly reporting questioned costs.

**DCAA Guidance on Reportable Costs Questioned.** The DCAA Management Information Systems Manual correctly described the procedures for reporting costs in accordance with the DoD Directive for contract audit followup purposes. However, the two field audit offices that adjusted costs questioned for Government participation followed separate guidance for internal reporting purposes. The worksheet used for internal reporting was incorrectly used for DoD Directive 7640.2 reporting. We discussed the discrepancies that resulted from the two sets of instructions with DCAA headquarters management. They agreed that audit guidance needed clarification.

## Compilation of Reportable Audits

We found 13 audits included in the Navy's semiannual reports by the five SUPSHIPS that did not meet the criteria for being reported, as well as eight reportable audits excluded from these semiannual reports, which should have been included. Each SUPSHIP incorrectly reported at least 1 of the 13 audits that did not meet the DoD Directive 7640.2 definition of a reportable audit. The Directive requires that reportable audits fall within one of several specified

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<sup>3</sup> Government participation means the costs questioned applies only to Government cost-type and fixed-price incentive contracts.

<sup>4</sup> This is SUPSHIP NNS data which has not been verified. Our initial assessment was approximately \$83 million.

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categories and contain findings and recommendations that require followup. Three of the 13 nonreportable audits represented data errors that neither SUPSHIP nor DCAA officials could explain. The remaining 10 reports did not include findings and recommendations that required followup.

The eight omitted reports were addressed to SUPSHIP New Orleans and covered open incurred cost audits for FY 1992 through FY 1996 with total costs questioned of \$7.4 million. SUPSHIP CAFU officials require an increased awareness of the requirements for accurately determining audits that are reportable under the Directive.

The Defense Contract Management Agency is developing a web-based CAFU system that may be of benefit to the Navy. The new system should help eliminate those types of errors. The system will be available for use by all Military Departments and DoD Agencies with CAFU responsibilities. The system will accept direct downloads from the DCAA information system of contract audit report numbers and sufficient information to enable contracting officers to process reportable audits. The system will incorporate edit checks and required data entry fields to minimize errors.

## **Navy Comments on the Finding and APO Response**

Summaries of Navy comments on the finding and the APO response are in Appendix C.

## **Recommendations, Navy Comments, and APO Response**

**C.1. We recommend that the Commander for Contracts, Naval Sea Systems Command, improve management controls at SUPSHIPS by enforcing the reporting requirements in DoD Directive 7640.2, “Policy for Followup on Contract Audit Reports,” and by requiring that data received by contracting officials be verified against the DCAA audit report.**

**Navy Comments.** NAVSEA partially concurred. Upon receipt of contract audit reports, the ACO identifies any discrepancies in the “Internal Remarks” portion of the Audit Information Form in the quarterly updates. This form is part of the Navy’s automated reporting system that ACOs are required to use for the CAFU program. As part of implementing Recommendation A.2, NAVSEA will review the CAFU management control process.

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**APO Response.** The NAVSEA comments are nonresponsive. Using the Navy's semiannual reports for the periods ending September 30, 2001 through September 30, 2003, we re-examined the information in both the Internal Remarks and Narrative fields for each of the 29 incurred cost audits with discrepancies in reported costs questioned. Although some of the 29 records contained limited information on adjustments to costs questioned, none of the records had sufficient information to resolve the discrepancies we identified.

We have no objection to using the Internal Remarks or Narrative fields to provide information on costs questioned adjustments. However, including explanations in these fields without adjustment of the costs questioned field is not adequate. That field must be kept accurate so costs questioned information can be readily summarized for oversight purposes including OIG DoD semiannual reporting. ACOs need to be instructed on the requirement to keep the costs questioned field accurate.

We request that NAVSEA reconsider its position on the recommendation and provide comments on the final report.

**C.2. We recommend that the Director, Defense Contract Audit Agency, clarify the need for accurate reporting of incurred costs questioned in audit reports.**

**DCAA Comments.** DCAA concurred, stating that they clarified the definition of costs questioned in their internal management information system, and would issue guidance to emphasize the accurate reporting of costs questioned using the web-based CAFU system.

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## Appendix A. Scope and Methodology

We evaluated the accuracy of the data in the NAVSEA semiannual reports prepared to comply with the DoD Directive 7640.2 and reviewed NAVSEA policies and procedures that implement the Directive. We interviewed managers at NAVSEA (Resources & Contract Policy Division) headquarters and contracting officials and audit managers at SUPSHIP locations in Newport News, VA; New Orleans, LA; Groton, CT; and Bath, ME. In addition, we performed desk reviews of reportable audits received from SUPSHIP San Diego, CA. At all of the above locations we:

- determined whether audit reports were resolved and dispositioned in a timely manner by reviewing their chronology of events and ascertaining whether the resolution and disposition dates fell within the prescribed guidelines—6 months for resolution and 12 months for disposition. We identified the reasons for any delays and determined whether the delays were justified. For open reports, we evaluated the written plan of action to determine if it was reasonable.
- evaluated the proper settlement of each closed reportable audit by examining whether settlement documentation was generally prepared in accordance with regulations and whether contracting officials addressed all significant audit recommendations, provided a rationale for not sustaining any costs questioned, and collected applicable penalties. We looked for management oversight through review boards or other means.
- assessed the accuracy of NAVSEA data within the Navy's semiannual reports to the Office of the Inspector General of the Department of Defense by comparing the semiannual report information to the data in the DCAA monthly reports and SUPSHIP official file documentation and by making inquiries to SUPSHIP and DCAA officials.

We performed this review from July 2002 through November 2003 in accordance with Office of the Inspector General policies and procedures.

**Use of Computer-Processed Data.** The Navy maintains a Navy-wide computer program for processing contract followup information, which we relied on. We also relied on computer-based data from the DCAA Management Information System to identify reportable audits sent to NAVSEA for resolution and disposition. Although we did not perform a formal reliability assessment of the computer-processed data from either system, we did determine that the

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assignment numbers, costs questioned, and other relevant data for the selected audit reports generally agreed with the computer-processed data. We did not find errors that would preclude the use of the data to meet the audit objectives or that would change our report conclusions.

We consolidated information from two NAVSEA semiannual reports for the periods ending September 30, 2001, and March 31, 2002, to select a sample for evaluating the resolution and disposition of audit reports. The process yielded a universe of 201 audits with total costs questioned of \$864 million, including 140 audits at the following five SUPSHIP locations:

- 26 audits at Bath, Maine;
- 33 audits at Groton, Connecticut;
- 41 audits at Newport News, Virginia;
- 33 audits at New Orleans, Louisiana; and
- 7 audits at San Diego, California.

We visited each location except San Diego and reviewed file documentation for 125 of the 140 audit reports selected. We excluded the remaining 15 reports because they were either erroneously included in the CAFU system or involved in litigation.

## **Prior Coverage**

During the last 5 years, the Inspector General of the Department of Defense (IG DoD) has issued 4 reports related to the Contract Audit Followup process.

IG DoD Report No. D-2002-6-009, "The Army Contract Audit Followup Process," September 18, 2002

IG DoD Report No. 00-003, "The Air Force Contract Audit Followup System," October 4, 1999

IG DoD Report No. 99-057, "Settlement of Contractor Incurred Indirect Cost Audits," December 21, 1998

IG DoD Report No. 99-048, "Dispositioned Defective Pricing Reports at the Naval Air Systems Command," December 8, 1998

## Appendix B. Expressly Unallowable Costs Claimed by NNS

<u>Unallowable Cost Element</u>	<u>FY 1996</u>	<u>FY 1997</u>	<u>FAR Clause</u>
Back Pay	\$399,212	\$27,501	31.205-6
Below Market Rate Loans	0	44,296	31.205-35
Bonus Signing	66,811	145,328	31.205-6
Consultants	0	488,065	31.205-27, 47
Contributions	0	3,000	31.205-8
Excess Compensation	17,072	70,665	31.205-6, 35
Idle Assets	0	302,792	31.205-17
Leased Property	0	58,877	31-205-22
Lobbying Costs	47,095	171,644	31.205-22
Lost Discounts	98,991	40,679	31.205-26
Patents and Trademarks	246,783	73,344	31.205-30
Promotional Material	430,901	0	31.205-1
Public Relations	240,836	181,147	31.205-1,13, 22, 14, 51
Recruiting and Relocation	0	110,209	31.205-20, 35
Spousal Travel	15,312	15,288	31.205-46
Stock Appreciation Rights	94,301	31,075	31.205-6
Stock Dividends/Incentives	<u>278</u>	<u>124,190</u>	31.205-6
<b>Total</b>	<b>\$1,657,592</b>	<b>\$1,888,100</b>	

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## Appendix C. Summary of Navy Comments on the Findings and Audit Policy and Oversight Response

The Deputy Assistant Secretary of the Navy (Acquisition Management) submitted overall comments, and the Naval Sea Systems Command submitted comments directed to the specific recommendations. The comments included detailed responses from all SUPSHIPs in our sample except SUPSHIP San Diego. The following are the synopsised SUPSHIP comments to each finding and Audit Policy and Oversight response.

