



OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

SPECIAL REPORT

DOE-OIG-21-26

April 2021

**THE TRANSITION TO INDEPENDENT
AUDITS OF MANAGEMENT AND
OPERATING CONTRACTORS' ANNUAL
STATEMENTS OF
COSTS INCURRED AND CLAIMED**



Department of Energy
Washington, DC 20585

April 9, 2021

MEMORANDUM FOR THE SECRETARY

SUBJECT: Special Project Report on “The Transition to Independent Audits of Management and Operating Contractors’ Annual Statements of Costs Incurred and Claimed”

This Special Project Report summarizes the results of a multi-year review of the Cooperative Audit Strategy and recommends that the Office of Inspector General (OIG) and the Department of Energy transition to an independent audit strategy as soon as the resources become available to do so.

The OIG greatly appreciates the Department’s concurrence with the recommendations of the Special Project Report. The OIG also appreciates the Department’s commitment to supporting the OIG’s efforts to make the transition to an independent audit program. The success of this transition will depend in large part on the cooperation and support of the Department.

By way of context, prior to 1994, the OIG, with assistance from independent public accounting firms, was responsible for auditing the annual Statements of Costs Incurred and Claimed for the Department’s management and operating contracts. The OIG conducted these audits pursuant to the United States Government Accountability Office’s (GAO) Generally Accepted Government Auditing Standards (GAGAS) that are issued by the Comptroller General of the United States.

Since 1994, the Cooperative Audit Strategy has placed the primary audit functions within the internal audit departments of the Department’s management and operating contractors. As a result, the contractors’ internal audit departments now conduct the audits of their own annual Statements of Costs Incurred and Claimed. In addition, the Cooperative Audit Strategy allows these audits to rely upon auditing standards promulgated by the Institute of Internal Auditors, instead of GAGAS.

From its inception, some stakeholders questioned the independence of the contractors’ audits of their own Statements of Costs Incurred and Claimed pursuant to the Cooperative Audit Strategy. In 2017, the OIG initiated a multi-year review to assess the validity, accuracy, and effectiveness of the contractors’ internal audits of their Statements of Costs Incurred and Claimed under the Cooperative Audit Strategy. This Special Project Report is the culmination of this multi-year review.

As you know, several congressional committees have been inquiring about the Cooperative Audit Strategy over the past 2 years. Notably, both the House Armed Services Committee report accompanying the National Defense Authorization Act (June 2020) as well as the report from the House Committee on Appropriations (July 2020) discuss this topic. Specifically, these congressional reports require that the Department review the Cooperative Audit Strategy,

identify potential changes, and formulate a plan to independently audit management and operating contractors. Implementing an independent audit strategy should resolve congressional concerns.

In closing, you will be pleased to know that the Council of the Inspectors General on Integrity and Efficiency has reviewed the Special Project Report and provided us a letter of support for transitioning to an independent audit program. The Inspector General community will be an important source of support and guidance as we move forward on this project. I've attached the letter for your information (Attachment 1). The Special Project Report is also attached (Attachment 2).



Teri L. Donaldson
Inspector General

Attachment 1 – Letter from Council of the Inspectors General on Integrity and Efficiency



April 1, 2021

The Honorable Teri L. Donaldson
Inspector General
Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Dear Inspector General Donaldson,

We appreciate the opportunity to review your office’s Special Project Report on “The Transition to Independent Audits of Management and Operating Contractors’ Annual Statements of Costs Incurred and Claimed.” Based on our assessment of that document, we agree that the Department of Energy must transition from the current Cooperative Audit Strategy to an approach that ensures the legitimacy of payments for its management and operating (M&O) contracts. The current process, where the audit of a contractor’s Statement of Costs is performed by internal auditors employed by the contractor, does not provide adequate assurance that payments to the contractor were proper. While the responsibility for ensuring the legitimacy of payments for all M&O contracts lies with the agency, the OIG’s oversight responsibilities must also be taken into consideration in developing a new approach.

We also agree that the OIG and Departmental leadership should organize a working group to advance the transition to an approach that ensures the legitimacy of payments for all M&O contracts. While we do not have sufficient information to assess the budgetary resources discussed in your report, determining the funding required for this new approach should clearly be one of the topics addressed by this working group.

We appreciate the opportunity to share our thoughts on this important issue and stand ready to provide additional feedback as this conversation progresses.

Sincerely,

Allison C. Lerner
CIGIE Chairperson

Hannibal Ware
Chair, CIGIE Audit Committee

THE TRANSITION TO INDEPENDENT AUDITS OF MANAGEMENT AND OPERATING CONTRACTORS' ANNUAL STATEMENTS OF COSTS INCURRED AND CLAIMED

INTRODUCTION

This Special Project Report contains six sections as follows:

- I. History and legal analysis of the Cooperative Audit Strategy
- II. Systemic threats to independence
- III. The lack of an independent audit program likely contributes to fraud, waste, and abuse
- IV. The lack of an independent audit program has resulted in significant lapses in the audit of subcontracts
- V. The lack of an independent audit program has caused other major deficiencies
- VI. Recommendations

I. HISTORY AND LEGAL ANALYSIS OF THE COOPERATIVE AUDIT STRATEGY

For most of the Department of Energy's history, its primary contract vehicle has been management and operating (M&O) contracts. This type of contract is unique in the U.S. Government and is a direct outgrowth of the effort during World War II to build the first atomic bomb known as the Manhattan Project. During the Manhattan Project, the Government was unable to define the technical scope, cost, or schedule of contracted work that it needed for the atomic bomb program. Accordingly, the Government awarded the first contractor, the University of California, an undefined and open-scope contract to build atomic bombs. This contract was the genesis of the current M&O contract model. One feature of the M&O contract model is that the contractor's financial records are integrated into the Department's accounts. For example, the contractor's general ledger feeds into the Department's financial books, records, and statements. Another feature of M&O contracts is "level of effort" billing. The M&O contract authorizes the contractor to perform work that it concludes is necessary to accomplish the contract's mission and to charge the Department on a monthly basis, using a "Letter of Credit" funding vehicle for any allowable cost incurred in performance of this work.

Annually, the Department's M&O contractors are required to complete a Statement of Costs Incurred and Claimed for the Department's Contracting Officers.¹ This Statement serves as the contractor's claim and certification that the contractor's costs were incurred in support of the Department's mission and are allowable, allocable, and reasonable under the terms of the contract. Incurred cost audits are designed to assess the accuracy of the contractor's Statements of Costs Incurred and Claimed. The incurred cost audit is therefore the single most critical audit

¹ The Department's Financial Management Handbook, Chapter 23, p. 23-1 (<https://www.energy.gov/sites/prod/files/AH-Chap23.pdf>).

measure available to control Federal expenditures and to ensure that Federal contractors are not overpaid, resulting in fraud, waste, or abuse.

In response to criticism from the Government Accountability Office (GAO) regarding inadequate audit coverage of the incurred costs of Department contractors,² in October 1992 the Department began a pilot effort to develop the Cooperative Audit Strategy. This Strategy was developed by the Office of Inspector General (OIG) in consultation with the Department's Office of the Chief Financial Officer and Office of Acquisition Management, as well as the Contractor Internal Audit Council. In September 1993, GAO issued a report, *Financial Management – Energy's Material Financial Management Weaknesses Require Corrective Action* (GAO/AIMD-93-29). This report concluded, among other things, that "Energy's IG has had difficulty in auditing, in a timely manner, whether costs claimed by integrated contractors are allowable and have been recorded in accordance with Energy's accounting policies."

The Inspector General (IG) and the Secretary of Energy adopted and approved the Cooperative Audit Strategy in 1994. Due to the passage of time and the turnover of staff, there is limited information available today about the rationale for this decision. Key elements of the Cooperative Audit Strategy included requiring M&O contractors to perform incurred cost audits.³ Notably, these contractor internal auditors do not perform audits in compliance with Generally Accepted Government Auditing Standards (GAGAS). The OIG's role was to conduct a limited assessment⁴ of the contractors' internal audit work. The Contracting Officers would then take corrective action on any findings. It should be noted that the Department's Naval Reactors Program⁵ opted out of the Cooperative Audit Strategy and has had Federal auditors perform the incurred cost audit for its M&O contractor. In 1997 and 2007, the OIG and the Department made minor changes to update the Strategy.

