



Department of Defense INSTRUCTION

NUMBER 7640.02
August 22, 2008

IG DoD

SUBJECT: Policy for Follow-up on Contract Audit Reports

References: See Enclosure 1

1. PURPOSE. This Instruction:

a. Reissues DoD Directive (DoDD) 7640.2 (Reference (a)) as a DoD Instruction (DoDI) in accordance with the guidance in DoDI 5025.01 (Reference (b)) and the authority in DoDD 5106.01 (Reference (c)).

b. Updates DoD policy and responsibilities, reporting requirements, and follow-up procedures on contract audits conducted by the Defense Contract Audit Agency (DCAA).

c. Implements the appendix to title 5, United States Code, and the Office of Management and Budget Circular No. A-50 (References (d) and (e)).

2. APPLICABILITY AND SCOPE. This Instruction:

a. Applies to OSD, the Military Departments, the Office of the Chairman of the Joint Chiefs of Staff and the Joint Staff, the Combatant Commands, the Office of the Inspector General of the Department of Defense (IG DoD), the Defense Agencies, the DoD Field Activities, and all other organizational entities within the Department of Defense (hereafter referred to collectively as the "DoD Components").

b. Does not apply to reports of the Government Accountability Office (GAO), the IG DoD, and other DoD internal audit organizations. Follow-up policies and procedures for reports of those organizations are contained in DoDD 7650.3 (Reference (f)). The IG DoD and contract audit follow-up officials may formulate special procedures for follow-up on post-award audit reports of the IG DoD and GAO.

3. DEFINITIONS. See Glossary.

4. POLICY. It is DoD policy that:

a. Audit follow-up is an integral part of good management and is a shared responsibility of agency management officials and auditors.

b. Findings and recommendations contained in contract audit reports shall be resolved and dispositioned in a timely manner which is consistent with legal statutes, regulations, and DoD policy.

c. DoD Components shall maintain complete, accurate, and up-to-date records of actions taken to resolve and dispose of reportable audit findings and recommendations.

5. RESPONSIBILITIES. See Enclosure 2.

6. PROCEDURES. See Enclosure 3.

7. RELEASABILITY. UNLIMITED. This Instruction is approved for public release. Copies may be obtained through the Internet from the DoD Issuances Web Site at <http://www.dtic.mil/whs/directives>.

8. EFFECTIVE DATE

This Instruction is effective immediately.



Gordon S. Heddell
Acting Inspector General

Enclosures

1. References
 2. Responsibilities
 3. Procedures
 4. Follow-up Status Reports
 5. Audit Reports Subject to Reporting Requirements
- Glossary

ENCLOSURE 1

REFERENCES

- (a) DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports," February 12, 1988 (hereby canceled)
- (b) DoD Instruction 5025.01, "DoD Directives Program," October 28, 2007
- (c) DoD Directive 5106.01, "Inspector General of the Department of Defense," April 13, 2006
- (d) Appendix to title 5, United States Code, "Inspector General Act of 1978," as amended
- (e) Office of Management and Budget Circular No. A-50 (Revised), "Audit Followup," September 29, 1982
- (f) DoD Directive 7650.3, "Follow-up on General Accounting Office (GAO), DoD Inspector General (DoD IG), and Internal Audit Reports," June 3, 2004
- (g) DoD Instruction 7600.02, "Audit Policies," April 27, 2007
- (h) Parts 1.4, 1.602, 15.407-1(b)(7), 31.205, 42.705-1(b)(5)(iii), 42.709, 52.230-2(a)(5), 52.230-3(a)(4), and 52.230-4 of the Federal Acquisition Regulation, current edition
- (i) Sections 2306(a), 2324(b)(1)(A), and 2324(b)(2) of title 10, United States Code

ENCLOSURE 2

RESPONSIBILITIES

1. IG DoD. The IG DoD, consistent with Reference (c), shall:

a. Establish policy and procedures for contract audit follow-up and provide guidance to the DoD Components on matters covered under this Instruction.

b. Monitor, coordinate, and evaluate the contract audit follow-up system and execution of DoD Component responsibilities assigned herein.

c. Identify cases or areas where contract audit follow-up procedures can be improved and recommend appropriate corrective action to the Heads of the DoD Components.

d. Provide reports on the status of DoD contract audit follow-up efforts for the semiannual reporting periods ending March 31 and September 30 of each year, including those required by References (c) and (d), to the Secretary of Defense and Congress.