### **Finding A. Timeliness of Resolution and Disposition of Audit Reports**

**Resolution.** SUPSHIPs NNS and Gulf Coast stated that their CAFU officials understood the difference between resolution and disposition of audit reports. SUPSHIP NNS also stated that the errors in its CAFU reports did not contribute to the delays in settling its financial system audit reports. In addition, SUPSHIPs NNS and Gulf Coast believe that the primary causes for delays in resolving and dispositioning audit reports included staff shortages, personnel turnover, higher priority efforts, and a recalcitrant contractor.

**APO Response.** We disagree that SUPSHIP NNS and Gulf Coast CAFU officials understood resolution and accurately reported it. If the CAFU officials understood the difference between resolution and disposition, they were not using that understanding correctly. We identified errors in the reported resolution status of several SUPSHIP NNS audits and helped its CAFU officials make the required changes. The SUPSHIP New Orleans ACO had suspended action on three of its financial system audits, but had not documented and reported this position. Resolution of audit reports is not complete until the ACO documents a position on the audit findings. Navy contract management officials cannot effectively assist with the settlement of audits when reported resolution information is not correct and complete.

We recognize that staff shortages, personnel turnover, etc. can contribute to delays in resolving and dispositioning audit reports. However, prompt settlement of audit findings can result in the recovery of significant acquisition funds that could be put to better use. Navy contract management officials can mitigate these adverse conditions in several ways. Examples include increased:

- involvement by DCAA auditors through the timely briefing of audit findings, explanation of applicable regulations, and full participation at negotiations.
- use of withholds or notices of intent to disallow costs would minimize repeated reporting of similar audit findings and reduce the number and complexity of DCAA reports.

**Resolution and Disposition Delays.** SUPSHIPs Bath and NNS took exception to the resolution and disposition delays for their audits as depicted in Table 1.

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SUPSHIP Bath could not verify the delays with its records. SUPSHIP NNS could not reconcile the information with its March 31, 2003 CAFU report.

**APO Response.** We provided officials at both SUPSHIPS with calculations supporting the Table 1 delays, and with one exception, they concurred. SUPSHIP Bath identified an incorrect resolution date for one operations audit and we corrected Table 1 and the related finding narrative.

**Management Controls.** SUPSHIP NNS disagreed that they did not identify the CAFU function as a separate functional area or test to determine if ACOs followed CAFU policies and procedures. This area was reviewed and self-certified during June 2003. SUPSHIP New Orleans disagreed with our assessment and believes DoD Directive 7640.2 does not require the establishment of a designated CAFU official at a field contracting activity. Additionally, the July 1999 edition of the SUPSHIP Operations Manual does not identify a specific requirement for a CAFU official.

**APO Response.** Although we agree that SUPSHIP NNS did identify the CAFU function as a functional area, we found no evidence of any testing. At the time of our review, SUPSHIP NNS had been cited in the July 22, 2002 Management Control Certification Statement with a material weakness because they had no Management Control Program Coordinator.

Although SUPSHIP Gulf Coast stated there was no requirement to establish a CAFU official, they have now designated a responsible CAFU official, giving the CAFU function more visibility.

### **Finding B. Collection of Penalties on Unallowable Costs**

**Penalty Assessments.** SUPSHIP Gulf Coast disagreed with the assessment that their ACO did not comply with the statutory and FAR requirements by failing to assess penalties for expressly unallowable costs. Penalties were not assessed because the ACO concluded that either the questioned costs were not expressly unallowable or if expressly unallowable, the contractor met the conditions necessary to obtain a waiver of penalties. The contractor agreed with the DCAA conclusion that the questioned costs were unallowable. The ACO determined that the overhead submission had been made on the basis of a good faith belief that the costs were recoverable.

SUPSHIP Groton stated that the DCAA report incorrectly recommended penalties associated with the calculation of the 1995 tax base for the contractor. The contractor's automated system identified incorrect amounts for warehouse material charged on contracts. SUPSHIP Groton's post negotiation memorandum stated that the Government had determined that those costs were not subject to the penalty provisions of the FAR and DFARS.

**APO Response.** We disagree with the SUPSHIP Gulf Coast comments because they do not reflect the requirements in the statute. If the ACO did not consider these costs expressly unallowable, why wait years to obtain the ASBCA rulings before settling the costs? The SUPSHIP response states that the

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contractor made the submission on the basis of a good faith belief that the overhead costs were recoverable and this fact in conjunction with a belief that the costs might not be considered expressly unallowable led the ACO to conclude that waiving the penalties was appropriate. In addition to the audit opinion, the ACO had legal counsel from inception agreeing that these costs were unallowable. The statute does not include the ACO's basis as a condition to waive penalties.

The SUPSHIP Groton negotiation memorandum stated only that the \$18,105 was not subject to penalties under the DFARS 231.7002 and FAR 42.709. The costs questioned of \$18,105 was completely sustained by the negotiator. As stated in our report, there was no explanation for why a cost that was questioned as expressly unallowable and completely sustained did not also result in a penalty assessment. The negotiation memorandum did not contain the explicit explanation included by SUPSHIP Groton above to explain the basis for waiving the penalty.

### **Finding C. Accuracy of Contract Audit Followup Information**

**Reported Costs Questioned.** SUPSHIPs Bath, NNS and Gulf Coast took exception to our conclusions on the inaccuracy of their reported costs questioned. SUPSHIP Bath believed its amounts were reported correctly. SUPSHIP NNS stated that it does not use costs questioned data from DCAA auditors to prepare its CAFU reports. SUPSHIP Gulf Coast stated that SUPSHIP New Orleans relied on costs questioned information from the DCAA auditors, and concurred with SUPSHIP New Orleans' reporting of only the amount of costs questioned that exclusively affected the Navy.

**APO Response.** We provided SUPSHIPs Bath and NNS with our supporting calculations. SUPSHIP Bath concurred. SUPSHIP NNS agreed that the costs questioned amounts for some of its reports were incorrectly reported. We revised our report to reflect the SUPSHIP NNS amounts. However, we have not verified the accuracy of that data. The intent of the finding was to quantify the number of reports in error and the effect of any inaccuracies in reported costs questioned. Each report needs to be closely monitored to ensure the accuracy of CAFU information. In addition, during our SUPSHIP NNS site visit, we collected examples of costs questioned information provided by DCAA to SUPSHIP NNS for use in preparing its CAFU reports. Finally, SUPSHIP Gulf Coast agreed when we explained to them the DoD Directive 7640.2 requirement to report costs questioned without adjustment for government participation.

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## **Appendix D. Report Distribution**

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

Under Secretary of Defense (Comptroller)/Chief Financial Officer  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Director, Defense Procurement and Acquisition Policy  
Director, Defense Contract Management Agency

### **Department of the Navy**

Deputy Assistant Secretary of the Navy (Acquisition Management)  
Naval Inspector General  
Auditor General, Department of the Navy

### **Other Defense Organization**

Director, Defense Contract Audit Agency

### **Non-Defense Federal Organization**

Office of Management and Budget

### **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform  
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform  
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform



# Deputy Assistant Secretary of the Navy (Acquisition Management) Comments



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

MAR 30 2004

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE


Subj: NAVAL SEA SYSTEMS COMMAND CONTRACT AUDIT FOLLOWUP  
PROCESS (PROJECT D2002-OA-0178)

Encl: (1) NAVSEA IG memo Ser 00N3/051 dtd 24 March 2004

As requested in subject draft report, the Naval Sea Systems Command (NAVSEA) provides the comments at enclosure 1 for consideration in preparing the final version. NAVSEA generally concurs with all recommendations except those regarding withholding of payments and penalties in response to audit findings. In this area, NAVSEA agrees that better documentation of decisions to waive penalties may be required in some cases but does not consider the draft report to have recognized that penalties and withholdings are assessed in some instances nor that such decisions are within the broad discretion of the Administrative Contracting Officers.

In regards to the issues affecting DASN(ACQ)'s oversight of the CAFU system, efforts will be made to adjust the dates of supplemental audits to those of the original audits. Additionally, this office has included Contract Audit Followup as a process in ASN(RDA)'s Procurement Performance Assessment Program reviews of the Systems Commands.

If there are any questions on this issue, please direct them to Katherine Petersen at (703) 614-9641.

  
M. J. BROWN  
CAPT, SC, USN  
DASN(ACQ)

# Naval Sea Systems Command Comments



## DEPARTMENT OF THE NAVY

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

7500  
Ser 00N3/051  
24 March 2004

IN REPLY TO

From: Commander, Naval Sea Systems Command  
To: Deputy Assistant Secretary of the Navy  
(Acquisition Management)

Subj: DRAFT DODIG AUDIT REPORT ON NAVAL SEA SYSTEMS  
COMMAND CONTRACT AUDIT FOLLOWUP PROCESS (PROJECT NO.  
D2002-OA-0178)

Ref: (a) DODIG Memo of 30 January 2004

Encl: (1) Response to DODIG Draft Report, Project No.  
D2002-OA-0178 with Attachments (1) - (4)

1. Enclosure (1) is NAVSEA's response to the draft audit report forwarded by reference (a).
2. The NAVSEA point of contact is Ruth Wolfe, SEA 00N3, on extension (202) 781-3328 or by email at [wolfere@navsea.navy.mil](mailto:wolfere@navsea.navy.mil).

