

**Incurring Cost Audit Reports Are Not
Effectively Used to Settle Indirect Rates**

June 2000

Reference Number: 2000-10-086

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

Margaret E. Bezzo

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Incurred Cost Audit Reports Are Not
Effectively Used to Settle Indirect Rates

This report presents the results of our review of the Internal Revenue Service's (IRS) use of Defense Contract Audit Agency (DCAA) audits. In summary, we found that IRS contracting officers effectively used DCAA proposal audits and other negotiation skills to save the government approximately \$31 million during negotiations. However, we found that additional emphasis is needed to ensure incurred cost audits are used effectively to settle indirect cost rates.

Our report recommended that the Director of Procurement ensure that Procurement personnel are aware of applicable guidance regarding incurred cost audit reports and encourage the use of quick close-out procedures. Also, we recommended modifications to the database used to monitor DCAA activity.

Management agreed with our recommendations. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as appendix V.

Copies of this report are being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Maurice S. Moody, Associate Inspector General for Audit (Headquarters and Operations and Exempt Organizations Programs), at 202-622-8500.

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Executive Summary

Defense Contract Audit Agency (DCAA) audit reports provide valuable information for awarding, administering, and closing out contracts. The Internal Revenue Service (IRS) primarily requests proposal and incurred cost audit reports from the DCAA. Proposal audit reports assist the contracting officer (CO) in negotiating a fair and reasonable price, while incurred cost audit reports establish the final indirect cost rates needed to close out completed contracts.

The overall objective of this review was to determine whether the IRS is effectively using DCAA audit reports. Using DCAA proposal audit reports received in Fiscal Years (FY) 1998 and 1999 and other negotiation skills, the COs saved the government approximately \$31 million. However, additional emphasis is needed to ensure incurred cost audit reports are used effectively to settle indirect cost rates.

Results

The COs are effectively using the Cost and Pricing Branch within the Office of Procurement Policy to help determine whether a proposal audit is necessary and if the contractors' proposed prices are fair and reasonable. By using the DCAA proposal audit reports received in FYs 1998 and 1999 and other negotiation skills, COs were able to achieve significant cost savings for the government. While the Office of Procurement effectively used the Cost and Pricing Branch and DCAA proposal audit reports to establish price reasonableness, we believe additional emphasis is needed to assist the COs in working with contractors to settle indirect cost rates on completed contracts and task orders. We identified approximately \$70,000 of funds that remained obligated on four completed task orders and found that the COs had not attempted to identify excess funds.

Contracting Officers Are Not Effectively Using Defense Contract Audit Agency Incurred Cost Audit Reports to Settle Indirect Cost Rates

We reviewed six contracts where DCAA incurred cost audit reports had been received by the IRS and noted that only one CO had received the applicable DCAA audit reports and could explain how to use the reports to determine the monetary effect of the final indirect rates. In the remaining five instances, the CO either never received the DCAA report, received the report after settlement, or was awaiting guidance before closing out the completed task order.

Incurred cost audit reports are used to assist in adjusting the indirect costs billed under the contract to the actual indirect costs incurred by the contractor. Completed cost reimbursable contracts cannot be closed out and excess funds deobligated until the final indirect costs are established and settled. These final indirect costs can be established

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and settled using either the incurred cost audit reports or quick close-out procedures. Quick close-out procedures facilitate settlement of unaudited indirect costs on a contract-by-contract basis, where agreement can be reached on a reasonable estimate of allocable dollars and the allocable indirect costs are relatively insignificant. In most instances, the COs we interviewed were either not familiar with or were not using the incurred cost audit reports or quick close-out procedures. As a result, we identified four completed task orders with approximately \$70,000 of obligated funds for which the COs had not attempted to identify excess funds.

Summary of Recommendations

The Director of Procurement should ensure that Procurement personnel are aware of the applicable guidance regarding the use of incurred cost audit reports and encourage the use of quick close-out procedures, when practical. In addition, the database used to monitor DCAA activity should be modified to capture additional information needed by the COs.

Management's Response: The Procurement function will issue guidance to all Procurement personnel to emphasize the use of incurred cost audit reports and the benefits of quick close-out procedures. Also, the incurred costs database will be modified and accessibility to COs will be expanded. Management's complete response to the draft report is included as Appendix V.

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Objective and Scope

The overall objective of this review was to determine whether the IRS is effectively using DCAA audit reports.

