

## CLASS DEVIATION TO REFLECT CHANGES TO THE COOPERATIVE AUDIT STRATEGY

### BACKGROUND

DOE's Office of Inspector General (IG) is statutorily responsible for the audit of DOE's management and operating contracts (M&Os). Those contracts have two significant financial characteristics in common: (1) the use of special bank accounts for payment of contract costs and (2) the annual reconciliation of contract costs through the use of a Statement of Costs Incurred and Claimed. These two characteristics operate in tandem, replacing a system of vouchers to reimburse incurred costs normally used on government cost type contracts. M&O contracts incur costs of several hundreds of millions of dollars to more than \$1 billion.

The IG has designed a Cooperative Audit Strategy to fulfill its M&O audit responsibilities. That strategy consists of reliance on the contractor's creating an internal audit function as a first line of audit, used to identify unallowable costs and weaknesses in financial control systems.

For the Cooperative Audit Strategy to fulfill its objective, it depends not only on the active involvement of the Inspector General but on the active involvement of the Chief Financial Officer (CFO) and the Contracting Officer.

Currently, the only coverage in DOE M&O contracts reflecting the Cooperative Audit Strategy is Alternate II to the clause at 970.5232-3, Accounts, Records, and Inspection, which states in part:

- (i) *Internal audit.* The contractor agrees to conduct an internal audit and examination satisfactory to DOE of the records, operations, expenses, and the transactions with respect to costs claimed to be allowable under this contract annually and at such other times as may be mutually agreed upon. The results of such audit, including the working papers, shall be submitted or made available to the contracting officer.

The IG provides guidance to its auditors on this subject, the Chief Financial Officer provides guidance on the Statement of Costs Incurred and Claimed in the Accounting Handbook, and the Acquisition Guide provides guidance to contracting officers in Chapter 70.4.

The IG, CFO, and the Office of Procurement and Assistance Management have cooperated to revise the Acquisition Guide chapter. In doing so, those offices have made important revisions to the Cooperative Audit Strategy, adding a requirement for the contractor to establish an internal audit design to describe its plan for audit during contract performance, adding depth to the discussion of the responsibilities of the three participating DOE functions, and expanding the contract coverage. The guide chapter is being coordinated for issuance. A proposed rule reflecting the alterations to the contractual coverage is being prepared.

## DESCRIPTION OF THE DEVIATIONS

The Department's interests would be well served by the authorization of the proposed clause changes for use in M&O contracts that are currently being competed or extended, rather than waiting for the promulgation of the changes by final rule.

The proposed changes are reflected by the emboldened text in the attached clauses. The changed contractual coverage consists of the addition of one sentence to paragraph (a)(4) of the Management Controls clause at 970.5203-1, revised paragraphs (i) and (j) to the Accounts, Records, and Inspection clause at 970.5232-3, and the deletion of Alternate II to that clause.

The revision to the Management Controls clause would direct the contractor to provide the contracting officer the contractor's reports showing the status of implementation of audit recommendations.

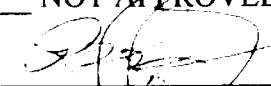
The new paragraph (i) of the Accounts, Records, and Inspection clause would require the contractor to provide the contracting officer with an internal audit design upon the award and any extension of the contract. It would describe the size, placement, and audit standards for the contractor's internal audit function. Additionally, the contractor is required to supply an annual audit report to summarize the activities of the contractor's internal audit function during the prior contract year and an annual audit plan to describe the audit activities of the internal audit function planned for the next contract year.

The new paragraph (j) of the Accounts, Records, and Inspection clause would provide a sample list of remedies available to the contracting officer should DOE lose confidence in the contractor's internal audit function or the contractor's system of controls. The proposed changes would render Alternate II unnecessary.

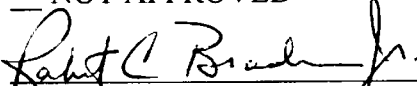
## RECOMMENDATION

It is recommended that the proposed deviations to the Management Controls clause, 970.5203-1, and Accounts, Records, and Inspection clause, 970.5242-3, be authorized for use in the class of M&O contracts that will be competed or extended prior to their promulgation into the DEAR through the rulemaking process. Contracting officers will also be authorized to negotiate this clause into existing M&O contracts at the next annual fee negotiation. This deviation will be effective through the promulgation of the final rule.