A handwritten signature in black ink, appearing to read "L. Lynn Jowers".

L. LYNN JOWERS  
CDR, JAGC, USN  
Deputy Inspector General

Copy to:  
NAVINGEN (N43)  
ASN (RDA) PP&R

DEPARTMENT OF THE NAVY COMMENTS TO  
DoDIG AUDIT REPORT ON NAVAL SEA SYSTEMS COMMAND  
CONTRACT AUDIT FOLLOWUP PROCESS  
(D2002-OA-0178)

1. Recommendation A-1: We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officer and their staff at Supervisor of Shipbuilding, Conversion, and Repair Offices to:
- a. Properly identify, document, and report the resolution of financial system and incurred cost audit reports.
  - b. Withhold payments to contractors on overage audits to encourage contractor correction of accounting and management system internal control deficiencies in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.7503, "Procedures," Federal Acquisition Regulation Subpart 32.503-6, "Suspension or Reduction of Payments," and Federal Acquisition Regulation Subpart 30.6, "CAS Administration," for noncompliances with cost accounting standards, or document reasons why withholding is not appropriate.
  - c. Track and report the date an audit report first identifies an accounting and management system deficiency that is restated in a followon report in accordance with DoD Directive 7640.2, paragraph 6.3.4.1, "Policy for Followup on Contract Audit Reports."
  - d. Prepare an action plan for the timely and proper resolution and disposition for each audit report addressed in this report and that is still open.

Management Response: Partially concur.

Recommendation A-1.a. Sufficient guidance exists in the form of DoD Directive 7640.2 "Policy for Followup on Contract Audit Reports and NAVSEAINST 7640.2, "Followup on DCAA Contract Audit Reports," describing the types of audits and documents needed to comply with the reporting requirements. The Naval Sea System Command's (NAVSEA) Contracts Directorate will review these procedures with the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) Offices. Estimated Completion Date: 30 July 2004

Enclosure (1)

Recommendation A-1.b. The decision to withhold payments on overage audits is a business decision and each circumstance must be reviewed and judged on its own merits and not against a formulaic or automatic approach. It is not prudent to automatically withhold payments from contractors without fully understanding the circumstances of the audit. Contractors are allowed a reasonable amount of time to respond to audit findings and the Administrative Contracting Officer (ACO) is obligated to provide Defense Contract Audit Agency (DCAA) the opportunity to perform a followup audit. ACOs have wide latitude to execute their duties and responsibilities in this area, as they should, once they have fully assessed the impact and appropriateness of their actions and all parties have the opportunity to respond, they withhold amounts as prudent.

Statements in the DoDIG report that withholdings are not occurring are inaccurate. SUPSHIPS have withheld amounts as appropriate. SUPSHIP Bath withheld amounts from billing rates in unresolved questioned issues in the audits. Likewise, SUPSHIP Gulf Coast (New Orleans) reported that they similarly withheld amounts when circumstances warrant. Action complete.

Recommendation A-1.c. NAVSEA uses the Department of the Navy's Contract Audit Followup (CAFU) report program. This program is the responsibility of Deputy Assistant Secretary of the Navy for Acquisition Management (DASN(ACQ)) and NAVSEA cannot modify the tracking and reporting mechanism used by this program. The DoDIG report acknowledges that the Navy (not NAVSEA) system does not contain a requirement to include the original report dates. It further discusses that the Defense Contract Management Agency (DCMA) is developing a DoD wide CAFU data system of which Navy is a participating member. As NAVSEA is not in a position to enact changes to the Navy's current system, this recommendation should be redirected to DASN(ACQ).

Recommendation A-1.d. NAVSEAINST 7640.2 already includes a requirement to maintain a milestone schedule of all reportable audits. ACOs identify and report the milestones on the required Audit Report Status and Evaluation System forms (enclosure 2 to NAVSEAINST 7640.2) for each open audit. Examples of completed forms were given the audit team. Action complete.

**2. Recommendation A-2: We recommend that the Commander for Contracts, Naval Sea Systems Command, establish performance measures for timely resolution and disposition of reportable contract audit reports.**

Deleted

**Management Response:** Concur. The Navy's CAFU reporting system requires that for each open audit report, resolution and target dates be provided. NAVSEA's ACOs provide this information in the summary report for each open audit report. Action complete.

**3. Recommendation A-3:** We recommend that the Commander for Contracts, Naval Sea Systems Command, include the contract audit followup function as an area of special interest in "FY 2004 Procurement Management Review Program."

**Management Response:** Concur. The contract audit followup function has been added to the FY 2004 Procurement Performance Management Assessment Program (PPMAP) as a special interest item. Action complete.

**4. Recommendation B-1:** We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officers and their staff at Supervisor of Shipbuilding, Conversion, and Repair offices to enforce the requirements of Title 10, United States Code, Section 2324(b), "Penalty for Violation of Cost Principles," for assessing penalties and interest on unallowable costs. If waivers are granted, they should be documented to reflect compliance with 10 U.S.C. paragraph 2324(c) as implemented by Federal Acquisition Regulation 42.709-5, "Waiver of the Penalty."

**Management Response:** Partially concur. NAVSEA's Contract Directorate will review issued guidance with the SUPSHIPS concerning the requirements for assessing penalties and interest on unallowable cost and properly documenting the file; however, exception is taken to the finding that penalties were not assessed.

SUPSHIP Bath provided copies of penalty checks received from Bath Iron Works, which were provided during the review but the report makes no mention of this. SUPSHIP Newport News acknowledges that penalties were not always collected as required, but that penalties were assessed in a settlement of 1996 overhead rates and a FY 2000 global settlement. SUPSHIP Gulf Coast (New Orleans) did not assess penalties in some instances because either DCAA recommended that penalties not be assessed or the ACO did not agree that the costs questioned were expressly unallowable or believed the contractor met the conditions to obtain a waiver of the penalties. Likewise, SUPSHIP Groton did issue a waiver of penalty per FAR 42.709-5 when it was determined that the contractor had inadvertently included unallowable costs in its proposal. The post

Renumbered  
as Recommendation  
A.2.

Deleted

negotiation clearance dated 13 March 2002, clearly stated that the Government determined that these costs were not subject to the penalty provisions of FAR and DFARS.

NAVSEA's Contract Directorate will remind the ACOs to ensure files and business clearance memoranda are thoroughly documented with respect to imposition of penalties on questioned expressly unallowable costs. Estimated Completion Date: 30 July 2004.

**5. Recommendation B-2:** We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officers and their staff at Supervisor of Shipbuilding, Conversion, and Repair Offices to comply with Federal Acquisition Regulation Part 42.705-1, "Contracting Officer Determination Procedure," on documenting determinations concerning costs questioned and auditor-recommended penalties in order to ensure the consistent application of costs principles and cost accounting standards.

**Management Response:** Concur. NAVSEA's Contracts Directorate will remind NAVSEA ACOs to ensure files and business clearance memoranda contain adequate documentation regarding the ACO determinations concerning costs questioned and auditor recommended penalties. Estimated Completion Date: 30 July 2004.

**6. Recommendation B-3:** We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officers and their staff at Supervisor of Shipbuilding, Conversion, and Repair Offices to issue a notice to disallow costs to contractors on expressly unallowable costs previously claims in proposals in accordance with Federal Acquisition Regulation Part 42.801, "Notice of Intent to Disallow Cost."

**Management Response:** Partially concur. As discussed under earlier recommendations, the ACO has broad discretion in determining and interpreting FAR and DFARS regulations. Mere allegation of unallowable costs should not result in an automatic notice to disallow such costs. Each circumstance must be reviewed to determine what action is warranted. DCAA initial findings may not be accurate and are revised upon rebuttal by the contractor or ACO. Such discretion must be permitted for the ACO to exercise the authority delegated.

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NAVSEA's Contracts Directorate will issue guidance to remind NAVSEA ACOs of the guidance regarding the determination of notices to disallow costs to contractors on unallowable costs. Estimated Completion Date: 30 July 2004.

**7. Recommendation C-1: We recommend that the Commander for Contracts, Naval Sea Systems Command, improve management controls at SUPSHIPS by enforcing the reporting requirements in DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," and by requiring the data received by contracting officials be verified against the DCAA audit report.**

**Management Response: Partially concur.** Upon receipt of contract audit reports, the ACO identifies any discrepancies in the "Internal Remarks" portion of the Audit Information Form in the quarterly updates. This form is part of the Navy's automated reporting system that NAVSEA's ACOs are required to use for the CAFU program. Use of this form, along with completed examples, was discussed during the exit brief with the auditors, however the report does not acknowledge the form or its usage.

As part of implementing Recommendation A-3 above, concerning inclusion of the CAFU function as a PPMAP special interest item, the CAFU management control process will be reviewed. Action complete.