2. SECRETARIES OF THE MILITARY DEPARTMENTS AND DIRECTORS OF THE DEFENSE AGENCIES. The Secretaries of the Military Departments and the Directors of the Defense Agencies shall:

a. In accordance with Reference (e), designate a top management official to oversee contract audit follow-up, including resolution and disposition actions. Assure that management officials throughout the DoD Components understand the value of the audit process and are responsive to audit findings and recommendations. Provide names, titles, and telephone numbers of the designated management officials to the IG DoD.

b. Establish and implement procedures whereby contracting officers shall fully consider all contract audit findings and recommendations in developing the pre-negotiation and post-negotiation positions, if applicable, including the assessment of recommended penalties and interest.

c. Establish and implement procedures to monitor the timeliness and appropriateness of resolution and disposition of contract audit reports, including the assessment of penalties and interest.

d. Address the timeliness and effectiveness in resolving and dispositioning audit findings and recommendations in appraisals and, where appropriate, performance standards for acquisition officials involved in contract audit follow-up actions.

e. Establish and implement procedures for maintaining records regarding the status of all reportable contract audit reports. Retain audit follow-up records for a minimum of 6 years and 3 months after final payment of the last contract affected by the audit.

f. Require periodic internal reviews of the DoD Components' follow-up programs to determine whether contracting officials timely and effectively resolve and disposition audit findings and recommendations, including the assessment of penalties and interest.

g. Require the contracting officer to provide a copy of the post-negotiation memorandum to the DCAA auditor and other affected Government offices, as applicable.

h. Promptly update the status of actions taken to resolve and disposition reportable contract audit reports to facilitate the reporting responsibilities in paragraph 1.d. of this enclosure.

i. Ensure that DoD Component acquisition personnel are trained in resolving and dispositioning contract audit reports and complying with the contract audit follow-up reporting requirements.

3. DIRECTOR, DCAA. The Director, DCAA, under the authority, direction, and control of the Under Secretary of Defense (Comptroller), shall:

a. Issue timely audit reports and provide timely and complete responses to contracting officers or review officials who request clarification or information supporting the audit findings and recommendations.

b. Issue timely supplemental audit reports to update audit findings or recommendations. Do not use other communication methods (such as memorandums or e-mails) to update the findings or recommendations when the updates have a significant impact on Government contract costs.

c. Provide timely and adequate support to the IG DoD and any other DoD organization reviewing a DoD Component's contract audit follow-up program, in accordance with DoDI 7600.02 (Reference (g)).

d. Consider all feedback provided by contracting officials to analyze and improve audit procedures and practices.

e. Provide a monthly listing of reportable contract audit reports to the DoD Components. (See subparagraph 1.b.(2)(a) of Enclosure 3.)

ENCLOSURE 3

PROCEDURES

1. TRACKING AND REPORTING REQUIREMENTS

a. Tracking Requirements. All contract audit reports are to be tracked. For non-reportable contract audits defined in the Glossary, tracking may be accomplished using records maintained in official contract files.

b. Reporting Requirements

(1) The DoD Components shall:

(a) Maintain a system that records the actions taken to resolve and disposition reportable contract audits, hereafter referred to as the contract audit follow-up system. The contract audit follow-up system shall include a record of the information listed in Enclosure 4, sections 1 and 2, for each open and closed reportable audit. The contract audit follow-up system records shall serve as the source for the semiannual status information reported by the IG DoD in accordance with paragraph 1.d. of Enclosure 2.

(b) Ensure that the DCAA monthly listing of reportable audits is promptly incorporated in the DoD Component's contract audit follow-up system. (See paragraph 1.b.(2)(a) of this enclosure.)

(c) Ensure that contracting officers promptly update the status of reportable audits.

(d) Provide to the IG DoD a hard-copy report on the status of reportable audits within 3 business days following the semiannual reporting periods March 31 and September 30 of each year if the DoD Component (or part of a DoD Component) does not use the automated Defense Contract Management Agency contract audit follow-up system. Include the information listed in Enclosure 4, sections 1 and 2, for each open and closed reportable audit.

(2) The DCAA shall:

(a) Provide a listing of reportable audits issued each month to the DoD Components, or designated point of contact, within 3 business days following month's end. Audits subject to the reporting requirements are listed in Enclosure 5.

(b) For each reportable audit include the report number, report date, contractor name, DoD Activity Address Code, type of audit (see Enclosure 4, section 3), questioned costs or potential cost avoidance and/or recommended price adjustment, questioned costs subject to penalty, and whether the report includes qualifications or unresolved costs.

(3) The DoD Component contracting officers shall:

(a) Establish and update estimated target dates for resolving and dispositioning each reportable audit assigned to them.

(b) Promptly update the status of reportable audits as unresolved, resolved, dispositioned, or under litigation or investigation in the contract audit follow-up system.