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) is effectively using Defense Contract Audit Agency (DCAA) audit reports. The audit work was performed during the period November 1999 to February 2000 at the Procurement office in the Washington, D.C. area and two regional offices. We selected judgmental samples of 26 contracts with a contractual action over \$500,000; 10 DCAA incurred costs audit reports; and 5 DCAA proposal audit reports requested by the IRS. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The DCAA performs many different types of audits: proposal, incurred costs, provisional billing rates, equitable adjustment claims, progress payments, voucher reviews, and financial capacity. The audit reports most commonly requested by the IRS are proposal and incurred cost audit reports.

Proposal audit reports can assist the CO in determining a fair and reasonable contract price.

A proposal audit is an audit of the offeror's proposal and may include all or only selected elements of the proposal. The contracting officer (CO) uses proposal audit reports in determining if the offeror's proposed price is fair and reasonable. Although prices for all procurements must be determined to be fair and reasonable, a proposal audit is frequently not required. The Federal Acquisition Regulations (FAR)¹ state that a proposal audit should be requested only when the buying agency does not have sufficient information to determine a fair and reasonable price.

¹ General Servs. Admin. et al., Federal Acquisition Reg. ("FAR"), 48 C.F.R. parts 1-52 (1997)

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In addition to proposal audit reports, incurred cost audit reports can be requested. Incurred cost audit reports are used to adjust the indirect costs billed under the contract to the final (actual) indirect costs incurred by the contractor. As part of the close-out process on cost reimbursable contracts, the contractor submits a final voucher based on the DCAA final indirect rates. The CO reviews the final voucher for the purpose of settling indirect costs and deobligating excess funds. Completed cost reimbursable contracts cannot be closed and excess funds deobligated until the final indirect costs are established and settled.

Within the Procurement organization, the Cost and Pricing Branch may assist the COs in determining if a proposal audit is needed to complete the assessment of the contractor's price and determine if the proposed price is fair and reasonable. In addition, the Cost and Pricing Branch assists the COs in obtaining the incurred cost audit reports needed to close out completed contracts.

Results

Procurement personnel saved approximately \$31 million using DCAA proposal audit reports and other negotiation skills.

We reviewed 26 contracts with contractual actions over \$500,000 in Fiscal Year (FY) 1998 or 1999 and found that the COs are effectively using the Cost and Pricing Branch to help determine whether a proposal audit is necessary and if the contractor's proposed price is fair and reasonable. The Cost and Pricing Branch analysts were properly requesting DCAA proposal audit reports when necessary and, as a result, COs were able to use three of the five selected DCAA proposal audit reports issued in FY 1998 or 1999 and other negotiation skills to save the government approximately \$31 million.

While the use of the Cost and Pricing Branch and DCAA proposal audit reports has helped achieve significant cost savings for the government, we believe additional emphasis is needed to assist the COs in working with the contractors to settle indirect cost rates on completed contracts and task orders.

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Contracting Officers Are Not Effectively Using Defense Contract Audit Agency Incurred Cost Audit Reports to Settle Indirect Cost Rates

The COs are not settling indirect cost rates on completed contracts and task orders. We reviewed six contracts where DCAA incurred cost audit reports had been received by the IRS and determined that only one CO had received the applicable DCAA audit reports and could explain how to use the reports to determine the monetary effect of the final indirect rates. In the remaining five instances, the CO either never received the DCAA report, received the report after settlement, or was awaiting guidance before closing out the completed task order.

The FAR requires that contract close-out begin when the contract is complete. A significant step in closing out the contract is reviewing the amount of funds obligated and identifying any excess funds remaining on the contract. However, identification of all excess funds remaining on the contract cannot be completed until the indirect cost rates are settled for all years of contract performance. The DCAA incurred cost audit reports can be used by the CO to verify the indirect costs on the contractor's final invoice and close out completed contracts and task orders.

The COs can use either DCAA incurred cost audit reports or quick close-out procedures to settle indirect rates on completed contracts.

Besides DCAA incurred cost audit reports, in limited circumstances the FAR provides that COs can use quick close-out procedures to settle indirect rates on completed contracts. Quick close-out procedures facilitate settlement of unaudited indirect costs on a contract-by-contract basis, where agreement can be reached on a reasonable estimate of allocable dollars and allocable indirect costs are relatively insignificant.

A draft Office of Procurement Policy and Procedures Memorandum provides that quick close-out procedures should be used when appropriate, especially where the DCAA incurred cost audit reports have historically accepted contractor costs as proposed or with only minor exceptions. It is costly and impractical to keep

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We identified \$70,000 of funds that remained obligated on completed task orders for which the COs were not attempting to identify excess funds.

completed contracts open pending audit resolution of relatively insignificant amounts of indirect costs. Usually, in such situations, it is mutually advantageous to the government and the contractor to expedite settlement of indirect costs and close these contracts as soon as possible, rather than waiting for final audit determination, which may take years.