**8. Comments on Report Findings.**

Detailed responses were provided by the SUPSHIPS and are included as attachments to this response. NAVSEA acknowledges that CAFU is an important function especially in the area of resolution and disposition of DCAA audit reports. However, the findings as presented in this report, do not give an accurate assessment of the ACOs' execution of these responsibilities. Many inaccuracies either in numbers presented or comments made were identified. These discrepancies should be reviewed and the report adjusted to reflect a more accurate representation of the CAFU program at NAVSEA and the SUPSHIPS visited.

# SUPSHIP Bath Comments

Final Report  
Reference



DEPARTMENT OF THE NAVY  
SUPERVISOR OF SHIPBUILDING  
CONVERSION & REPAIR, USN  
574 WASHINGTON ST.  
BATH, ME 04530-1905

4330  
Ser 401/505  
23 Mar 04

From: Supervisor of Shipbuilding, Conversion and Repair, USN, Bath  
To: Commander, Naval Sea Systems Command (SEA 02C)

Subj: RESPONSE TO "DRAFT" REPORT "NAVAL SEA SYSTEMS COMMAND  
CONTRACT AUDIT FOLLOWUP PROCESS"

Ref: (a) Draft Report Project No. D202-0A-0189  
(b) DOD Directive 7640.2

1. The reference (a) draft report was provided to this office for comment. As requested the following comments and concerns are provided.

a. The "draft" report states on page 4, "For example, at Supervisor of Shipbuilding (SUPSHIP) Bath, 5 of 11 operations audit reports exceeded the 6-month resolution guideline by a range of 1 to 23 months." Although 5 operations audits reports exceeded the 6 month resolution guideline; 2 were over by a month, one by 1.5 months, one by 2 months (and that was only because DCAA performed a follow-up on the same audit), and one was over by 18 months. In addition, on page 4 the report states that "Eight of the 11 reports exceeded the 12 month disposition guideline by a range of 4 to 42 months." This statement is again referring to SUPSHIP Bath. The SUPSHIP Bath records show only 6 audits were overage not 8. Included in the 6 audits were an original audit (2365-98Y10503006) and it's supplement (2361-98Y10502006-S1), therefore bringing the exceeds disposition number to 5. To further clarify the following information is provided:

(1) One audit (2361-2000Y10501002) exceeded the requirement by 3 months while awaiting DCAA follow-up audit.

(2) Two audits (2361-2000Y10502002-S1 and 2361-98Y10503006-S1) the ACO attempted to disposition the audits because of non-concurrence to the findings but provided DCAA an opportunity to perform a follow-up audit. In fact the ACO requested guidance in a memo to the IG dated January 13, 2003 concerning DCAA's need to perform follow-ups.

(3) The remaining two audits (2361-97Y10502004 and 2361-1999W10503309) were very important audits that required extensive review by the Navy, the contractor, and DCAA. Teams were set up to resolve the issues cited in the audits. To perform the required corrective measures were time consuming and would not have been effective if done within the required time constraints. Extensive documentation was contained in the files that detailed the steps being taken by the contractor in the process to disposition.

b. Operations audits historically require more then 12 months to disposition. The guidance, reference (b), does not adequately address how to deal with the length of time to properly implement and measure corrective action required by contractors as a result of these type of audits. In addition the ACO is obligated to provide DCAA the opportunity to perform a follow-

ATTACHMENT (1)

Page 5

Revised  
Pages 5-6

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Subj: RESPONSE TO "DRAFT" REPORT "NAVAL SEA SYSTEMS COMMAND  
CONTRACT AUDIT FOLLOWUP PROCESS"

up audit. Both these factors contribute to the length of time required to disposition operations audits.

c. "Table 1" on page 5 is incorrect based on the ACO records and documentation. On two occasions, February 12 and 24, the ACO in e-mails requested the IG auditor review the table and provide backup to the ACO. No response has been received. In addition on page 5, "Table 1" under the section "Bath, Incurred Cost Reports Overage," the table states that 6 audits were overage. In response the ACO's records show that:

(1) One audit (2361-99Y101500001) and its supplement (2361-1999Y10150001S1) were both counted and the supplement was only 1 month over the time.

(2) Two audits (2361-1998Y10100011S1 and 2361-1999Y10100001) remained open for corporate allocation. In fact the ACO requested guidance in a memo to the IG dated January 13, 2003 on how we should deal with corporate allocation. At no time did the IG mention that we could execute a bilateral agreement in accordance with E2.1.7.6 of reference (b) to close the audits. The ACO will execute an agreement with the contractor to disposition incurred cost audits when local negotiations are complete.

d. On page 7 the report states "All five SUPSHIPs had overage internal control system or CAS noncompliance reports..." Although SUPSHIP Bath had 4 overage internal control system audits, three remained open to allow DCAA to perform a follow-up audit and one (2361-1999Y24010081) audit was one month over the requirement. Again the guidance and the IG fail to recognize the requirement of DCAA performance of follow-up audits. Additionally, the report further states on page 7 that, "ACOs had not used the regulatory provisions on withholding payments to encourage contractor corrective actions." The documentation relative to the 4 audits specific to SUPSHIP Bath provided reasonable explanations as to why the audits were not closed, and that the contractor was making significant and reasonable gains to correct the findings. A significant portion of the time elapsing is attributable to affording the contractor ample time to implement the corrective action and providing DCAA an opportunity to perform a follow-up audit. Specifically, all SUPSHIP Bath's internal control system audits were found "inadequate in part" and the following action was taken:

(1) One audit (2361-1999Y1107007) was found "inadequate in part" for lack of desk procedures. The contractor had prepared desk procedures, however it was 18 months before DCAA performed the follow-up audit.

(2) One audit (2361-1999Y12030022) required extensive review by the ACO, BIW and DCAA. In fact an IPT was formed to resolve outstanding issues.

(3) One audit (2361-1999Y24010081) was one month over the required guideline.

(4) One audit (2361-2000Y14980001) remains open awaiting DCAA follow-up.

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Page 6

Page 8

Page 8

Subj: RESPONSE TO "DRAFT" REPORT "NAVAL SEA SYSTEMS COMMAND  
CONTRACT AUDIT FOLLOWUP PROCESS"

Page 11

e. The report states on page 10 that, "The ACO at SUPSHIP Bath was pro-active in settling audit reports by having biweekly meetings with contractor representative and DCAA resident auditors to resolve issues on ongoing and open audits. The ACO is a member of a joint integrated process team at SUPSHIP Bath and attends DCAA entrance and exit conferences." In response, the ACO does have biweekly meetings and does attend DCAA entrance and exit conferences. However, the portion of this statement that deals with the joint integrated process team is misleading. The ACO will form IPTs on particular audits to resolve findings in an audit. These IPTs will be formed on a case by case basis to ensure that the subject matter experts are part of the team.

Page 16

f. The report states on page 12, "The SUPSHIP ACOs did not enforce the statute to apply penalties on expressly unallowable costs." Although SUPSHIP Bath is not mentioned specifically in the narrative, it leads the reader to believe that all the ACOs did not enforce the statute. In fact, SUPSHIP Bath did collect penalty checks, with copies provided to the IG auditor.

Page 22

g. The report states on page 18, "SUPSHIP Bath included costs questioned from corporate audit reports, which resulted in overstated costs questioned." After review of current incurred cost audits I believe we are reporting the amounts correctly.

Page 22

h. On page 18 the report also states, "Each SUPSHIP incorrectly reported at least 1 of the 13 audits that did not meet the DOD Directive 7640.2 definition of a reportable audit." SUPSHIP Bath did not report non-reportable audits to NAVSEA.

2. For any additional information required on this subject, please contact Mrs. M. Whitney at (207) 442-2429 or Mr. B. Bowers at (207) 442-2738.



B. BOWERS  
Contracting Officer

# SUPSHIP Groton Comments

## SUPSHIP GROTON – COMMENTS IN RESPONSE TO DoDIG DRAFT REPORT FINDINGS

The finding contained on page 15 of the subject report claims that SUPSHIP Groton did not adequately explain a waiver of recommended penalties on unallowable costs of 18,105 dollars in its FY 1995 BCM.

The recommendation to assess penalties came from the DCAA audit report in a finding associated with the Sales, Use and Property Tax expense where material charges were incorrectly included in the base for calculation of the 1995 tax. The Contractor's automated system that identifies the taxable warehouse material charged on contracts incorrectly included the cost of weld wiring in the computation of the use tax.

The DCAA audit report incorrectly recommended penalties associated with this issue. FAR 42.709-5(c)(2) provides an exception for unallowable costs subject to the penalty if they were inadvertently incorporated into the proposal.

On page 7, note 7 of our post-negotiation clearance dated 13 March 2002 clearly states that the Government determined that these costs were not subject to the penalty provisions of FAR and DFAR. The Government did correctly assess interest associated with the misclassification.

As it relates to the finding associated with the Material Management Accounting System (MMAS) we find that the audit was closed because it and its finding was superseded by a subsequent audit. This fact was documented in the specified audit report submitted for the period.