For the 26 years that the Cooperative Audit Strategy has been in place, interested stakeholders, including GAO⁶ and the Department of Defense (DOD),⁷ have expressed concerns about the appropriateness of contractors auditing their own costs. Along the same lines, the OIG has engaged in efforts to evaluate the Cooperative Audit Strategy. The most recent effort began in 2017 when the OIG performed audits of several contractors' Statements of Costs Incurred and Claimed in lieu of the contractors' internal audit departments. Resulting OIG reports identified serious concerns regarding the effectiveness of the Cooperative Audit Strategy and the validity

² *Department of Energy Contract Management* (GAO/HR-93-9, Dec. 1992).

³ The Department of Energy Acquisition Regulation § 970.5204-9h.

⁴ Department Acquisition Guide 70.42.101 2.4 *Responsibilities*.

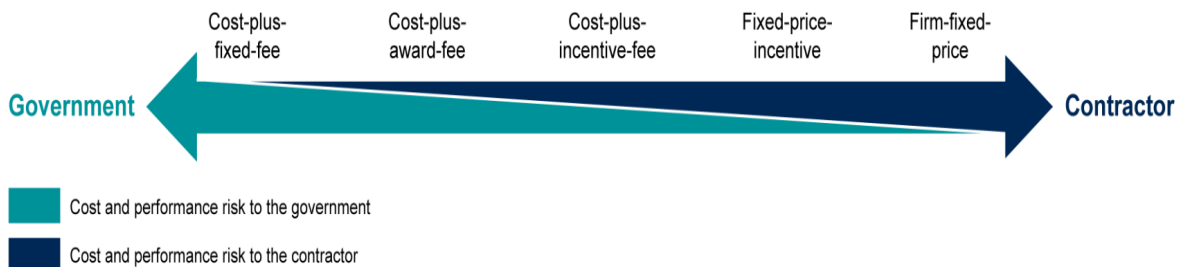
⁵ The Department's Naval Reactors program is also known as the Naval Nuclear Propulsion Program in the U.S. Navy. This single Federal entity has offices in the U.S. Navy and the Department's National Nuclear Security Administration. An M&O contractor operates the Department's Naval Reactors Federal facilities.

⁶ *Financial Management – Energy's Material Financial Management Weaknesses Require Corrective Action* (GAO/AIMD-93-29) p.50. *Department of Energy – Use of Leading Practices Could Help Manage the Risk of Fraud and Other Improper Payments* (GAO-17-235, Mar. 2017) pp. 21–22.

⁷ The DOD OIG Report *More DoD Oversight Needed for Purchases Made Through the Department of Energy* (D-2011-021, Dec. 2010). DOD OIG Report *DoD Does Not Have Visibility Over the Use of Funds Provided to the Department of Energy* (DODIG-2013-046, Feb. 2013).

of the contractors' audits performed pursuant to the Cooperative Audit Strategy.⁸

Commentators have noted that contracts such as the Department's M&O contracts are high-risk contracts. On March 2, 2021, GAO released its *High-Risk List* to the new Congress. One major recurring risk is the Department's contract management and administration.⁹ M&O contracts are "cost plus" contracts that, by their very nature, are considered to be much higher-risk than alternative forms of contracting (Figure 1).



Source: Defense Acquisition University. | GAO-20-352

Figure 1: Cost Plus Contracts Are Riskier

Further, the Department has limited contract oversight resources compared to other Federal agencies (Figure 2), which heightens the need for independent audits.

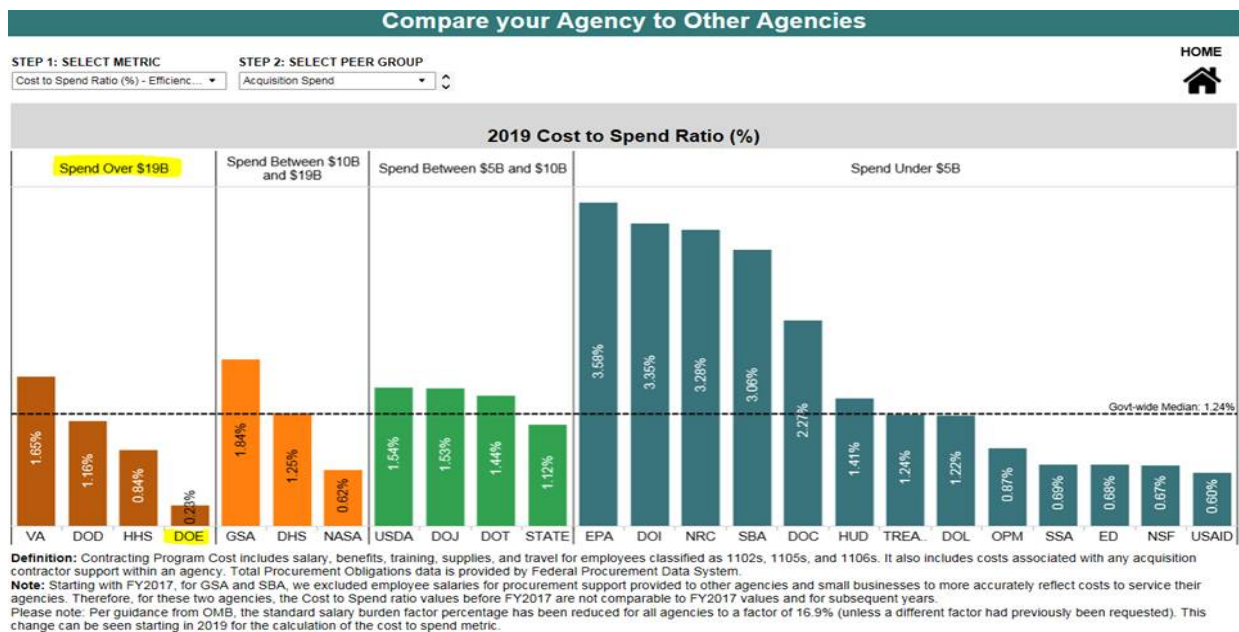


Figure 2: DOE Has Lowest Ratio of Procurement Professionals to Contract Dollars

According to a 2020 benchmarking study performed by the White House Office of Management and Budget, the Department's ratio of procurement professionals to agency spending on

⁸ Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016 (DOE-OIG-20-02, Oct. 2019); Lawrence Livermore National Security, LLC, Costs Claimed under Department of Energy Contract No. DE-AC52-07NA27344 for Fiscal Year 2015 (DOE-OIG-18-12, Dec. 2017).

⁹ GAO notes that 'contract management and administration' has appeared on GAO's *High-Risk List* since its inception in 1990. GAO-20-285PR DOE Priority Recommendations, p.3.

contractors ranks as the lowest in the Federal government.¹⁰

The OIG’s Office of Counsel has prepared the following legal analysis:

A. The Inspector General Act explicitly requires independent audits, including audits of incurred costs

IGs are the cognizant Federal auditors for their agencies.¹¹ By statute, IGs are required “to provide policy direction for and to conduct, supervise, and coordinate audits and investigations relating to the programs and operations of” their Federal agencies.¹² The IG Act requires, among other things, that IGs determine when agencies may use non-Federal auditors and take steps to ensure that any non-Federal auditors comply with GAGAS when carrying out their duties.¹³ The IG Act expressly limits the discretion IGs have when performing these functions by requiring that IGs ensure that these audits “comply with standards established by the Comptroller General of the United States for audits of Federal establishments, organizations, programs, activities, and functions,” which includes GAGAS.¹⁴ The IG Act requires Federal IGs to take appropriate steps to ensure that audits, such as incurred cost audits, comply with GAGAS.¹⁵

¹⁰ Office of Management and Budget acquisition workforce benchmarking study, July 2020.

¹¹ 5 United States Code (U.S.C.) Appx. 3.

¹² 5 U.S.C. Appx. 3 § 4(a)(1).