(c) Ensure the accuracy of all data in the contract audit follow-up system.

(d) Report questioned costs and sustained amounts in the contract audit follow-up system by:

1. Including those agreed to between the auditor and contractor, except for audit-determined incurred cost audits where the auditor and contractor agree on all questioned costs and the auditor does not identify questioned costs subject to penalty.

2. Including those negotiated by another DoD contracting officer that are not being reported elsewhere in the contract audit follow-up system.

3. Excluding corporate or divisional allocated costs if another DoD contracting officer is responsible for negotiating and reporting them in the contract audit follow-up system.

4. Not adjusting for contract type (e.g., fixed-price or cost-type) or percent of commercial business.

(e) If a report is updated by a supplemental report, disposition the original report with questioned cost and questioned cost sustained amounts of zero as of the date of the supplemental report.

(4) The IG DoD shall:

(a) Collect the contract audit follow-up data of each DoD Component for the semiannual reporting periods ending March 31 and September 30.

(b) Summarize the contract audit follow-up data for all DoD Components and include the summary in the IG DoD Semiannual Report to Congress.

2. RESOLUTION OF REPORTABLE CONTRACT AUDIT REPORTS. The DoD Component contracting officer, consistent with the authority and responsibilities described in part 1.602 of the Federal Acquisition Regulation (Reference (h)), shall:

a. Resolve reportable audit reports within 6 months of report issuance. If the audit report is not resolved within 6 months, document the actions taken to achieve resolution at least monthly.

b. Coordinate with the other Government agencies that have negotiation responsibility over a portion of the findings or recommendations.

c. Document the resolution of the audit report in a signed and dated pre-negotiation memorandum, if applicable. Indicate whether each finding and/or recommendation is agreed to and, if not, the rationale for the disagreement. When no negotiation is required, document the resolution of the audit in a memorandum to the contract file.

(1) Document the legal basis for the resolution if the contracting officer's disagreement with the reported findings or recommendations involves an interpretation of law, regulation, or the authority of officials (Reference (e)). Obtain a review of the legal basis at a level above the contracting officer. Document the legal basis and review in the contract file.

(2) Resolve all audit findings and recommendations (including any associated penalties and interest) and complete the pre-negotiation memorandum prior to reporting the audit as resolved in the contract audit follow-up system.

3. DISPOSITION OF REPORTABLE CONTRACT AUDIT REPORTS. The DoD Component contracting officer, consistent with the authority and responsibilities described in part 1.602 of Reference (h), shall:

a. Disposition reportable audit reports within 12 months of report issuance. If the audit report is not dispositioned within 12 months, document the actions taken to achieve disposition at least monthly.

b. Document the disposition results of all reported findings and recommendations in a signed and dated post-negotiation memorandum. For indirect rates, include a reconciliation of all costs questioned to the DCAA audit report and the identification of cost or pricing data submitted during the negotiations that were relied upon in reaching a settlement, as part 42.705-1(b)(5)(iii) of Reference (h) requires. For each audit finding and recommendation, indicate whether the finding and/or recommendation is agreed to and, if not, the rationale for the disagreement. When no negotiation is required, document the disposition of the audit in a memorandum to the contract file.

(1) Document the legal basis for the disposition when there is a disagreement with the reported findings or recommendations based on an interpretation of law, regulation, or the authority of officials, as Reference (e) requires. Obtain a review of the legal basis at a level above the contracting officer if it has not already been reviewed under the pre-negotiation memorandum. Document the legal basis and review in the post-negotiation memorandum or elsewhere in the contract file.

(2) Incorporate the negotiation results from other Government agencies in the post-negotiation memorandum, if applicable.

(3) Address all audit findings and recommendations (including the disposition of unresolved costs and the assessment of penalties and interest) and complete the post-negotiation memorandum prior to reporting the audit as dispositioned in the contract audit follow-up system. However, the contracting officer may disposition an incurred cost audit report in the contract audit follow-up system prior to dispositioning unresolved costs if the unresolved costs have no impact on the indirect rates (e.g., subcontract costs). Include a remark in the post-negotiation memorandum and the contract audit follow-up system indicating that the unresolved costs will be addressed upon receipt of the DCAA audit opinion on the unresolved costs.

c. Provide a copy of the negotiation memorandum to DCAA and to other Government agencies involved in, or affected by, the negotiation, as appropriate.

d. Assess penalties and interest (or document a waiver) in accordance with part 42.709 of Reference (h) if the contracting officer determines that a contractor included costs that are expressly unallowable or previously determined to be unallowable in its final indirect cost rate proposal. Report the amount of assessed penalties in the contract audit follow-up system separate from the reported questioned costs sustained.

e. Collect interest assessed on overpayments resulting from defective cost or pricing data on DoD contracts in accordance with section 2306(a) of title 10, United States Code (Reference (i)) and part 15.407-1(b)(7) of Reference (h). Collect interest assessed on increased costs paid by the Government as a result of a cost accounting standard (CAS) noncompliance in accordance with parts 52.230-2(a)(5), 52.230-3(a)(4), and 52.230-4 of Reference (h).