APPROVED  
 NOT APPROVED

  
Richard H. Hopf, Director  
Office of Procurement and  
Assistance Management  
DEAR 970.5203-1 Management controls.

APPROVED  
 NOT APPROVED

  
Robert C. Braden, Jr., Director  
Office of Procurement and  
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DEAR 970.5203-1 Management controls.

As prescribed in 48 CFR 970.0370-2(a) and 48 CFR 970.3270(a)(4), insert the following clause:

970.5203-1 MANAGEMENT CONTROLS (DEC 2000)(DEVIATION)

(a)(1) The contractor shall be responsible for maintaining, as an integral part of its organization, effective systems of management controls for both administrative and programmatic activities. Management controls comprise the plan of organization, methods, and procedures adopted by management to reasonably ensure that: the mission and activities assigned to the contractor are properly executed; efficient and effective operations are promoted; resources are safeguarded against waste, loss, mismanagement, unauthorized use, or misappropriation; all encumbrances and costs that are incurred under the contract and fees that are earned are in compliance with applicable clauses and other current terms, conditions, and intended purposes; all collections accruing to the contractor in connection with the work under this contract, expenditures, and all other transactions and assets are properly recorded, managed, and reported; and financial, statistical, and other reports necessary to maintain accountability and managerial control are accurate, reliable, and timely.

(2) The systems of controls employed by the contractor shall be documented and satisfactory to DOE.

(3) Such systems shall be an integral part of the contractor's management activities, including defining specific roles and responsibilities for each level of management, and holding employees accountable for the adequacy of the management systems and controls in their areas of assigned responsibility.

(4) The contractor shall, as part of the internal audit program required elsewhere in this contract, periodically review the management systems and controls employed in programs and administrative areas to ensure that they are adequate to provide reasonable assurance that the objectives of the systems are being accomplished and that these systems and controls are working effectively. **Annually, or at other intervals directed by the contracting officer, the contractor shall supply to the contracting officer copies of the reports reflecting the status of recommendations that result from audits of business, financial, or management controls performed by its internal audit activity and any other audit activity.**

(b) The contractor shall be responsible for maintaining, as a part of its operational responsibilities, a baseline quality assurance program that implements documented performance, quality standards, and control and assessment techniques.

DEAR 970.5232-3 Accounts, records, and inspection.

As prescribed in 48 CFR 970.3270(a)(2), insert the following clause:

970.5232-3 ACCOUNTS, RECORDS, AND INSPECTION (DEC 2000)(DEVIATION)

(a) *Accounts.* The contractor shall maintain a separate and distinct set of accounts, records, documents, and other evidence showing and supporting: all allowable costs incurred; collections accruing to the contractor in connection with the work under this contract, other applicable credits, negotiated fixed amounts, and fee accruals under this contract; and the receipt, use, and disposition of all Government property coming into the possession of the contractor under this contract. The system of accounts employed by the contractor shall be satisfactory to DOE and in accordance with generally accepted accounting principles consistently applied.

(b) *Inspection and audit of accounts and records.* All books of account and records relating to this contract shall be subject to inspection and audit by DOE or its designees in accordance with the provisions of Clause \_\_\_\_\_, Access to and ownership of records, at all reasonable times, before and during the period of retention provided for in paragraph (d) of this clause, and the contractor shall afford DOE proper facilities for such inspection and audit.

(c) *Audit of subcontractors' records.* The contractor also agrees, with respect to any subcontracts (including fixed-price or unit-price subcontracts or purchase orders) where, under the terms of the subcontract, costs incurred are a factor in determining the amount payable to the subcontractor of any tier, to either conduct an audit of the subcontractor's costs or arrange for such an audit to be performed by the cognizant government audit agency through the contracting officer.

(d) *Disposition of records.* Except as agreed upon by the Government and the contractor, all financial and cost reports, books of account and supporting documents, system files, data bases, and other data evidencing costs allowable, collections accruing to the contractor in connection with the work under this contract, other applicable credits, and fee accruals under this contract, shall be the property of the Government, and shall be delivered to the Government or otherwise disposed of by the contractor either as the contracting officer may from time to time direct during the progress of the work or, in any event, as the contracting officer shall direct upon completion or termination of this contract and final audit of accounts hereunder. Except as otherwise provided in this contract, including provisions of Clause \_\_\_\_\_, Access to and ownership of records, all other records in the possession of the contractor relating to this contract shall be preserved by the contractor for a period of three years after final payment under this contract or otherwise disposed of in such manner as may be agreed upon by the Government and the contractor.