We interviewed six COs who advised us that they either did not receive or know how to use the DCAA incurred cost audit reports. In addition, the COs were not pursuing whether quick close-out procedures could have been used. We determined that the 10 DCAA incurred cost audit reports we reviewed could have been used to identify excess funds on 4 completed task orders, which had approximately \$70,000 of funds obligated.

The COs may have difficulty in monitoring incurred cost audit reports since the reports are for all government contracts with a specific contractor and may cover one or more fiscal years. Therefore, one DCAA incurred cost audit report may be applicable to one or more cost reimbursable type contracts. Although the Cost and Pricing Branch within the Procurement organization has a database to monitor the DCAA audit reports requested and received, the database does not identify the fiscal years covered by each incurred cost audit report.

Additionally, the database is not accessible by the COs and does not identify all relevant contract information. Without access to the database, the COs cannot readily determine if needed DCAA audit reports have been received to facilitate the close-out of completed cost reimbursable contracts.

Timely closing completed contracts can help the IRS reduce administrative costs and enable the deobligation of excess funds.

Recommendations

1. The Director of Procurement should re-emphasize to Procurement personnel the applicable guidance

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regarding settlement of indirect cost rates and use of DCAA incurred cost audit reports.

Management's Response: Procurement management will ensure all Procurement personnel are aware of the guidance on settlement of indirect cost rates and emphasize the use of DCAA incurred cost audit reports to more effectively complete the contract close-out process.

2. The Director of Procurement should encourage the use of quick close-out procedures to settle indirect costs on completed contracts and task orders, when applicable.

Management's Response: Procurement management will issue guidance to all Procurement personnel on the benefits of the use of quick close-out procedures and encourage their consideration and use wherever appropriate.

3. The Director of Procurement should modify the tracking system to identify the incurred cost audit reports received, the contractor, the fiscal year covered, and the applicable cost reimbursable contracts. This system should be accessible by the COs.

Management's Response: Procurement's Office of Procurement Policy, Cost and Price Analysis Branch will facilitate enhancements to the incurred costs database and expansion of accessibility to COs.

Conclusion

Improvements are needed in using DCAA incurred cost audit reports to settle indirect cost rates. Most of the COs did not fully understand how to use the DCAA incurred cost audit reports to close out completed contracts and task orders. In addition, some COs were unaware that the incurred costs audit reports had been received. We believe that increased awareness of existing guidance on the close-out process and

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enhancements to the tracking system would assist the COs in closing out completed contracts and task orders.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) is effectively using Defense Contract Audit Agency (DCAA) audit reports. To accomplish this objective, we:

- I. Determined if Procurement personnel effectively used DCAA audit reports to negotiate fair and reasonable prices.
 - A. Selected and reviewed a judgmental sample of 26 contracts from a universe of 183 contracts with contract actions over \$500,000 in Fiscal Years (FY) 1998 or 1999.
 1. Evaluated the method used by the Contracting Officer (CO) and determined whether sufficient information was available to establish a fair and reasonable price.
 2. Determined whether the CO requested the assistance of the Cost and Pricing Branch or the DCAA to assess the contractor's pricing.
 - B. Reviewed a judgmental sample of five DCAA proposal audit reports received by the IRS in FYs 1998 and 1999 from a universe of eight.
 1. Interviewed the CO to determine whether the DCAA report was included in the official contract file.
 2. Reviewed the Price Negotiation Memorandum to determine how the CO used the DCAA report.
 3. Determined the benefit received from using the DCAA audit report.
 - C. Determined if the Cost and Pricing Branch is effectively using DCAA audit services.
 1. Determined if the Cost and Pricing Branch coordinates its services and database information with the COs.
 2. Determined if the Cost and Pricing Branch researches available in-house information before requesting DCAA audit services.
 3. Evaluated the risk assessment process used to determine the extent of information needed by the CO for a fair and reasonableness price determination.

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- II. Determined if Procurement personnel efficiently settle indirect costs and recover questioned costs.
 - A. Reviewed the procedures used to close out cost reimbursable contracts.
 - B. Assessed the process used to track due dates for settlement of indirect cost rates.
 - C. Reviewed a judgmental sample of 10 DCAA incurred cost audit reports received in FYs 1998 and 1999 from a universe of 21 audit reports. Interviewed the COs to determine their involvement in settlement of indirect cost rates, requests for incurred cost audit reports, recovery of questioned costs, and use of quick close-out procedures.
 - D. Determined if the Cost and Pricing Branch assessed the applicability of quick close-out procedures before agreeing to participate in incurred cost audit reports.