ENCLOSURE 4

FOLLOW-UP STATUS REPORTS

The status reports shall provide information for open and closed audit reports in the contract audit follow-up system.

1. OPEN AUDIT REPORTS. Information reported for each open audit report shall include, as applicable:

- a. Report number
- b. Report date
- c. Contractor name
- d. DoD Activity Address Code
- e. Audit type (see section 3 of this enclosure)
- f. Questioned costs, potential cost avoidance, or recommended price adjustment
- g. Questioned costs subject to penalty
- h. Qualifications or unresolved costs (yes or no)
- i. Audit status (unresolved, resolved, litigation, investigation)
- j. Target resolution date
- k. Target disposition date
- l. Actual resolution date
- m. Armed Services Board of Contract Appeals (ASBCA) docket number or U.S. Court of Federal Claims case number
- n. Original audit report date.

2. CLOSED AUDIT REPORTS. Information reported for each closed audit report shall include, as applicable:

- a. Report number

- b. Report date
- c. Contractor name
- d. DoD Activity Address Code
- e. Audit type (see section 3 of this enclosure)
- f. Disposition date
- g. Questioned costs, potential cost avoidance, or recommended price adjustment
- h. Qualifications or unresolved costs (yes or no)
- i. Questioned costs, potential cost avoidance, or recommended price adjustment sustained
- j. Percentage of questioned costs or potential cost avoidance sustained
- k. Questioned costs subject to penalty
- l. Penalty assessed
- m. Original audit report date and/or supplemental audit report number

3. CODES FOR TYPE OF AUDIT. The codes listed in the Table shall be used in the Contract Audit Follow-up System for designating the type of audit.

Table of Audit Codes

<u>Code</u>	<u>Type of Audit</u>
A	Reserved
B	Accounting and Management Systems Audits
C ¹	Claims (Hardship and Escalation) and Equitable Adjustments
D	Post-award Audits (Defective Pricing)
E	CAS Noncompliance and Cost Impact Statement Audits
F ¹	Operations Audits and Operations Audits Follow-up
G ¹	Incurred Costs and Settlement of Final Indirect Cost Rates
H	Insurance and Pension Audits
I ¹	Final Pricing
J ¹	Terminations
K	Earned Value Management System Audits
<hr/> ¹ Reported questioned costs or potential cost avoidance that equal \$100,000 or more	

ENCLOSURE 5

AUDIT REPORTS SUBJECT TO
REPORTING REQUIREMENTS

1. The following types of contract audit reports are subject to the reporting requirements if they include findings and recommendations.

a. Accounting and management systems audits, including estimating systems, control environment and overall accounting systems, billing systems, compensation systems, material management and accounting systems, budget and planning systems, labor systems, information technology systems, purchasing systems, and direct and indirect cost systems.

b. Accounting and management systems follow-up audits.

c. Estimating system real-time deficiency reports.

d. Earned value management systems.

e. Post-award audits.

f. CAS noncompliance reports.

g. CAS cost impact statements.

2. The following types of contract audit reports are subject to the reporting requirements if they include questioned costs or potential cost avoidance of \$100,000 or more.

a. Incurred costs, except for audits of audit-determined indirect rates where the auditor and contractor agree on all questioned costs and the auditor does not identify questioned costs subject to penalty.

b. Settlement of indirect cost rates.

c. Final pricing submissions.

d. Termination settlement proposals.

e. Equitable adjustment claims.

f. Hardship claims.

g. Escalation claims.

- h. Operations and operations follow-up audits.
 - i. Insurance and pension audits.
 - j. Capital and direct medical and education cost audits.
 - k. Retention incentive pay audits.
 - l. Service Contract Act wage determination reviews.
3. All supplemental audit reports that supersede or supplement a previously issued reportable audit report are reportable, regardless of whether the supplemental report includes findings, recommendations, questioned costs, or potential cost avoidance.