¹³ 5 U.S.C. Appx. 3 § 4(b)(1). The Cooperative Audit Strategy involves non-Federal auditors acting under IG guidelines when auditing incurred costs. The pertinent provision of the IG Act requires that IGs: “(B) establish guidelines for determining when it shall be appropriate to use non-Federal auditors; and (C) take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General as described in paragraph (1).” “Appropriate steps” must bring about the assurance that the non-Federal auditors’ work complies with GAGAS. The phrase “appropriate steps” in this context cannot be read to undercut the assurance requirement or permit the non-Federal auditors not to comply with GAGAS. Likewise, the mandate to “establish guidelines for determining” when it is appropriate to use non-Federal auditors cannot, in the context of this statutory scheme, render the guidelines permissive on the issue of whether non-Federal auditors must apply GAGAS. Treating the guidelines as permissive, or having the guidelines allow a departure from GAGAS, would render the assurance requirement in 5 U.S.C. Appx. 3 § 4(b)(1)(C) meaningless. Other congressional directives that Executive Branch elements “establish guidelines for determining” requirements have resulted in mandatory, not permissive guidelines. See e.g., 42 U.S.C. § 11385(e)(2)(requiring Secretaries of the Department of Housing and Urban Development and Health and Human Services jointly “establish guidelines for determining appropriateness of proposed outpatient health services under this section...” Notably, the Department of Housing and Urban Development promulgated those guidelines as requirements in 24 The Code of Federal Regulations (C.F.R.) § 583.330(c).

¹⁴ 5 U.S.C. Appx. 3 § 4(b)(1)(A). The GAO publishes the GAGAS standards in the “Yellow Book.” <https://www.gao.gov/products/GAO-18-568G> (published July 2018; last accessed Jan. 15, 2021).

¹⁵ U.S.C. Appx. 3 § 4(b)(1). The legislative history also emphasizes this point. “GAO is the only Federal organization which has established appropriate auditing standards and has been doing so for over 20 years. The committee believes that this bill is an appropriate medium for Congress to require that such standards be followed by major Departments and agencies. Since Congress has the unquestioned authority to prescribe the audit standards to be followed by executive departments and agencies, the delegation by Congress to GAO, a legislative agency, is not open to question.” S. Rep. 95-1071, p.12 (Sept. 22, 1978).

B. All other Federal IGs require that the annual audit of incurred costs be conducted under GAGAS

The annual audit of the Statement of Costs Incurred and Claimed¹⁶ is the single most critical audit measure available to control contractor costs claimed. Federal IGs consistently require that the audit of contractors' costs incurred be conducted using the GAGAS standards. The General Services Administration ordering guide for civilian contract audit services explicitly mandates that independent public accounting Firms (IPAs) providing these services must use GAGAS.¹⁷ Many Federal agencies use outside contractors. The DOD, for example, manages the largest volume of Federal contractors. The Defense Contract Audit Agency (DCAA), established in 1965, is the entity beneath the Under Secretary of Defense to conduct independent audits of DOD's Federal contractors. Such audits are conducted under GAGAS.¹⁸ Other Federal agencies also manage significant volumes of payments to civilian contractors. The Department of Veterans Affairs manages more than \$27 billion dollars per year and the Department of Health and Human Services manages more than \$26 billion dollars per year.¹⁹ Both the Department of Veterans Affairs and the Department of Health and Human Services audit these expenditures under GAGAS. The Department of Energy is the only Federal agency that does not follow this required practice.

C. Why is GAGAS important to the integrity of these audits?

GAGAS is based on the foundational principal that the payment of Government dollars does not involve an arms-length transaction similar to private sector transactions where each party has a significant incentive to vigorously protect its own financial interests.²⁰ For this reason, GAGAS focuses on the critical importance of third-party independent auditors to help offset what some commentators have referred to as the tendency to treat Government dollars like spending Monopoly money. GAGAS sets forth a robust framework designed to ensure auditor independence.²¹ GAGAS identifies threats to independence, including self-interest threats, familiarity threats, undue influence threats, and management participation threats.²²

¹⁶ Most Federal agencies refer to this form as a "Statement of Cost." The Department refers to the form as "the Statement of Costs Incurred and Claimed." These forms function in the same manner.

¹⁷ <https://www.gsa.gov/cdnstatic/CCAS%20Ordering%20Guide%20December%202017.pdf> (last accessed Mar. 9, 2021).

¹⁸ 48 C.F.R. § 252.237–7001. The Federal use of independent accounting firms (i.e., IPAs) to review contract costs requires adherence to GAGAS. The 2018 National Defense Authorization Act, for example, addressed the backlog of DCAA audits by directing that DCAA use commercial IPAs complying with GAGAS to help resolve the backlog by Oct. 1, 2020. P.L. 115–91 § 803 (Dec. 2017), codified at 10 U.S.C. § 2313b(d). Report to Congress on Fiscal Year 2019 Activities Defense Contract Audit Agency p. 20 (Mar. 2020)

<https://www.dcaa.mil/Portals/88/FY2019%20DCAA%20Report%20to%20Congress.pdf?ver=2020-06-08-105608-830> (last accessed Mar. 9, 2021). The IG Act's language regarding use, and control of, non-Federal auditors similarly allows the Government to use IPAs provided the IG takes appropriate steps to assure that IPAs utilize GAGAS when conducting the annual audit of incurred costs. 5 U.S.C. Appx. 3 § 4(b).

¹⁹ Small Business Goaling Report 2019.

https://www.fpbs.gov/downloads/top_requests/FPDSNG_SB_Goaling_FY_2019.pdf (last accessed Mar. 9, 2021).

²⁰ See GAGAS 1.07, describing how the framework focuses on obtaining and evaluating evidence with respect to Government programs. This points to a metric different from the profitability driving private concerns. See GAGAS 3.17–3.63.

²¹ See GAGAS 3.17–3.63.

²² See Ibid. 3.27–3.30.

D. Congress has made no exception for the Department of Energy

Prior to 1994, OIG employees were responsible for auditing the Department's contractors' Statements of Costs Incurred and Claimed, and such audits were conducted under GAGAS.²³

In 1994, the OIG and the Department implemented the Cooperative Audit Strategy, which allows the Department's contractors to audit their own incurred costs utilizing the Institute of Internal Auditors (IIA) standards, rather than GAGAS. IIA standards do not have the same rigor as GAGAS standards on the issue of independence because internal auditors are embedded within a company. Private sector internal auditors are not required to have the same level of independence as Federal auditors. The economic self-interest that provides cost discipline to internal auditors in the private sector is not present in public sector auditing.²⁴

The Department's M&O contractors' internal auditors are hired by, supervised by, paid by, and responsible to the contractors.²⁵ In addition, the contractors' audit executives typically have their personal bonuses tied to contract award fees.²⁶ This creates a fox-guarding-the-henhouse problem. This design flaw is particularly problematic because an incurred cost audit is the single most critical audit measure available to control Federal expenditures and to ensure that Federal contractors are not overpaid, resulting in fraud, waste, or abuse.

We have been unable to locate any prior legal analysis that supports the Cooperative Audit Strategy. We have also conducted extensive research on the issue and located no authority to support an IG's agreement to not follow the plain meaning of the IG Act and its mandate that GAGAS be applied to these audits.²⁷

On the contrary, there is substantial authoritative support for the proposition that executive employees may not disregard the express requirements of Congress. The Supreme Court has noted the general rule "that a federal official may not with impunity ignore the limitations which the controlling law has placed on his powers."²⁸ When a statute has an explicit requirement, it

²³ *Making Contracting Work Better and Cost Less: Report of the Contract Reform Team* (Feb. 1994). Prior to 1994, what is now called "the Statement of Costs Incurred and Claimed" was a Voucher Accounting for Net Expenditures Accrued.

²⁴ Contrast IIA Performance Standard 2000, in respect to adding value, with GAGAS 1.05 emphasizing accountability "to legislators, oversight bodies, those charged with governance, and the public."

²⁵ The primary Federal criminal statute on financial conflicts of interest, 18 U.S.C. § 208, does not apply in this situation because the internal audit staff members are not considered by the Department as Federal employees. However, the type of risk that statute addresses, including individuals engaging in duties with respect to Federal funds that may be inconsistent with their own financial interests, is present in the Cooperative Audit Strategy. Requiring non-Federal auditors to comply with GAGAS addresses that conflict.

²⁶ The OIG has documented these bonuses at Lawrence Livermore, Idaho, and Oak Ridge National Laboratories.