(e) *Reports.* The contractor shall furnish such progress reports and schedules, financial and cost reports, and other reports concerning the work under this contract as the contracting officer may from time to time require.

(f) *Inspections.* The DOE shall have the right to inspect the work and activities of the contractor under this contract at such time and in such manner as it shall deem appropriate.

(g) *Subcontracts.* The contractor further agrees to require the inclusion of provisions similar to those in paragraphs (a) through (g) and paragraph (h) of this clause in all subcontracts (including fixed-price or unit-price subcontracts or purchase orders) of any tier entered into hereunder where, under the terms of the subcontract, costs incurred are a factor in determining the amount payable to the subcontractor.

(h) *Comptroller General.* (1) The Comptroller General of the United States, or an authorized representative, shall have access to and the right to examine any of the contractor's directly pertinent records involving transactions related to this contract or a subcontract hereunder.

(2) This paragraph may not be construed to require the contractor or subcontractor to create or maintain any record that the contractor or subcontractor does not maintain in the ordinary course of business or pursuant to a provision of law.

(3) Nothing in this contract shall be deemed to preclude an audit by the General Accounting Office of any transaction under this contract.

**(i) Internal audit. The contractor agrees to establish and maintain an internal audit activity and provide the following reports:**

**(1) Internal Audit Implementation Design.** Within thirty (30) days of contract award and each 5<sup>th</sup> year of contract performance or upon the exercise of any contract option or the extension of the contract, the contractor shall submit to the contracting officer an Internal Audit Implementation Design to include the overall strategy for the audit activity. The Implementation Design will describe (i) the audit activity's placement within the contractor's organization including reporting requirements; (ii) its size and the experience and educational standards of the audit staff; (iii) its relationship to the corporate parent(s) of the contractor; (iv) the standards used to audit; (v) an overall audit strategy for relevant performance period of this contract, considering particularly the method of auditing costs incurred in the performance of the contract; (vi) the intended use of external audit resources; (vii) the plan for audit, both pre-award and post-award of subcontracts; and (viii) the schedule of peer review of the internal audit activity by other DOE contractor internal audit activities.

**(2) Annual Audit Report.** By each January 31 of the contract performance period, the contractor shall submit an annual audit report, providing a summary of the audit activities undertaken during the previous fiscal year and their results.

**(3) Annual Audit Plan.** By each June 30 of the contract performance period, the contractor shall submit to the contracting officer an annual audit plan that reflects the activities to be undertaken during the next fiscal year. The contractor shall design the Annual Audit Plan to test the costs incurred and contractor management systems described in the internal audit design.

**(4) Contracting officer's satisfaction.** The design of the internal audit activity submitted under subparagraph (1), the annual report submitted under subparagraph (2), and the annual audit plan submitted under subparagraph (3) shall be satisfactory to the contracting officer.

**(j) Statement of Costs Incurred and Claimed.** At any time during contract performance, should the contracting officer determine that the costs incurred are unallowable to an extent to cause him or her to lose confidence in the contractor's management controls or the contractor's management systems that validate the costs incurred and claimed, the contracting officer may, in his or her sole discretion, impose conditions upon the contractor's use of the special financial institution account or use of the Statement of Costs Incurred and Claimed in whole or in part, including direction that specific types of costs be claimed by periodic vouchering. This action shall not relieve the contractor from any obligation to perform its obligations under this contract. In addition, the contracting officer may direct the contractor to pay the Government an amount equal to the unallowable costs or payments improperly made and take any other action or combination of actions provided in this contract, at law, or in equity.

(End of Clause)

*Alternate I (DEC 2000).* As prescribed in 48 CFR 970.3270(a)(2)(i), if the contract includes the clause at 48 CFR 52.215-11, Price Reduction for Defective Cost or Pricing Data, the basic clause shall be modified as follows:

(a) Paragraph (a) of the basic clause shall be modified by adding the words "or anticipated to be incurred" after the words "allowable costs incurred."

(b) Paragraph (g) of the basic clause shall be modified by adding the following:

The contractor further agrees to include an "Audit" clause, the substance of which is the "Audit" clause set forth at 48 CFR 52.215-2, in each subcontract which does not include provisions similar to those in paragraph (a) through paragraph (g) and paragraph (h) of this clause, but which contains a "defective cost or pricing data" clause.