GLOSSARY

All terms and definitions are for the purposes of this Instruction.

adverse opinion. An audit opinion containing the statement that the contractor's proposal is not acceptable as a basis for negotiation of a fair and reasonable price.

closed audit report. A report that has been dispositioned by the contracting officer and closed for follow-up reporting purposes.

contract audit report. The contract auditor's written advice to a contracting officer advocating specific action and/or including qualified or adverse opinion information. An audit report could include amounts questioned or disapproved, recommendations on a contractor's system or operations (usually expressed in terms of cost avoidance), recommended price adjustments, or notification of a contractor's noncompliance with CAS.

disposition. An audit is considered to be dispositioned when the contracting officer completes a signed and dated post-negotiation memorandum and one of the following actions occurs:

The contracting officer renders a decision involving accounting and management systems findings and recommendations and notifies the contractor in writing.

The contracting officer negotiates a settlement covering all audit issues with the contractor and executes any required contracting action (e.g., indirect rate agreement).

The contracting officer issues a final determination pursuant to the disputes clause, and 90 days elapse without contractor appeal to the ASBCA.

For CAS noncompliance audits, the contracting officer issues a written final determination to the contractor. (Should the contractor appeal to the U.S. Court of Federal Claims within 12 months after final determination, the audit must be reinstated as an open report in litigation.)

A decision is rendered on an appeal made to the ASBCA or U.S. Court of Federal Claims and any corrective actions directed by ASBCA or the Court are complete, and a contractual document has been executed.

Audit reports have been superseded or updated by a subsequent report.

The contracting officer determines final action on a CAS cost impact proposal.

Any corrective actions have been taken, so that no further actions can be reasonably anticipated.

investigation. An audit is considered to be in investigation status when an investigative agency of the U.S. Government is reviewing any of the audit issues.

litigation. An audit is considered to be in litigation status when any of the audit issues are under review by a court or tribunal including the ASBCA, the U.S. Court of Federal Claims, the U.S. Court of Appeals for the Federal Circuit, or the United States Supreme Court.

non-reportable audits. Audits covering pre-award proposals; forward pricing labor, overhead, and other advance rate proposals; progress payments; pre-award surveys; proposals for change orders or modifications; assist audits; contract audit closing statements; auditor-determined final indirect rates where the auditor and contractor agree on the questioned costs and DCAA does not identify questioned costs subject to penalty; and any other audit reports not specifically identified as reportable in Enclosure 5.

open audit report. An audit report that has not been dispositioned during the reporting period.

original audit report date. The date of an initial audit report that was superseded or supplemented by a subsequent audit report.

penalties and interest. Amounts assessed for an unallowable cost, a CAS noncompliance, or a post-award price adjustment. Penalties and interest are assessed in addition to the recovery of questioned costs sustained.

potential cost avoidance. The DCAA estimate of cost savings associated with implementing a DCAA recommendation to improve the economy or efficiency of contractor operations.

qualification. A restriction on the audit scope and/or the lack of sufficient evidential matter which preclude the auditor from expressing an unqualified opinion.

questioned costs. The amount of audit exception, potential cost avoidance, or recommended price adjustment in the audit report including:

An alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other document governing the expenditure of funds.

An auditor finding that at the time of the audit, such cost is not supported by adequate documentation.

An auditor finding or determination that the intended purpose for a particular expenditure of funds is unnecessary or unreasonable.

questioned costs subject to penalty. Includes:

Questioned costs identified as expressly unallowable based on part 31.205 of Reference (h) or other Agency supplement, which are subject to a single-level penalty under section 2324(b)(1)(A) of Reference (i).

Questioned costs determined to be unallowable (or mutually agreed to be unallowable) prior to a contractor claiming them in an indirect cost proposal, which are subject to a second-level penalty under section 2324(b)(2) of Reference (i).

questioned costs sustained. The total questioned amount that shall not be charged to the Government. The sustained cost amount includes the questioned amounts that are agreed to by the contractor during the course of the audit, and those resulting from the contracting officer's final decision.

recommended price adjustment. An amount calculated by DCAA in a post-award audit that reflects the estimated increase in contract price caused by a contractor submitting defective cost or pricing data.

reportable audit. Certain audits that are subject to the reporting requirements in paragraph 1.b. of Enclosure 3. Refer to Enclosure 5 for a detailed listing of reportable audits.

resolution. An audit is considered to be resolved when the contracting officer has determined and documented an action plan for addressing the audit findings in a pre-negotiation memorandum. For CAS noncompliances, resolution is achieved when the contracting officer issues a notice of potential noncompliance to the contractor.

unresolved. An audit is considered to be unresolved when the contracting officer has not yet determined a plan of action on the reported findings and recommendations or documented the plan in a pre-negotiation memorandum.

unresolved costs. Costs for which the auditor has not yet expressed an opinion.