²⁷ Nothing within the statutory authorization of the M&O contracts anticipated or sanctioned allowing Federal contractors to audit their own incurred costs. This flawed concept did not emerge until 1994, when the Cooperative Audit Strategy was implemented. It appears that the legal issues addressed in this memorandum were not discussed on the record during the timeframe that the Cooperative Audit Strategy was being developed. See e.g., *Subcommittee on Oversight of Government Management, Committee on Governmental Affairs*, U.S. Senate, "Inadequate Federal Oversight of Federally Funded Research and Development Centers," 102d Cong., 2d Sess., S. Rpt. 102-98, at 38-39 (1992) (no references to the Cooperative Audit Strategy).

²⁸ *Butz v. Economou*, 438 U.S. 478, 489 (1978). Where, as here, that examination yields a clear answer, judges must

prohibits finding an unstated alternative to that requirement.²⁹ The plain and direct nature of Section 4 compelling the use of GAGAS by non-Federal auditors conducting audits would not permit an IG to allow the use of lesser auditing standards for incurred cost audits, which are critically important audits.³⁰

E. Did the concept of the OIG conducting “limited assessments” of the work of the contractors’ internal auditors cure the defect?

No, these “limited assessments” or “reliance reviews” could not cure the legal and practical defect. The IG Act does not allow this practice because GAGAS mandates independent audits of incurred costs. Moreover, as a practical matter, this approach was also misplaced. The concept of an external auditor relying on the work of an internal auditor was borrowed from private sector accounting. In the private sector, external auditors retain complete control over what they will examine when conducting reviews. Because the external auditor retains control, the external auditor may reduce its need to test certain accounts if the external auditor determines that these accounts were correctly tested by an internal auditor.

The Cooperative Audit Strategy reverses these roles. The external auditor, or in this case the OIG, does not retain complete control over the scope and performance of the financial audit. The Cooperative Audit Strategy grants the contractors’ internal auditors the authority over both the scope of the audit and the nature of the report. In summary, the internal auditor determines both where to look and what to say.

To compound this problem, the OIG’s limited assessments did not require a close replication of the underlying audit work. The limited assessments, or reliance reviews, consisted of the OIG auditors reviewing the training and qualifications of the contractors’ internal auditors, reviewing the audit files for evidence of supervisory review, and reviewing other matters that fall short of performing substantive transaction testing. These reliance reviews were not designed to be as rigorous as a GAGAS audit.³¹

Notably, an auditing scheme that would require rigorous post-auditing procedures by the OIG would also be highly inefficient. The taxpayer would be paying for the self-audit by the contractor and then paying again for the rigorous re-audit. Such audits should be conducted properly, and once.

stop. *Food Mktg. Inst. v. Argus Leader Media*, 139 S. Ct. 2356, 2364 (2019), citing *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438 (1999).

²⁹ *Botany Worsted Mills v. United States*, 278 U.S. 282, 289 (1929).

³⁰ See also 2A Sutherland Statutory Construction § 47:23 (Expressio unius est exclusio alterius) (7th ed. 2020).

³¹ Along the same lines, the limited role of the Contracting Officers is no substitute for an independent audit. The Cooperative Audit Strategy does give some limited responsibility to the Department’s Contracting Officers, who are not audit professionals. Contracting Officers are tasked with reviewing and approving audit plans and reports. Contracting Officers are also tasked with approving the Statement of Costs Incurred and Claimed. DOE Acquisition Guide, Chapter 70.42.101 ¶ 2.4 *Responsibilities*. However, Department Contracting Officers do not analyze each cost incurred. The Contracting Officers analyze only the costs identified by the internal auditors as “questioned.” The analysis of what costs should not have been charged stays with the contractor, which requires the internal auditors to exercise judgments that should be exercised only by independent auditors.

To conclude this summary legal analysis, the OIG notes that our research did not suggest any evidence that the legal issues discussed above were understood or discussed prior to the implementation of the Cooperative Audit Strategy. Whatever the rationale may have been for implementing the Cooperative Audit Strategy in 1994, the OIG does not question that rationale here since little is known about it. Going forward, however, the Cooperative Audit Strategy must be evaluated based upon our current understanding of the law and the facts.

F. Coordination with other stakeholders

In the autumn of 2020, the OIG's Office of Counsel prepared a legal analysis of the Cooperative Audit Strategy and provided it to the Department's Office of General Counsel.

The OIG's Office of Counsel is also coordinating with other IGs and with the Council of the Inspectors General on Integrity and Efficiency (CIGIE). Federal IGs have a keen interest in the independence of these important annual audits, and in the correct interpretation of the IG Act. The OIG will continue coordinating with other IGs, CIGIE, and others to transition to an independent audit strategy, consistent with the practices of other Federal agencies.

Finally, we note that several congressional committees have been inquiring about the Cooperative Audit Strategy over the past 2 years. Notably, both the House Armed Services Committee report accompanying the National Defense Authorization Act (June 2020) and the report from the House Committee on Appropriations (July 2020) discuss this topic. Specifically, these congressional reports require the Department to "review its Cooperative Audit Strategy and identify potential changes," articulate "a plan to independently audit each management and operating contractor," and assess "the challenges and benefits of implementing such a plan." Implementing an independent audit strategy should resolve congressional concerns.

II. SYSTEMIC THREATS TO INDEPENDENCE

This section provides examples of the threats to auditor independence that are "baked into" the Cooperative Audit Strategy. GAGAS has a robust structure designed to ensure auditor independence. GAGAS identifies threats to independence, including self-interest threats, familiarity threats, undue influence threats, and management participation threats. All of these threats create an actual conflict of interest or an appearance of a conflict of interest.³² GAGAS specifically addresses and identifies threats to independence, such as the auditor's personal interest or affiliation with the audited entity.

GAGAS 3.18 (2018) provides:

In all matters relating to a Government Auditing Standards engagement, auditors and audit organizations must be independent from an audited entity.³³

³² 18 U.S.C. § 208(a) prohibits Federal employees from working on particular matters involving their financial interests.

³³ See GAGAS 3.18.

Additionally, GAGAS 3.19 (2018) provides:

Auditors and audit organizations should avoid situations that could lead reasonable and informed third parties to conclude that the auditors and audit organizations are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the engagement and reporting on the work.³⁴

GAGAS provisions on independence specifically address threats to independence. GAGAS requires the auditor to identify, evaluate, and address whether any threats to independence exist.

In contrast, the Department's M&O contractors hire, supervise, and pay the internal auditors, which eliminates the prospect of the independence required by GAGAS. The following are a few examples of the "baked-in" independence problems with the Cooperative Audit Strategy:

A. Government Auditing Standard 3.30(a) – Self-Interest Threat

A self-interest threat is "[t]he threat that a financial or other interest will inappropriately influence an auditor's judgment or behavior."³⁵ One self-interest threat that the OIG observed was large performance bonuses for Chief Audit Executives at three M&O contractors, ranging from \$35,000 to \$57,000.³⁶ These large dollar performance bonuses demonstrate an actual and/or an appearance of a self-interest threat to independence because they are directly tied to the contractors' award fee. This compensation structure provides an incentive to the contractors' Chief Audit Executives to maximize the M&O contractors' award fee, a goal that may directly conflict with the objectives of a thorough and effective incurred cost audit.

B. Government Auditing Standard 3.30(b) – Self-Review Threat

The self-review threat is "[t]he threat that an auditor or audit organization that has provided non-audit services will not appropriately evaluate the results of previous judgments made or services provided as part of the non-audit services when forming a judgment significant to an [audit] engagement."³⁷ The OIG identified self-review threats in a variety of circumstances at M&O contractors. For example, at Battelle Energy Alliance, the OIG found that the contractor's internal audit of incurred costs overlooked significant deficiencies in Battelle's compliance with Cost Accounting Standards (CAS). Prior to the internal audit, Battelle's Chief Audit Executive participated in the review and approval of Battelle's accounting methods that it used to calculate year-end indirect cost variances. By doing so, the Chief Audit Executive could not objectively audit whether the accounting methods that it already helped to approve were appropriate or

³⁴ See GAGAS 3.19.

³⁵ See GAGAS 3.30.

³⁶ The OIG has documented these bonuses at Lawrence Livermore, Idaho, and Oak Ridge National Laboratories.