ATTACHMENT (2)

# SUPSHIP Newport News Comments

Final Report  
Reference

Page 4

## SUPSHIP NEWPORT NEWS COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS

### A. Timeliness of Resolution and Disposition of Audit Reports (p. 3)

“Administrative contracting officers at five NAVSEA SUPSHIPs did not resolve and disposition contract audit reports within the guidelines in DoD Directive 7640.2. Of the 123 reports reviewed, 68 reports exceeded the 6-month resolution guideline and 95 reports with questioned costs of \$539 million exceeded the 12-month disposition guideline. These results are based on data as of 31 March 2003. The following actions contributed to the delays:

- Contracting officers did not recognize the distinction between resolution and disposition.
- Contracting Officers were reluctant to use regulatory provisions that allow for the withholding of monies to encourage contractor correction of deficiencies.
- NAVSEA did not track the date of the original audit report on internal control system deficiencies.”

### **SUPSHIP Newport News (NN) Comments:**

SUPSHIP-NN disagrees with the above conclusion which states that “the following actions contributed to the delays” in not resolving and dispositioning contract audit reports within the guidelines in DoD Directive 7640.2. The primary reason contract audit reports are not being resolved and dispositioned at SUPSHIP-NN within the guidelines is insufficient personnel resources to work on the backlog of outstanding contract audit reports. SUPSHIP-NN ACOs do recognize the difference between audit resolution and disposition. We acknowledge that our Contract Audit Report for the Quarter Ending 31 December 2002 listed the incorrect resolution dates for 7 contract audit reports that were subsequently corrected as of 31 March 2003. The incorrect resolution dates did impact the number of contract audits that we reported as not being resolved within 6-months in our Contract Audit Report as of 31 December 2002; however, the incorrect resolution dates did not cause any additional delay in the contract audits not being dispositioned in a timely manner. As explained earlier, the primary reason why contract audit reports are not being dispositioned in a timely manner is insufficient personnel resources to work on the backlog of outstanding contract audit reports.

### Timeliness of Settlements (p. 4)

### **SUPSHIP-NN Comments:**

Table 1 on page 5 of the Draft DoD IG Report lists by SUPSHIP location the audit report resolution and disposition delays for contract audit reports as of 31 March 2003. SUPSHIP-NN disagrees with the data contained in the chart for our location. Based on our Contract Audit Report for the Quarter Ending 31 March 2003 (31 reports on contract audits are listed), the corrected data for our location is as follows:

Page 5

Page 6

**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

	Total Audits	<u>Resolution &gt; 6 months</u>		<u>Disposition &gt; 12 months</u>	
		Reports Delayed	Months Delayed	Reports Overage	Months Overage
<u>Newport News:</u>					
Financial Systems	8	3	7-10	5	3-16
Cost Accounting Standards	12	3	3-45	9	1-63
Operations	3	2	4-24	1	18
Incurring Costs	<u>7</u>	<u>7</u>	12-58	<u>7</u>	6-58
Site Total and Average Delay	30	15		22	

One contract audit report, which was for a Claim, was excluded from the Table 1 data.

Actions Taken to Resolve Audit Reports (p.6)

“Specialists who administered the reports and recorded the follow-up information incorrectly believed that the resolution occurred when the ACO was ready to close the audit and therefore, delayed reporting the resolution until that time.”

**SUPSHIP-NN Comments:**

SUPSHIP-NN disagrees with this statement. SUPSHIP-NN ACOs and their representatives who administer the CAFU function do recognize the difference between audit resolution and disposition. If this statement is true for certain SUPSHIP locations, the specific locations should be identified where this situation exists.

Regulatory Provisions for Correcting Deficiencies

Withholding Payments to the Contractor to Correct System Deficiencies (p. 8)

“A June 25, 1996 report issued to SUPSHIP NNS on Newport News Shipbuilding and Dry Dock Company (NNS&DDCO)’s indirect cost system stated that the company had inadequate policies and procedures for identifying and excluding unallowable costs from claims and billings to the Government. DCAA initially reported at least one deficiency as early as March 1992. Although the ACO resolved the report in October 1996, the contractor never implemented corrective actions. The ACO dispositioned the report in March 2003, after awaiting completion of the DCAA review of a new financial system that replaced the existing system in June 1999. The uncorrected deficiencies caused DCAA to expand its audit efforts to identify and report on the expressly unallowable costs that the contractor continued to claim in its incurred cost submissions. The contractor claimed expressly unallowable costs of \$19 million in FY 1998 and \$15 million in FY 1999. Because the system deficiencies remain uncorrected, DCAA issued separate CAS noncompliance reports on Newport News Shipbuilding and Dry Dock Company and Naptheon, Incorporated, a subsidiary with the same deficiency.”

**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

**SUPSHIP-NN Comments:**

During 1999, Newport News Shipbuilding and Dry Dock Company (NNS&DDCo) implemented a new accounting and indirect cost system that made many of the deficiencies on the indirect cost system reported by DCAANN in the 25 June 1996 report no longer applicable. (This statement was included as part of our CAFU Report.) Additionally during the years 1999 and 2000, the SUPSHIP-NN administrative contracting officer's (ACO) staff of 4 ACOs as well as the ACO's cost monitor were completely replaced primarily due to retirements and reassignments. The new staff faced an existing and significant backlog of contract audit reports (dating back to 1993) that needed to be dispositioned. For example, the contract audit report covering 1993 overhead costs was not negotiated with NNS&DDCo until April 2000.

The statement above, "the contractor claimed expressly unallowable costs of \$19 million in FY 1998 and \$15 million in FY 1999", is based on Cost Accounting Standard (CAS) noncompliance reports issued by DCAANN in March 2002. These reported amounts are based on DCAANN's interpretation of the Federal Acquisition Regulation (FAR). For 1998, DCAANN subsequently revised the amount of expressly unallowable costs claimed by NNS&DDCO in its final report on 1998 overhead costs. NNS&DDCO submitted its 1998 and 1999 overhead submissions to the Government during July 1999 and July 2000, respectively. As stated above, the SUPSHIP-NN ACO did not resolve 1993 overhead costs until April 2000. The ACO needed to resolve 1994-1997 overhead costs before resolving 1998 and 1999 overhead costs. SUPSHIP-NN agrees that NNS&DDCO has historically claimed unallowable costs in its overhead submissions to the Government. Although this is the case, it is not always prudent to automatically withhold payments from the contractor based on the DCAANN reported amount. The expressly unallowable costs contained in the DCAANN audit reports are frequently overstated and normally adjusted downward based on the ACO's interpretation of the FAR in effect. Additionally, the results of overhead negotiations for 1993-1995 resulted in the government owing the contractor additional monies for 1993-1995 because the contractor provisionally withheld too much for unallowable costs from government billings. Also, although DCAANN issues reports that state there are deficiencies in the contractor's systems, the ACO should not automatically withhold payments based on DCAANN's review. As an example, a report states that the contractor has inadequate written policies and procedures. The policies and procedures need to be corrected. However, if it is determined that there is no immediate cost impact to government contracts because of the inadequate policies and procedures, it is not prudent to automatically withhold monies from the contractor. The ACO must evaluate the deficiencies reported by DCAANN and then make a determination as to whether they are material or significant enough to withhold payments from the contractor until the deficiencies are corrected.

**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

Management Controls Related to the CAFU Function (p. 10)

Page 10

“We interviewed officials at the NAVSEA Headquarters and the four SUPSHIP contracting offices we visited to determine what management control procedures were in place and whether management reviewed compliance with those procedures periodically. The SUPSHIP offices at Bath and Groton performed internal oversight reviews of the CAFU function. SUPSHIP offices at New Orleans and NNS, however, did not specifically identify CAFU as a separate functional area within their overall contracting function or test to determine whether contracting officers followed CAFU policies and procedures.”

**SUPSHIP-NN Comments:**

SUPSHIP-NN disagrees with the statement that we did not specifically identify CAFU as a separate functional area within our overall contracting function or test to determine whether ACOs followed CAFU policies and procedures. The CAFU function at SUPSHIP-NN is assigned to the Contractor Performance and Analysis Division of the Contracts Department. This division consists of a Supervisory Accountant and one Accountant. While performing the CAFU function, all letters and correspondence provided to DCAANN, the contractor, or NAVSEA are reviewed and signed by the ACO before being sent out. The quarterly CAFU Report is also reviewed and approved by the ACO before being submitted to NAVSEA. The ACO and his representatives also have monthly meetings with DCAANN and NNS&DDCo to resolve issues on ongoing and open audits. When appropriate, the ACO and his representatives also attend DCAANN entrance and exit conferences. Additionally, SUPSHIP-NN has an internal management control program that separately identifies CAFU (under the category DCAANN Reports) as a separate functional area and process. This area was reviewed by the SUPSHIP-NN ACO and self-certified during June 2003.

**B. Collection of Penalties on Unallowable Costs (p. 14)**

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“At SUPSHIP-NNS, the BCMs for five audit reports did not adequately explain the negotiated treatment of expressly unallowable costs and the audit recommendations of penalties related to those costs. The ACO failed to properly address \$5.5 million in expressly unallowable costs, which resulted in an estimated \$4.5 million in lost penalties.”