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Appendix II

Major Contributors to This Report

Maurice S. Moody, Associate Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

John R. Wright, Director

Nancy LaManna, Audit Manager

Regina Dougherty, Senior Auditor

Jill Moore, Senior Auditor

Dawn Smith, Senior Auditor

Andrew Harvey, Auditor

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Appendix III

Report Distribution List

Deputy Commissioner, Operations C:DO
Chief, Agency-Wide Shared Services A
Director of Procurement A:P
Director, Office of Program Evaluation and Risk Analysis M:O
National Director for Legislative Affairs CL:LA
Office of Management Controls M:CFO:A:M
Office of the Chief Counsel CC
Office of the Taxpayer Advocate C:TA
Audit Liaison: Director of Procurement A:P

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Finding and recommendation:

Procurement personnel are not effectively using Defense Contract Audit Agency (DCAA) incurred cost reports to settle indirect cost rates on completed contracts and task orders (see page 3).

Type of Outcome Measure:

Cost Savings (funds put to better use) - potential

Value of the Benefit:

There was \$70,000 remaining on completed task orders for which the contracting officers (COs) did not attempt to identify excess funds.

Methodology Used to Measure the Reported Benefit:

We interviewed the COs and reviewed documentation in the contract files that indicated these funds had been obligated and not expended.

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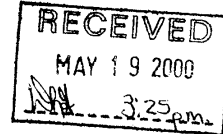
Appendix V

Management's Response to the Draft Report



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



May 19, 2000

MEMORANDUM FOR DAVID C. WILLIAMS
TREASURY INSPECTOR GENERAL FOR
TAX ADMINISTRATION

FROM:

for Charles O. Rossotti *Bohlander*
Commissioner of Internal Revenue

SUBJECT:

Draft Audit Report: Incurred Cost Audit Reports Are Not
Effectively Used to Settle Indirect Rates (2000100003)

Thank you for the opportunity to respond to your draft report on incurred cost audits. We appreciate your pointing out that the negotiating skills of IRS Procurement personnel, in conjunction with their use of Defense Contract Audit Agency (DCAA) proposal audits, saved the Government \$31 million. With regard to your recommendations concerning incurred cost audits, we agree that they should be implemented and that this will help improve close-outs of cost reimbursable contracts. This will also help us, as you pointed out, to more quickly identify excess funds for deobligation, such as the \$70,000 you identified through your sampling.

Attached are proposed corrective actions in response to the recommendations. Please call Jim Williams, Director, Procurement, at (202) 283-1200 if you have any questions. Your staff may also contact Donna Craver at (202) 283-1122 for additional information.

Attachment

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Recommendation No. 1:

The Director of Procurement should re-emphasize to Procurement personnel the applicable guidance regarding settlement of indirect cost rates and use of DCAA incurred cost audit reports.

Assessment of Cause:

The report finds that failure to effectively use DCAA audit reports to settle indirect cost rates may result in delays in de-obligating excess funds.

Corrective Action:

The Office of Procurement Policy will issue guidance to all Procurement personnel to identify guidance on settlement of indirect cost rates and to emphasize the use of the DCAA incurred cost audit reports to more effectively complete the contract close-out process.

Implementation Date:

Proposed July 1, 2000.

Responsible Official:

Director, Procurement.

Recommendation No. 2:

The Director of Procurement should encourage the use of quick close-out procedures to settle indirect costs on completed contracts and task orders, when applicable.

Assessment of Cause:

The report finds that failure to consider the possibility of quick close-out procedures upon contract completion could result in delays in contract close-out and delays in de-obligating excess funds.

Corrective Action:

The Office of Procurement Policy will issue guidance to all procurement personnel on the benefits of the use of quick close-out procedures and encourage their consideration and use wherever appropriate.

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Implementation Date:

Proposed July 1, 2000.

Responsible Official:

Director, Procurement.

Recommendation No. 3:

The Director of Procurement should modify the tracking system to identify the incurred cost audit reports received, the contractor, the fiscal year covered, and the applicable cost reimbursable contracts. This system should be accessible by the COs.

Assessment of Cause:

The report finds that while the Cost and Price Analysis Branch has established a database to monitor DCAA activity, the database needs enhancements and extended accessibility to COs to make its usage more effective in the contract close-out process.

Corrective Action:

The Office of Procurement Policy, Cost and Price Analysis Branch will facilitate enhancements to the incurred costs database and expansion of accessibility to COs.

Implementation Date:

Proposed May 2001.

Responsible Official:

Director, Procurement.