³⁷ See GAGAS 3.30(b).

introduced problems. The OIG concluded that this lack of independence, caused by the self-review actions, directly contributed to an OIG finding in which the OIG questioned \$26 million of Battelle Energy Alliance’s claimed costs.³⁸

C. Government Auditing Standard 3.30(d) – Familiarity Threat

The familiarity threat is “[t]he threat that aspects of a relationship with management or personnel of an audited entity, such as a close or long-term relationship, or that of an immediate or close family member, will lead an auditor to take a position that is not objective.”³⁹ To mitigate this risk, DCAA requires audit managers rotate from specific contractors every 5 to 7 years. Similarly, in the private sector, the “Big Four” certified public accounting firms require audit partner rotation every 5 years.⁴⁰

In contrast, the OIG observed that the familiarity threat was pervasive and unaddressed in the Department’s M&O contractors’ internal audit community. The OIG examined three M&O contractors and found that the Chief Audit Executive had been in the same leadership position for a range of 9 to 30 years, with no policies to mitigate this threat to independence.⁴¹

D. Government Auditing Standard 3.30(e) – Undue Influence Threat

The undue influence threat is “[t]he threat that influences or pressures from sources external to the audit organization will affect an auditor’s ability to make objective judgments.”⁴² The OIG identified instances of undue influence at M&O contractors. For example, in January 2009, the OIG issued an audit report, *Washington Savannah River Company, LLC Internal Audit Function*, that demonstrated undue influence and independence issues. The OIG report concluded that the M&O contractor’s internal audit “violated professional standards related to auditor independence and objectivity; proper performance of the audit engagement; and appropriate communication of audit results [...] and the work performed by [the contractor’s] Internal Audit [Department] could not be relied upon.” Additionally, the OIG is now engaged in an inspection involving the President of a M&O contractor who terminated an internal audit on incurred costs.⁴³ An auditee terminating an incurred cost audit is a significant example of an undue influence threat.

³⁸ *Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016* (DOE-OIG-20-02, Oct. 2019).

³⁹ See GAGAS 3.30(d).

⁴⁰ “Big Four” refers to the four largest global accounting networks: Deloitte, Touche Tohmatsu, Ltd.; Ernst & Young; KPMG International Ltd.; and PricewaterhouseCoopers. Title II of the Sarbanes-Oxley Act adds new subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934 as follows: Section 203 adds subsection (j), which establishes mandatory rotation of the lead partner and the concurring partner every 5 years. These rules expand the number of engagement personnel covered by the rotation requirement and clarify the “time out” period.

⁴¹ The OIG has documented these terms at Lawrence Livermore, Idaho, and Oak Ridge National Laboratories.

⁴² See GAGAS 3.30(e).

⁴³ Although this inspection is ongoing, the fact that the President terminated the audit is not in dispute.

E. Government Auditing Standard 3.30 (f) – Management Participation Threat

The management participation threat is “[t]he threat that results from an auditor taking on the role of management or otherwise performing management functions on behalf of the audited entity, which will lead an auditor to take a position that is not objective.”⁴⁴ This standard does not allow auditors to perform management roles or to advocate on behalf of management. The concern behind this threat to independence is that the auditor will promote management’s interest to the point where the auditor’s objectivity is compromised. The OIG observed that at many M&O contractors the Chief Audit Executives serve a collateral duty as audit liaison to external auditors, such as the GAO and the OIG. However, rather than just perform liaison duties, the OIG has observed a pervasive problem in which M&O contractor audit executives routinely and aggressively argue on behalf of company management positions and against the findings of the external auditors. This behavior creates, at a minimum, an appearance that an auditor’s objectivity is compromised.

F. Public Interest Standard Not Met by M&O Internal Auditors

The overriding purpose of GAGAS is to ensure public trust. Standard 3.07 provides “[o]bserving integrity, objectivity, and independence in discharging their professional responsibilities helps auditors serve the public interest and honor the public trust. The principle of the public interest is fundamental to the responsibilities of auditors and critical in the government environment.” Standard 3.08 goes on to provide that “[a] distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embodies the concept of accountability for public resources, which is fundamental to serving the public interest.”⁴⁵

In contrast, the IIA audit standards do not include these objectives because “internal” auditors are embedded within a company and are chartered to serve that company’s best interest. Internal company auditors in the private sector do not have the same elevated duty to public interest as Federal auditors and external auditors performing audits under GAGAS.⁴⁶

Some proponents of the Cooperative Audit Strategy have suggested that it could be rehabilitated by giving additional instructions to the contractors’ internal auditors. We note that the design of the Cooperative Audit Strategy included the use of an OIG Audit Manual, and a Steering Committee to guide the work of the internal auditors. These tools, however, are no substitute for independence. The OIG Audit Manual for example, leaves significant discretion to the internal auditors who are responsible for using professional judgment in planning, conducting, and reporting upon the audit results. The exercise of this professional judgment must be independent

⁴⁴ See GAGAS 3.30(f).

⁴⁵ See GAGAS 3.07–3.08.

⁴⁶ The public interest is also not well served when the Government pays more than it should for a particular service. The M&O contractors’ internal auditors are paid substantially more than Federal employees performing the same functions. We estimate that the salary differential is as high as 2.15 times higher compensation for the contractors’ internal auditors at the management level. We do not have detailed data on how many audit hours have been expended by M&O contractor internal auditors for conducting incurred cost audits and audits of subcontractor costs.

and free of even the appearance of any conflict of interest. The OIG has concluded that no amount of changes to the Cooperative Audit Strategy would cure the fundamental defect that the internal auditors cannot meet the independence standards required by GAGAS.

III. THE LACK OF AN INDEPENDENT AUDIT PROGRAM LIKELY CONTRIBUTES TO FRAUD, WASTE, AND ABUSE

A. Fraud Investigations

The Department's prime contractors directly employ 102,500 full-time employees.⁴⁷ Contractor labor cost is the largest expense in the Department, totaling an estimated \$16 billion per year of the Department's \$35 billion annual budget. Despite existing internal controls, the OIG has repeatedly investigated labor-related fraud cases by the Department's contractors (M&O and non-M&O) across the Department complex. Payroll-related investigations have increased from 9 percent of all contract and grant fraud investigations in fiscal year (FY) 2017 to 23 percent in FY 2020. From FY 2017 through FY 2020, the number of administrative actions resulting from labor mischarging investigations has increased ten-fold.

Currently, the OIG Office of Investigations has numerous ongoing fraud investigations related to labor overcharging at multiple Department sites. The preliminary results of just one of these investigations indicates that the M&O contractor has engaged in a large-scale time and attendance fraud, which involves over half of the employees and supervisors in a major program over a period of approximately 10 years, including several hundreds of thousands of questionable labor hours.

Additionally, the OIG is currently conducting an inspection of contractor compliance with the Mandatory Disclosure Rule.⁴⁸ The mandatory disclosure rule requires Federal contractors to disclose, in writing, situations for which they have credible evidence of a potential violation of the civil False Claims Act, among other things. This rule has the full force and effect of law. Our interim inspection results have shown that at one M&O contractor, of 35 disclosures that should have been made, 89 percent of those were timekeeping-related. It was clear that the contractor documented credible evidence of wrongdoing, yet the contractor did not report the cases to the OIG as required. In fact, the contractor took action to address the issues in approximately 48 percent of the labor overcharging cases,⁴⁹ none of which were reported to the OIG.

These problems would likely have been identified, reported, and corrected in a timely way through a GAGAS-compliant, independent audit.

⁴⁷ *Agency Financial Report, Fiscal Year 2019* (DOE/CF-0160, Nov. 2019) p.5.

⁴⁸ Federal Acquisitions Regulation 52.203-13(b)(3)(i).

⁴⁹ While this inspection is ongoing across the complex, our analysis of the data presented here is complete.