**SUPSHIP-NN Comments:**

SUPSHIP-NN disagrees with the above statement. We believe the BCMs did adequately explain the negotiated treatment of the expressly unallowable costs in question for 1994-1997. For 1994, 1995, and 1997, all of the expressly unallowable costs were sustained during negotiations and this is documented in the BCMs. For 1996, some of the expressly unallowable costs in question (approximately \$300,000) were included as part of a 50/50 lump sum settlement that included numerous items of disagreement between SUPSHIP-NN and NNS&DDCo. However, we do agree that we did not enforce the statute to apply penalties on expressly unallowable costs when negotiating final overhead costs for 1994-1997 and that the reasons used in the BCMs for not assessing penalties were not in accordance with the statute.

**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

SUPSHIP-NN does not agree with the amounts reported in Table 2, Schedule of Unallowable Costs Claimed by the Contractor. According to our records, the correct amounts are as follows:

**(Gross) Expressly Unallowable Costs**

<u>FY1994</u>	<u>FY1995</u>	<u>FY1996</u>	<u>FY1997</u>	<u>Total</u>
\$75,596	\$274,986	\$1,657,592	\$1,888,100	\$3,896,274

For FY 1996, the DoD IG draft report states that expressly unallowable costs were \$2,868,262. SUPSHIP-NN calculated \$1,657,592, a difference of \$1,210,670. This difference represents potential expressly unallowable costs relating to corporate aircraft costs. In the 1996 DCAA overhead report, DCAANN recommended that the penalties be waived for corporate aircraft. Per DCAANN, "The questioned costs that exceed the cost of commercial airfare are expressly unallowable costs. However, for this fiscal year 1996 review, we recommend that you waive the penalty because NNS&DDCO did not receive the ACO's determination of the unallowability of the costs until 6 May 1998. NNS&DDCO submitted its 1996 overhead submission on 7 July 1997 and could not have known what the ACO's determination would be. However, we will assess the penalty for the unallowable costs for fiscal year 1997 if the contractor does not voluntarily disallow the costs".

For FY 1997, the DoD IG draft report states expressly unallowable costs of \$2,280,031. SUPSHIP-NN calculated \$1,888,100, a difference of \$391,931. This difference represents potential expressly unallowable costs relating to corporate aircraft costs. In May 1998, SUPSHIP-NN determined that NNS&DDCO's reimbursement for corporate aircraft costs will be limited to coach airfare. NNS&DDCO submitted its 1997 overhead submission in June 1998. Since the date that SUPSHIP-NN notified NNS&DDCO of its position on allowable corporate aircraft costs was close to the date that NNS&DDCO submitted its 1997 overhead submission, SUPSHIP-NN did not include the penalties on corporate aircraft costs.

The following data shows the amount of penalties that should have been assessed on the NNS&DDCO based on the portion of expressly allowable costs that were allocated to government contracts.

**Penalties Applicable to Expressly Unallowable Costs Allocated to Government Contracts**

<u>FY1994</u>	<u>FY1995</u>	<u>FY1996</u>	<u>FY1997</u>	<u>Total</u>
\$64,861	\$216,194	\$1,376,464	\$1,575,053	\$3,232,572

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**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

Assessment of Penalties (p.14)

“The BCMs for FY1994 through 1996 included the general statement costs questioned had been sustained and had been settled 50-50 as part of a lump sum settlement, which was considered immaterial and which represented contractor unintentional errors. We take exception to considering \$5.5 million of expressly unallowable costs as immaterial.”

**SUPSHIP-NN Comments:**

SUPSHIP-NN never made a blanket statement that \$5.5 million of expressly unallowable costs are immaterial in the BCMs for 1994-1997. SUPSHIP-NN did make a statement in the BCMs for 1994 and 1995 where NNS&DDCo should have been assessed penalties of \$64,681 for 1994 and \$216,194 for 1995 that these amounts were immaterial based on the portion of expressly unallowable costs allocated to government contracts compared to the total overhead costs being negotiated for 1994 and 1995 of approximately \$800 million each year. In the 1996 and 1997 BCMs, the ACO did not make a statement that the expressly unallowable costs for 1996 and 1997 were immaterial. This comment should be either corrected or removed from the DoD IG draft report.

As shown above, we believe the correct gross amount of expressly unallowable costs for 1994-1997 is \$3,896,274, not the \$5.5 million shown in Table 2.

Documentation Requirements (p. 15)

“The failure of the SUPSHIP NNS ACO to collect penalties on expressly unallowable costs has been a long-standing problem. In our report, IG DoD Report No. PO 97-056, Defense Hotline Allegations Concerning Contract Audit Recommendations, September 1997, we stated that the ACO had no justification to waive \$7.8 million in penalties that DCAA recommended he assess on unallowable costs included by NNS in its FY 1989 and FY 1990 incurred cost submissions...The SUPSHIP NNS ACO, however, has never collected any penalties.”

**SUPSHIP-NN Comments:**

The SUPSHIP-NN ACO acknowledges that penalties were not assessed on the contractor for expressly unallowable costs as part of the negotiations of 1994-1997 overhead costs. As mentioned earlier, during 1999 and 2000, the SUPSHIP-NN ACO's staff handling contract audits had a complete turnover of staff. The new staff faced an existing and significant backlog of contract audit reports that needed to be dispositioned. For example, 1993 overhead costs were not negotiated with the contractor until April 2000. 1994-1997 overhead costs were negotiated during the period May 2000-April 2003. The SUPSHIP-NN ACO is in the process of negotiating 1998 overhead costs with NNS&DDCo. NNS&DDCo has already been notified that penalties will be assessed for all expressly unallowable costs claimed in its 1998 incurred cost submission and all future submissions that contain expressly unallowable costs. The penalties to be assessed on NNS&DDCo will be explained and documented in the BCM for 1998.

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**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

Although the DoD IG issued a report on the SUPSHIP-NN ACO in 1997 that cited SUPSHIP-NN for not assessing penalties on expressly unallowable costs, none of the SUPSHIP-NN ACO's current staff were at SUPSHIP-NN at the time and were not aware of the previous DoD IG report findings until the current DoD IG review which started here in August 2002. The SUPSHIP-NN ACO understands the requirement to assess penalties on NNS&DDCo for claiming expressly unallowable costs in its incurred cost submissions. Starting with 1998, the SUPSHIP-NN ACO will assess penalties on NNS&DDCo if the overhead submissions contain expressly unallowable costs.

The above statement, "The SUPSHIP NNS ACO, however, has never collected any penalties", is not true. The SUPSHIP-NN ACO did assess NNS&DDCo approximately \$200,000 in penalties and \$2.4 million in interest as part of an April 2000 Global Settlement that covered numerous CAS Non-compliances and the settlement of 1993 overhead costs.

**C. Accuracy of Contract Audit Follow-up Information**

**Costs Questioned Understated in the Follow-up System (p.17)**

"Two of the four offices, NNS and New Orleans, relied on incorrect cost questioned data obtained from the auditors, which was incorrectly recorded in the Navy followup system."...At SUPSHIP NNS, the contracting officials understated costs questioned for six audit reports by approximately \$83 million (62 percent) because the contracting officials used the cost questioned provided by DCAA, which had been reduced for government participation and adjusted for negotiation results and other improper exclusions."

**SUPSHIP-NN Comments:**

SUPSHIP-NN disagrees with the above statement since we were unable to identify the six audit reports that the DoD IG auditors used to derive the \$83 million difference. We need to obtain the six audit reports in question in order to respond to DoD IG's comments regarding the \$83 million difference.

At SUPSHIP-NN, our understanding of the Contract Audit Follow-Up (CAFU) Process is as follows:

DCAANN issues audit reports that contain exhibits that show the cost questioned. DCAANN inputs the cost questioned for each applicable contract audit report into their DMIS system. On a monthly basis, the DCAA Procurement Liaison Auditor (PLA) in Washington, D.C. accesses the DCAA DMIS system containing contract audit report costs questioned and emails this data to the Assistant Secretary of the Navy's (ASN) office. ASN provides this data to the NAVSEA representative performing the CAFU function. The NAVSEA representative performing the

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**SUPSHIP NEWPORT NEWS  
COMMENTS IN RESPONSE TO DoD IG DRAFT REPORT FINDINGS**

CAFU function faxes this data containing contract audit report cost questioned to the SUPSHIP-NN representative performing the CAFU function. The SUPSHIP-NN representative maintains a CAFU database of all contract audit reports issued by DCAANN. The questioned cost amount entered into the SUPSHIP-NN CAFU database for each contract audit is based on the contract audit report cost questioned data provided by the NAVSEA representative performing the CAFU function (which is based on the DCAA DMIS system questioned cost amounts). The SUPSHIP-NN representative also gets copies of the contract audit reports containing questioned costs directly from DCAANN. When the contract audit report questioned cost received from NAVSEA (based on the DCAA DMIS system) does not agree with the questioned cost amounts contained in the DCAA contract audit reports, the SUPSHIP-NN representative uses the cost questioned amounts obtained from NAVSEA (based on the DCAA DMIS system) to enter into our Quarterly Contract Audit Follow-Up Report. SUPSHIP-NN does not use cost questioned data obtained from DCAANN auditors to prepare our CAFU report.