B. Savannah River Site Audits and Investigations

In January 2009, the OIG issued an audit report, *Washington Savannah River Company LLC Internal Audit Function*, (IG-0811), which concluded that “[the contractor’s] Internal Audit during FY 2007 was not satisfactory in several material respects” and could not be relied upon. In particular, the OIG reported the following:

- Internal auditors identified procurements that were not properly approved, but the contractor’s Chief Audit Executive permitted the approving officials to retroactively approve the expenditures 3 years after-the-fact in an apparent attempt to cover up the internal control failure. This finding was then omitted from the final internal audit report.
- The contractor’s Chief Audit Executive encouraged M&O contractor management to omit information from the contractor’s written response to the draft internal audit report that confirmed and quantified improper labor cost allocations. By including this information in its official response, the Chief Audit Executive suggested that the Contracting Officer could have a basis to request the contractor to reimburse the Department for inappropriate labor charges, which the Chief Audit Executive was trying to avoid.
- After the completion of audit testing, the contractor’s Chief Audit Executive directed a staff auditor to modify the testing attribute related to independent receipt of procured goods and services. This is a test of a key fraud prevention control which prohibits a Purchase Card holder from directly receiving items purchased. Instead, an individual independent of the card holder, such as a warehouse receiving clerk, would serve as a control to prevent inappropriate purchases. When the contractor’s Chief Audit Executive directed his staff to modify the audit testing attribute, it served to cover up a key fraud indicator and caused the audit report to exclude some of the questioned costs associated with this audit finding.

The OIG review demonstrated that through the inappropriate modification of internal audit findings, the contractor’s Chief Audit Executive violated audit standards related to auditor independence and objectivity, proper performance of the audit, and appropriate communication of audit results requiring that audit findings be reported.

The issues with the M&O internal audit practices and procedures at the Savannah River Site evolved in such a way as to lead the OIG to perform multiple investigations. OIG investigators, together with the Department of Justice, spent several years sorting through the complex documentation and issues. In September 2020, Savannah River Nuclear Solutions, LLC reached a settlement agreement with the United States for \$4 million to resolve violations of the contract related to unallowable labor charges, such as executive compensation costs that exceeded allowable thresholds. Additionally, OIG investigators, together with the Department of Justice, concluded an investigation, resulting in the filing of a False Claims Act complaint in the District Court involving unallowable home office expenses of approximately \$5 million. Had a timely independent incurred cost audit been performed in accordance with GAGAS, these problems would likely have been identified and corrected in a timely way.

C. URS | CH2M Oak Ridge, LLC (UCOR) Subcontractor Investigation and Audit

On July 19, 2016, the owner of Transportation, Operations and Professional Services, Inc. pleaded guilty to a one count violation of 18 U.S.C. § 371, *Conspiracy to Defraud the Government*. Pursuant to the plea, the defendant was sentenced to prison for 1 year and agreed to pay restitution in the amount of \$2.5 million. The outcome of this criminal investigation into one of the largest subcontractors for UCOR, a major Department contractor in Oak Ridge, Tennessee, raised concerns over the UCOR Internal Auditing Department's characterization of unsupported subcontract costs identified in its own internal audit report. Specifically, although UCOR's internal auditors identified \$5.7 million that did not have supporting documentation of subcontractor claimed costs of \$30.7 million, the OIG found that UCOR's internal audit report did not explicitly question these costs or provide this finding to the Department's Contracting Officer for an allowability determination, as required under the Cooperative Audit Strategy. In addition, the defendant pleaded guilty to using an elaborate system of false invoices and cash payments to channel funds to the son of UCOR's President.

Since UCOR's internal audit had not performed additional audit work pertaining to this subcontract, the OIG subsequently issued a report, *Audit Coverage of Cost Allowability for URS | CH2M Oak Ridge LLC* (DOE-OIG-19-26, April 2019), which questioned the entire \$30.7 million of invoices as unresolved pending a more detailed final audit of this subcontractor. This OIG report identified major concerns with internal audit's work including: costs lacking supporting documentation that were not explicitly questioned; insufficient documentation to support audit conclusions; and resolution of questioned costs and internal control weaknesses that were not well documented.

In this case, an M&O contractor conducted an internal audit, but the audit was not sufficient to protect the interests of the Federal taxpayer. If an independent audit had been performed in accordance with GAGAS, these issues would likely have been identified and corrected in a timely manner.

IV. THE LACK OF AN INDEPENDENT AUDIT PROGRAM HAS RESULTED IN SIGNIFICANT LAPSES IN THE AUDIT OF SUBCONTRACTS

An analysis of recent and ongoing reports from the OIG and GAO demonstrates deficiencies in the implementation of the Cooperative Audit Strategy, including M&O contractors' subcontracts that were:

- Not audited at all
- Not audited due to misclassification issues
- Audited, but not well

A. Subcontracts Not Audited

In FY 2016,⁵⁰ the Department's 24 largest contractors,⁵¹ with a total spending authority of \$23.6 billion, awarded about \$6.9 billion (nearly 30 percent) to thousands of subcontractors. Each M&O contract includes a clause requiring the M&O contractor internal auditor to perform incurred cost audits of the subcontractors' costs.⁵² However, we found that only a small fraction of subcontractor costs had been audited. Some of the reports that address this issue include the following:

- *GAO Report – Department of Energy Contracting: Actions Needed to Strengthen Subcontract Oversight* (GAO-19-107, March 2019). In a 10-year review, GAO found that the contractors' internal auditing programs had failed to audit, as required, more than \$3.4 billion paid for subcontract incurred and claimed costs, some of which were already past the 6-year statute of limitations to recover unallowable costs.⁵³
- *OIG Report – Audit Coverage of Subcontract Costs for Lawrence Livermore National Security, LLC from October 1, 2013, through September 30, 2014, and from October 1, 2015, through September 30, 2017* (DOE-OIG-21-19, April 7, 2021). The M&O contractor conducted internal audits over only a fraction of its subcontract costs. Specifically, during FYs 2014, 2016, and 2017, Livermore's internal auditor conducted only eight audits that reviewed only \$32 million of the \$252 million of subcontractor costs incurred and claimed (13 percent).
- In 2017, an M&O contractor's Internal Audit Department performed no audits on \$273.5 million in subcontracts where costs incurred were a factor in determining the amount payable to the subcontractor, as required by its M&O contract with the Department and the Cooperative Audit Strategy.⁵⁴

Similar findings were reported in *OIG Report – Audit Coverage of Cost Allowability for Honeywell Federal Manufacturing & Technologies, LLC* (DOE-OIG-20-18, December 2019) and *OIG Report – Audit Coverage of Cost Allowability for Stanford University During Fiscal Years 2012 and 2013 Under Department of Energy Contract No. DE-AC02-76SF00515* (OAS-V-15-04, September 2015). These reports show the M&O contractor's Internal Audit Department did not perform required internal audits for subcontracts in place to acquire goods and services.⁵⁵

⁵⁰ 2016 is the most current year for which this comprehensive data was independently compiled by GAO.

⁵¹ The 24 contractors cited include both M&O and non-M&O contractors (GAO-19-107, Mar. 2019).

⁵² Incurred cost audits are generally required for subcontracts with flexibly-priced cost components. Incurred cost audits are not required for firm-fixed-price subcontracts.

⁵³ Adding to the risk, GAO's report found that the Department's contractors often have subcontracts with affiliates, compounding the risk when incurred costs audits are not performed on subcontractors.

⁵⁴ The OIG report has been issued in Preliminary Draft. The auditee has presented some evidence that it has taken steps to arrange for incurred cost audits for certain subcontracts.

⁵⁵ Stanford University did ensure that audits were performed for subcontracts to other colleges and universities.

B. Subcontracts Not Audited Due to Misclassification Issues

M&O contractors' procurement organizations routinely misclassified subcontract types. The most common situation occurred where the M&O contractor incorrectly classified a subcontract as a "firm-fixed-price contract," which does not require an audit, but the M&O contractor should have classified the subcontract as a "flexibly-priced contract," which requires an audit.⁵⁶ The OIG's recent audit work includes:

- At 1 M&O contractor, of the 16 firm-fixed-price construction subcontracts, 4 (25 percent) were misclassified and inappropriately excluded from audit.⁵⁷
- *DRAFT OIG Report – Subcontract Administration at the Kansas City National Security Campus*. Of the 92 fixed-price subcontract records, 16 (about 17 percent) were misclassified and inappropriately excluded from audit.⁵⁸
- *DRAFT OIG Report – Sandia National Laboratories Subcontract Closeout Process*. Of the 60 subcontracts, 10 (almost 17 percent) were misclassified and inappropriately excluded from audit.⁵⁹
- *OIG Report – Fiscal Year 2016 Evaluation of Incurred Cost Coverage at the Pacific Northwest National Laboratory* (DOE-OIG-21-23, April 2021). Of 25 subcontracts, 4 (16 percent) were classified as fixed-price when, in fact, they were flexibly-priced, which inappropriately excluded them from audit.
- *OIG Report – Audit Coverage of Cost Allowability for Alliance for Sustainable Energy, LLC from October 1, 2013, to September 30, 2018, Under Department of Energy Contract No. DE-AC36-08G028308* (DOE-OIG-20-39, April 2020). Three labor hour subcontracts, totaling approximately \$12.6 million, were misclassified, and inappropriately excluded from audit.
- *OIG Report – Fiscal Year 2017 Evaluation of Incurred Cost Coverage at the Los Alamos National Laboratory* (DOE-OIG-21-24, April 2021). Three subcontracts with a current funded value totaling \$7.7 million, were classified as fixed-price but had flexibly-priced elements and were inappropriately excluded from audit.