**Summary of SUPSHIP-NN Comments:**

The SUPSHIP-NN ACO realizes the importance and accuracy of the CAFU function and reporting. For the period covered by the DoD IG audit of the SUPSHIP CAFU function, we agree that the resolution dates for some contract audits were reported incorrectly. We also acknowledge that many of our contract audits have not been resolved and dispositioned within the guidelines in DoD Directive 7640.2. As stated previously, the primary reason why contract audit reports are not being resolved and dispositioned at SUPSHIP-NN within the guidelines of DoD Directive 7640.2 is insufficient personnel resources to work on the backlog of outstanding contract audit reports. As of March 2003, there were 31 contract audits awaiting disposition at SUPSHIP-NN. We have one supervisory accountant and one accountant performing the CAFU function, and the CAFU function is not their sole responsibility. Because the new staff of the SUPSHIP-NN ACO inherited a huge backlog of old contract audit reports, our goal was to identify ways to become more current on the contract audit backlog with our existing personnel resources. During this process, we settled numerous contract audit reports, including overhead years and CAS noncompliances, but not enough emphasis was placed on collecting penalties on expressly unallowable costs claimed by NNS&DDCo. Starting with 1998, the SUPSHIP-NN ACO will assess penalties and interest, if applicable, on NNS&DDCo if the overhead submissions contain expressly unallowable costs. The penalties to be assessed on NNS&DDCo will be explained and documented in the BCM for 1998. We also realize that if penalties are not assessed as recommended in the contract audit report, the business clearance must contain a justification as to why penalties were not assessed and a waiver must be obtained as required by the regulations.

# SUPSHIP Gulf Coast Comments



DEPARTMENT OF THE NAVY  
SUPERVISOR OF SHIPBUILDING, CONVERSION AND REPAIR, USN  
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4330  
Ser 400/00414  
11 Mar 04

From: Supervisor of Shipbuilding, Conversion and Repair,  
U.S. Navy, Gulf Coast  
To: Naval Sea Systems Command, ATTN: SEA 0212BW (Brenda  
Wilson)

Subj: PROPOSED RESPONSES TO DEPARTMENT OF DEFENSE INSPECTOR  
GENERAL AUDIT OF SUPSHIP NEW ORLEANS CONTRACT AUDIT  
FOLLOWUP (CAFU) PROGRAM

Ref: (a) DOD IG Audit Project No. D2002-OA-0178 of 30 January  
2004

Encl: (1) Proposed Responses

1. In accordance with reference (a), enclosure (1) is forwarded for your consideration. Responses are categorized by major subheading in the DoD IG audit with each page listing.
2. The deficiencies noted in the DoD IG report have been addressed as part of the SUPSHIP Gulf Coast processes.
3. If there are any questions concerning this letter, please contact the undersigned at (228) 769-4250 or [russelljf@supship.navy.mil](mailto:russelljf@supship.navy.mil).

  
J. F. RUSSELL

SUPSHIP GULF COAST IS A FIELD ACTIVITY OF THE NAVAL SEA SYSTEMS COMMAND

ATTACHMENT (4)

**A. Timeliness of Resolution and Disposition of Audits**

DoD IG page 3 first paragraph:

Administrative contracting officers at five NAVSEA SUPSHIPS did not resolve and disposition contract audit reports within the guidelines in DoD Directive 7640.2. Of 123 reports reviewed, 68 reports exceeded the 6-month resolution guideline and 95 reports with costs questioned of \$539 million exceeded the 12-month disposition guideline. These results are based on data as of 31 March 2003. The following actions contributed to the delays:

- Contracting officers did not recognize the distinction between resolution and disposition.
- Contracting Officers were reluctant to use regulatory provisions that allow for the withholding of monies to encourage contractor correction of deficiencies.

**SUPSHIP Gulf Coast Comments:**

*SUPSHIP Gulf Coast (SSGC) agrees that resolution and disposition guidelines were exceeded, however, we disagree with the conclusion. The primary reason contract audit reports were not resolved and dispositioned at SSNO was due to a culmination of insufficient personnel resources to work on the backlog of outstanding contract audit reports, designated higher priority efforts, and generally recalcitrant behavior by the primary contractor. SSNO had simultaneous increases in change activity while downsizing the organization resulting in the prioritizing of efforts in support of Program Managers. In addition, the primary contractor was not responsive to inquiries that could lead to a potential loss in cash flow.*

*SSNO ACOs did recognize the difference between audit resolution and disposition but at the time had not achieved disposition IAW DODD 7640.2 (25 of 29 reports). Of the total of 33 reports, 27 have now been dispositioned.*

DoD IG page 5 Table:

Table 1. Audit Report Resolution and Disposition Delays

Total Audits:	29
Resolution > 6 months:	26
Disposition > 12 months:	25

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Enclosure 1

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**SUPSHIP Gulf Coast Comments:**

Although this was a recurring problem, the realignment of SSNO and SUPSHIP Pascagoula (SSPA) under SSGC has resulted in significant process changes, one of which is that subsequent audit files will be monitored. Of the 33 audits provided to the DoD IG, 4 files were found acceptable. 27 remaining audits have since been dispositioned and six remain overaged pending resolution. SSNO currently has 12 outstanding audits, of which 11 are overaged (including the six previously mentioned), but are being monitored.

**DoD IG page 7 first paragraph; Regulatory Provisions for Correcting Deficiencies:**

All five SUPSHIPS had overage internal control system or CAS noncompliance reports citing long-standing deficiencies. Some deficiencies were identified in prior reports or unnecessarily increased the number of reports issued by DCAA.

**SUPSHIP Gulf Coast Comments:**

Although the DoD IG discovered audit deficiencies that mirrored a CAFR-92-21 assessment of Aug 92, there have been significant improvements that resulted from the merging of SSNO and SSPA into SSGC. For example, adopting SSPA management control monitoring system.

**DoD IG page 10 first paragraph; Management Controls Related to the CAFU Function:**

SUPSHIP offices at New Orleans and NNS, however, did not specifically identify CAFU as a separate functional area within their overall contracting function or test to determine whether contracting officers followed CAFU policies and procedures.

**SUPSHIP Gulf Coast Comments:**

SSGC disagrees with the DoD IG assessment. DoD Directive No. 7640.2 does not require the establishment of a designated CAFU at a field Headquarters Contracting Activity. The lowest level where a CAFU official must be designated is at the Secretary of the Military Departments and the Directors of the Defense Agencies, para 5.2.1. NAVSEA contract manual of 3/16/00 update (1998 edition) did not identify a requirement for specifically designating a CAFU. The July 1999 edition of SUPSHIP Operations Manual also does not identify a specific requirement for a CAFU. SSNO had established an audit section, Code 422,

to monitor compliance with audit requests. This code routinely performed CAFU functions, to include meeting all reporting requirements. There was no requirement to further designate, as an additional duty, a CAFU official as implied by the DoD IG report. It should be noted, however, that the newly established SSGC has designated a CAFU official.

**DoD IG page 11: Recommendations:**

**A. We recommend that the Commander for Contracts, Naval Sea Systems Command:**

1. Instruct administrative contracting officers and their staff at Supervisor of Shipbuilding, Conversion and Repair offices to:

a. Properly identify, document, and report the resolution of financial system and incurred cost audit reports.

b. Withhold payments to contractors on overage audits to encourage contract correction of accounting and management system internal control deficiencies in accordance with Defense Federal Acquisition Regulation Supplement Subpart 242.7503, "Procedures," Federal Acquisition Regulation Subpart 32.503-6, "Suspension or Reduction of Payments," and Federal Acquisition Regulation Subpart 30.6, "CAS Administration," for noncompliance's with the cost accounting standards, or document reasons why withholding is not appropriate.

c. Track and report the date an audit report first identifies an accounting and management system deficiency that is restated in a follow-on report in accordance with DoD Directive 7640.2, paragraph 6.3.4.1, "Policy for Followup on Contract Audit Reports."

d. Prepare an action plan for the timely and proper resolution and disposition for each audit report addressed in this report and that is still open.

2. Establish performance measures for timely resolution and disposition of reportable contract audit reports.

3. Include the contract audit followup function as an area of special interest in "FY 2004 Procurement Management Review Program."

**SUPSHIP Gulf Coast Comments to A1a:**  
Contract Audit functions do not receive the exposure as part of Contract Administration DAWIA training as focused on by DoD IG. Proper and relevant file documentation has become a learned skill via individualized instruction and mentoring. A separate, on-line course on this topic could address this issue, or a program of instruction change at the appropriate DAWIA audit course.

**SUPSHIP Gulf Coast Comments A1b:**  
This is an ACO business decision. Each circumstance has to be individually evaluated for the desired effect. SSNOs ACOs were aware that this option existed and used it accordingly. SSGC will ensure future BCMS will document the ACOs business judgment decision to withhold or not withhold contractor payments due to CAS non-compliance issues.

**SUPSHIP Gulf Coast Comments A1c:**  
SSGC will include this recommendation when revising local instructions.

**SUPSHIP Gulf Coast Comments A1d:**  
CAFU responsibilities have been designated as part of the SSNO and SSPA realignment under SSGC.

**SUPSHIP Gulf Coast Comments to 2:**  
SSGC has already included audit tracking (to ensure timely resolution of audit reports) as a metric.