⁵⁶ A "firm-fixed-price contract" does not have variable costs, so these subcontracts do not require audit. "Flexibly-priced contracts" include variable costs and therefore require audit.

⁵⁷ The OIG report has been issued in Preliminary Draft. The auditee does not dispute these findings.

⁵⁸ The OIG report has been issued in Official Draft. In the event the auditee challenges these findings, the OIG will report such challenges and respond in the Final Report.

⁵⁹ The OIG report has been issued in Official Draft. In the event the auditee challenges these findings, the OIG will report such challenges and respond in the Final Report.

C. Subcontracts Were Audited but Not Well

The OIG reported instances where subcontract audits were performed by M&O contractor internal audit as required by their contracts. However, we identified cases in which the M&O contractor internal auditors performed poorly. One of these audits was previously discussed and resulted in criminal investigations (*OIG Report – Audit Coverage of Cost Allowability for URS | CH2M Oak Ridge LLC* (DOE-OIG-19-26, April 2019)).

In another instance, in *DRAFT OIG Report – Sandia National Laboratories Subcontract Closeout Process*,⁶⁰ the OIG found that the M&O contractor did not sustain subcontract costs that were questioned by its own contract audit office in 54 of 61 (88.5 percent) subcontract closeout files, with no documentation or justification as to the M&O contractor's rationale.⁶¹ This major finding indicates that either internal audit's work was superficial and that the recommendations could not be acted upon, or worse, that the M&O contractor's management may have disregarded the internal audit report findings and billed the Government for the questionable subcontract costs despite the internal audit report findings.

Some of the problems with M&O contractors not conducting audits of subcontracts have been occurring for years. In a 2013 report, *Management and Operating Contractors' Subcontract Audit Coverage*, (DOE/IG-0885, April 2013), the OIG reported that nine M&O contractors between 2010 and 2012 failed to audit or review \$906 million in subcontracts in a manner that met contract requirements.

On the issue of subcontract audits, it should be noted that Department of Energy Acquisition Regulation (DEAR) 970.5232-3 requires that the M&O contractor either conduct an audit or arrange for an audit to be performed for any subcontract where costs incurred are a factor in determining the amount payable, including fixed-price or unit-price subcontracts. Additionally, DEAR 970.5244-1 allows for arrangements to be made with the cognizant Federal agency to perform any required subcontract audits, assigns responsibility for determining the cost allowable under each cost-reimbursement subcontract to the contractor, and emphasizes that for costs to be allowable they must be incurred per the Federal Acquisition Regulation and DEAR cost principles.

Both of these DEAR requirements have been incorporated into the Department's M&O contracts. There are no provisions in the DEAR or in the contracts that allow for certain subcontracts that otherwise require incurred cost audits to not receive the required audit.

However, subsequent practices have diverged from the clearly stated rules in the DEAR and contract clauses. Specifically, on October 16, 2013, the Department issued Acquisition Letter AL-2014-01. This Acquisition Letter begins by clearly explaining the language of the acquisition regulations as requiring that the contractor ensure that incurred costs audits be conducted for certain cost reimbursable subcontracts. Following this analysis in the Acquisition Letter, there is a discussion summarizing various issues identified by OIG audits in which the

⁶⁰ See *supra* note 59.

⁶¹ The OIG audit found that 263 of 3,250 subcontract closeout files had questioned costs identified by Sandia National Laboratories' Internal Audit Department. The OIG judgmentally selected 61 of these files for review.

OIG found that the M&O contractor internal auditors were not performing the required audits and did not have a risk-based approach. The Acquisition Letter states, “To resolve these issues, it is imperative Contracting Officers ensure contractors [...] adopt a documented risk-based approach for conducting audits with a reasonable threshold for selecting subcontracts.” This appears to be the first time that the Department, in writing, gave permission to limit audits of subcontract costs based on a risk assessment, rather than performing audits of all subcontracts. It appears that the OIG concurred with the Department’s changed approach. However, this approach is inconsistent with the DEAR requirements.

In addition to the issue raised by adopting a practice that is inconsistent with clear regulatory and contractual requirements, granting the contractors’ internal auditors the discretion to evaluate risks in this context also presents a significant independence issue. Specifically, M&O contractors were given discretion to decide whether to perform incurred cost audits of subcontract costs based solely on a risk assessment, which did not include any specific criteria issued by the Department. It is important to note that these subcontractors’ costs flow through the M&O contract and are fully reimbursed with Federal funds.

In any case, the substantial volume of subcontract costs that have not been audited over a period of many years demonstrates the importance of implementing an independent auditing strategy.

V. THE LACK OF AN INDEPENDENT AUDIT PROGRAM HAS CAUSED OTHER MAJOR DEFICIENCIES

Over the past several years, the OIG initiated nine reviews designed to examine the efficacy of the Cooperative Audit Strategy. These nine reviews found that the M&O contractors’ internal audits on the contractors’ costs incurred and claimed did not adequately evaluate incurred costs for allowability, allocability, and reasonableness.⁶²

The OIG reported noncompliances with how contractors account for indirect costs, which typically represent half of all costs incurred and claimed by Department contractors. Indirect costs are those general and administrative costs that are not specific to the direct work of a project but are necessary for the proper functioning of a contractor and its administrative oversight. For example, indirect costs include costs for top management, legal services, accounting departments, and human resources. Indirect costs are distributed to direct cost centers by means of indirect cost rates, commonly referred to as overhead rates. The manner in which Federal contractors apply indirect costs is governed by CAS,⁶³ which articulates numerous detailed technical accounting requirements with the goal of fair and consistent allocation of indirect costs. If indirect costs are not applied to direct projects in a fair and consistent manner, then one direct Department project may inappropriately pay for more indirect costs than it

⁶² All audits of costs incurred and claimed test against 2 C.F.R. Part 200 Subpart E, *Cost Principles*, which defines allowability, allocability, and reasonableness.

⁶³ CAS are promulgated by the Cost Accounting Standards Board of the Office of Federal Procurement Policy in the White House. CAS are codified in 48 C.F.R. Chapter 99. These standards apply to all the Department’s M&O contracts.

should, while another project, such as a Strategic Partnership Project,⁶⁴ may pay for less than it should, creating an inappropriate subsidy. The net impact is that if the indirect cost rates are not managed properly, the Department may inappropriately pay for Strategic Partnership Project costs rather than the Strategic Partners' paying their full share.

The OIG audits disclosed numerous violations of CAS across the Department, which were not identified and reported by the M&O contractor's internal audit departments. In particular, the OIG reported instances of noncompliance with CAS 418, *Allocation of Direct and Indirect Costs*. For example:

- *OIG Report – Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016* (DOE-OIG-20-02, October 2019). The OIG reported a violation of CAS 418 when Battelle Energy Alliance inappropriately reallocated year-end indirect costs in a manner that was not fair and systematic, causing the OIG to question \$26 million.
- For one M&O contractor, the audit found a violation of CAS 418 when the M&O contractor inappropriately reallocated year-end indirect costs in a manner that was not fair or systematic, causing the OIG to question \$20.8 million in over-recovery and \$11.1 million in under-recovery.⁶⁵
- *OIG Report – Fiscal Year 2016 Evaluation of Incurred Cost Coverage at the Pacific Northwest National Laboratory* (DOE-OIG-21-23, April 2021). The OIG reported a violation of CAS 418 where the contractor inappropriately reallocated year-end indirect costs in a manner that was not fair or systematic.