**SUPSHIP Gulf Coast Comments to 3:**  
Agreed.

**B. Collection of Penalties on Unallowable Costs**

**DoD IG page 12 first paragraph:**

..ACOs at three SUPSHIP offices did not appropriately assess penalties or justify waivers of penalties for expressly unallowable costs. Eleven of 14 audits had penalties recommended but penalties were not assessed.

**DoD IG page 13 second paragraph through page 14 second paragraph:**

**SUPSHIP New Orleans.** The ACO waived penalties and interest of more than \$1.7 million for expressly unallowable depreciation costs. The DCAA reports for the FY 1996 through FY 1999 questioned the excess depreciation and recommended penalties and interest. The BCM documenting the settlement showed that the ACO had calculated the penalty and interest applicable to the expressly unallowable depreciation costs of (\$476,605) for FY 1997 through FY 1999, but the ACO used factors in deciding not to assess the penalties and interest...the explanation did not address the specific conditions under which a waiver may be granted by statute.

We do not consider the reasons listed as appropriate..The litigation costs should not have been considered because of the legal position and because the court decision supported the auditor recommendation...None of the reasons the ACO used for waiving the penalties were in accordance with the statute-that the contractor withdraws the proposal before formal initiation, that the contractor demonstrates it has established policies that preclude unallowable costs in the proposals, or that the ACO is satisfied that unallowable costs were inadvertently incorporated into the proposal.

**SUPSHIP Gulf Coast Comments:**

*SSGC disagrees with the DOD IG assessment that the SSNO ACO did not comply with statutory and FAR requirements by failing to assess penalties for expressly unallowable costs.*

*Penalties were not assessed because the ACO concluded that either the questioned costs were not "expressly unallowable", or, if expressly unallowable, the contractor met the conditions necessary to obtain a waiver of the penalties.*

*With respect to the questioned \$ 1.7 million for depreciation costs, the ACO determined that the questioned depreciation costs might not be considered by a third party (i.e., a board or court) as "expressly unallowed." The relatively new depreciation recapture rules were the subject of much disagreement in the defense industry. Although a case addressing this issue (Kierfott) had recently been decided by the ASBCA, the contractor stated that the ASBCA holding did not apply to the facts of its case. The contractor also maintained that the holding in Kierfott was wrong. The ASBCA decision in Kierfott was appealed to the United States Court of Federal Claims. The ACO and contractor decided to suspend action on the*

depreciation issue until after the appeal was decided. The uncertainty of the application of the depreciation recapture rules supports the ACO's decision that the questioned costs in this case were not "expressly unallowable."

The contractor agreed with the DCAA conclusion that the questioned depreciation costs were unallowable after the Court of Federal Claims upheld the ASBCA Kierfott holding. The ACO concluded that, even if the questioned depreciation costs were expressly unallowable, the conditions for a waiver of penalties in FAR 42.709-5 (c) had been met. The ACO determined that, even though the overhead submission had not been inadvertent, it had been made on the basis of a good faith belief that the overhead costs were recoverable. This fact, in conjunction with a belief that the questioned costs might not be considered "expressly unallowable" led the ACO to conclude that waiver of penalties was appropriate.

This case (asset step-up and depreciation recapture) and others reviewed by the DOD IG illustrate the fact that many DCAA reports contain questioned costs that require the ACO to make discretionary decisions based on a reasonable interpretation of applicable statutes and regulations.

**DoD IG page 16; Recommendation:**

B. We recommend that the Commander for Contracts, Naval Sea Systems Command, instruct administrative contracting officers to:

1. Enforce the requirements of Title 10, United States Code, Section 2324(b), "Penalty for Violation of Cost Principle," for assessing penalties and interest on unallowable costs. If waivers are granted, they should be documented to reflect compliance with 10 U.S.C. paragraph 2324(c) as implemented by Federal Acquisition Regulation Part 42.709-5, "Waiver of the Penalty."
2. Comply with Federal Acquisition Regulation Part 42.705-1, "Contracting Officer Determination Procedure," on documenting determinations concerning costs questioned and auditor-recommended penalties in order to ensure the consistent application of cost principles and cost accounting standards.
3. Issue a notice of intent to disallow costs to contractors on expressly unallowable costs previously claimed

in proposals in accordance with Federal Acquisition Regulation Part 42.801, "Notice of Intent to Disallow Cost."

**SUPSHIP Gulf Coast Comments to B1:**  
*SSGC ACOs will evaluate cases on an individual basis and use enforcement tools, such as penalties and withholdings, when appropriate to ensure contractor compliance with FAR and CAS requirements.*

**SUPSHIP Gulf Coast Comments to B2:**  
*Agreed. SSGC will ensure that all future BCMs contain adequate documentation regarding ACO determinations regarding questioned costs and auditor recommended penalties.*

**SUPSHIP Gulf Coast Comments B3:**  
*Issuing notices of intent to disallow costs are included in the new SSGC audit response procedures.*

**C. Accuracy of Contract Audit Followup Information**

**DoD IG page 17 last paragraph: Reporting of Questioned Incurred Costs:**

**Costs Questioned Understated in the Followup System.** Four of the five SUPSHIP offices recorded incorrect costs questioned for 29 of the 44 incurred cost audit reports reviewed. Two of the four offices, NNS and New Orleans, relied on incorrect costs questioned data obtained from the auditors, which was incorrectly recorded in the Navy followup system. At SUPSHIP New Orleans, 15 audit reports understated costs by \$11.5 million (36 %) because contracting officials incorrectly relied on the auditor's adjusted costs questioned for Government participation.

**SUPSHIP Gulf Coast Comments:**  
*This data was provided by the DCAA auditors and not questioned by SSNO audit officials. The reporting of total incorrect costs questioned were focused on the dollar amounts that exclusively affected Navy contracts. Questioned costs outside the Navy's domain are not the responsibility of the Navy to report.*

**DoD IG page 19 first paragraph: Compilation of Reportable Audits:**

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Three of the 13 nonreportable audits represented data errors that neither SUPSHIP nor DCAA officials could explain. The remaining 10 reports did not include findings and recommendations that required followup.

The eight omitted reports were addressed to SUPSHIP New Orleans and covered open incurred cost audits for FY 1992 through FY 1996 with total costs questioned of \$7.4 million. SUPSHIP CAFU officials require an increased awareness of the requirements for accurately determining audits that are reportable under the Directive.

**SUPSHIP Gulf Coast Comments:**

*SSNO is unable to determine the correctness of the DoD IG statement, as we were unable to identify the audit reports that the DoD IG auditors used to derive the \$7.4 million difference. The ACO has since reviewed and corrected all open audits and ensured that those that are reportable are addressed. In addition, the realigned SSGC has identified a CAFU official who is responsible for accurately determining what is reportable under the directive.*

**DoD IG page 19; Recommendations:**

C.1. We recommend that the Commander for Contracts, Naval Sea Systems Command, improve management controls at SUPSHIPS by enforcing the reporting requirements in DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," and by requiring that data received by contracting officials be verified against the DCAA audit report.

C.2. We recommend that the Director, Defense Contract Audit Agency, clarify the need for accurate reporting of incurred costs questioned in audit reports.

**SUPSHIP Gulf Coast Comments to C1:**  
*Agreed.*

**SUPSHIP Gulf Coast Comments to C2:**  
*No action for NAVSEA.*

# Defense Contract Audit Agency Comments



DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

March 24, 2004

OWD 720.3A.A.4

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT POLICY AND  
OVERSIGHT

SUBJECT: Naval Sea Systems Command Contract Audit Follow-Up (CAFU) Process  
(Project No. D2002-OA-0178)

Reference your January 30, 2004 draft report on the Naval Sea Systems Command CAFU Process. Your recommendation to the Director, DCAA and our response follow.

Recommendation C.2: We recommend that the Director, Defense Contract Audit Agency, clarify the need for accurate reporting of incurred costs questioned in audit reports.

Response: Concur. As discussed with the review staff during the exit briefing, DMIS version 3.1, which was issued August 27, 2003, added two DMIS program edits to reemphasize the distinction between the entry for "Costs Questioned" and the entry for "Total Exception Dollars"; wherein total exception dollars is the unrounded amount of total costs questioned and should not be adjusted to reflect a reduction for Government participation. We also explained that we would be issuing a Memorandum for Regional Directors (MRD) to address the new Defense Contract Management Agency web-based CAFU system and would use that memorandum to further emphasize the importance of data accuracy for these data elements. The MRD, which is in final coordination, provides a summary of the new system enhancements as well as again emphasizing the difference between the two data elements. Additionally, the DMIS User Guide – Appendix A, will address this issue. These changes are expected to be completed prior to the release of the final report for this project.

Please contact Mr. Martin Berry, Program Manager, Workload Analysis Division, at (703) 767-2258, or by e-mail at [Martin.Berry@dcaa.mil](mailto:Martin.Berry@dcaa.mil) regarding any questions you may have related to the subject reports or the content of the guidance enhancements.

Handwritten signature of Earl J. Newman in cursive.

Earl J. Newman  
Assistant Director  
Operations