The noncompliance with CAS 418 at these three M&O contractors resulted in improper accounting for Laboratory Directed Research and Development (LDRD)⁶⁶ costs. Specifically, the M&O contractors over-collected funds for the indirect cost pool that funds LDRD. Instead of returning the over-collected funds to the direct funded projects, as required by CAS 418, these three M&O contractors inappropriately transferred the surplus LDRD funds to other indirect cost pools. This resulted in a violation of the LDRD program's legal and regulatory requirements, which specifically prohibit LDRD funds to be used for anything other than LDRD program activities. For example, one of the LDRD rules prohibits LDRD from being used on infrastructure expenses; however, because of the way Battelle Energy Alliance reallocated the surplus LDRD funds, some of these funds were in fact spent on infrastructure expenses.⁶⁷

⁶⁴ Strategic Partnership Projects, formerly known as "Work for Others," are projects that the Department performs through its M&O contractors for other Federal agencies, such as DOD, as well as industrial partners.

⁶⁵ The OIG report has been issued in Preliminary Draft. The auditee has not presented any evidence inconsistent with these findings.

⁶⁶ The LDRD program is a Department program authorized by Congress that allows the Department's M&O contractors to accumulate indirect cost allocations from direct projects to spend on innovative research and development, largely at the M&O contractors' discretion. Because LDRD funds are indirect, and since LDRD has numerous requirements, CAS noncompliances have an outsized impact on LDRD.

⁶⁷ *OIG Report – Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016* (DOE-OIG-20-02, Oct. 2019).

The OIG reported similar but smaller dollar-amount instances of noncompliance with CAS 418 in the following OIG reports:

- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at the East Tennessee Technology Park* (DOE-OIG-21-20, April 2021). UCOR did not properly manage the special capital general and administrative indirect cost allocation against actual costs, and UCOR improperly managed year-end indirect cost balances.
- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories* (DOE-OIG-21-25, April 2021). The contractor inappropriately reallocated year-end indirect costs in a manner that was not fair or systematic.
- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at the Lawrence Berkeley National Laboratory* (DOE-OIG-21-21, April 2021). The contractor inappropriately accounted for year-end indirect costs in a manner that was not fair or systematic, and made questionable year-end accounting entries related to these allocations.

Additionally, the OIG reported instances of non-compliance with CAS 405, *Accounting for Unallowable Costs*, by several M&O contractors. CAS 405 requires that unallowable costs are allocated their fair share of the contractors' indirect costs. However, the OIG found that the contractors did not correctly and consistently apply indirect cost rates to unallowable costs. If these costs are not accounted for correctly, the Department will inappropriately reimburse a portion of the unallowable costs. The OIG reports that discuss this noncompliance with CAS 405 include the following:

- *OIG Report – Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016* (DOE-OIG-20-02, October 2019). The M&O contractor did not always include the appropriate indirect cost allocation to unallowable expenses.
- In an ongoing audit, we have found that the M&O contractor did not always include the appropriate indirect cost allocation to unallowable expenses.⁶⁸
- *OIG Report – Fiscal Year 2017 Evaluation of Incurred Cost Coverage at the SLAC National Accelerator Laboratory* (DOE-OIG-21-22, April 2021). The M&O contractor did not always include the appropriate indirect cost allocation to unallowable expenses.
- *OIG Report – Fiscal Year 2016 Evaluation of Incurred Cost Coverage at the Pacific Northwest National Laboratory* (DOE-OIG-21-23, April 2021). The M&O contractor did not always include the appropriate indirect cost allocation to unallowable expenses.

⁶⁸ The OIG report has been issued in Preliminary Draft. The auditee has not presented any evidence inconsistent with these findings.

Further, the OIG reported concerns associated with poor design and execution of M&O internal auditors' audits of the contractor's costs incurred and claimed. The OIG observed that across the Department, M&O contractors' internal auditors did not always audit indirect cost management practices, even though approximately half of all contractor costs are categorized as indirect costs.

Additionally, the OIG identified concerns with the M&O contractors' internal auditors' compliance with audit standards, risk assessments, problems with statistical sampling methodologies, and other requirements. For example, some of the OIG's findings related to quality concerns of the contractors' internal audits include the following:

- *OIG Report – Battelle Energy Alliance, LLC Costs Claimed Under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016* (DOE-OIG-20-02, October 2019). The M&O contractor's Internal Audit Department did not comply with its own policies or with IIA standards for one consulting project that we reviewed in the following areas: planning, performing the engagement, supervising, communicating, exercising due professional care, and independence. Also, the OIG concluded that the shortcomings of the Internal Audit Department likely contributed to its non-compliance with CAS 418.
- An ongoing inspection report will conclude that the President of the M&O contractor inappropriately terminated an internal audit on allowable costs, raising concerns about the independence and accuracy of the contractor's internal audits.⁶⁹
- An ongoing audit found that an M&O contractor's internal auditors did not participate in peer review programs required by the Cooperative Audit Strategy for 8 years.⁷⁰
- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at the East Tennessee Technology Park* (DOE-OIG-21-20, April 2021). There were weaknesses in the M&O contractor's internal audit design of the audit risk assessment and sampling approach.
- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories* (DOE-OIG-21-25, April 2021). There were weaknesses in the contractor's internal audit design of the audit risk assessment, sampling approach, and incurred cost reconciliation process.
- *OIG Report – Fiscal Year 2018 Evaluation of Incurred Cost Coverage at the Lawrence Berkeley National Laboratory* (DOE-OIG-21-21, April 2021). There were weaknesses in the contractor's internal audit design of the audit risk assessment, sampling approach, and documentation.
- *OIG Report – Fiscal Year 2016 Evaluation of Incurred Cost Coverage at the Pacific Northwest National Laboratory* (DOE-OIG-21-23, April 2021). There were weaknesses

⁶⁹ See *supra* note 43.

⁷⁰ The OIG report has been issued in Preliminary Draft. The auditee has not presented any evidence inconsistent with these findings.

in the contractor's internal audit design of the audit risk assessment and sampling approach.

- *OIG Report – Fiscal Year 2017 Evaluation of Incurred Cost Coverage at the SLAC National Accelerator Laboratory* (DOE-OIG-21-22, April 2021). There were weaknesses in the contractor's internal audit design of the audit risk assessment, sampling approach, and informal disposition of costs identified by the auditor as unallowable.
- *OIG Report – Fiscal Year 2017 Evaluation of Incurred Cost Coverage at the Los Alamos National Laboratory* (DOE-OIG-21-24, April 2021). There were weaknesses in the contractor's internal audit design of the audit risk assessment and sampling approach.

The above summaries are illustrative and do not cover the full depth of issues discussed in these reports.

VI. RECOMMENDATIONS

The OIG recommends that Departmental leadership cooperate fully with the OIG to:

1. Transition from the Cooperative Audit Strategy to an independent audit strategy.

The Department currently has 23 active M&O contracts. Transition to an independent audit strategy should include a near-term plan for FY 2021 to administer independent, GAGAS-compliant⁷¹ audits of the Statements of Costs Incurred and Claimed⁷² for FY 2020 for as many M&O contracts as the OIG is able to audit, given limited available resources. Although the current M&O contracts assign this duty to the internal auditors, the OIG has the authority to conduct these audits at any time.⁷³

The transition plan should also include a longer-term plan to address the additional audit work needed for FY 2021, and to address FY 2022 and beyond.

Resource Estimates: The OIG calculates that annual, independent audits will require approximately 87 full-time-equivalent employees at an annual cost of approximately \$18.75 million. This calculation includes the resources needed to perform independent audits of the claimed costs for work performed by the M&O contractors as well as their subcontractors. The costs associated with work performed by subcontractors' accounts for approximately a third of

⁷¹ The GAO's *Government Auditing Standards* are commonly referred to as GAGAS or the "Yellow Book." The 2018 version of GAGAS, which is the version in effect when this Special Project Report was written, is available at: <https://www.gao.gov/assets/700/693136.pdf>.

⁷² Each M&O contractor is required by its contract to annually submit a Statement of Costs Incurred and Claimed form to the Contracting Officer. This form serves as the M&O contractors' representation that all costs claimed on the form were incurred in support of allowable contract activities.

⁷³ The IG Act, section 6(a)(2) [5 U.S.C. Appx. 3 § 6(a)(2)], gives the IG the authority "to make such investigations and reports relating to the administration of the programs and operations of the applicable establishment as are, in the judgment of the IG, necessary or desirable."

the M&O contracts' costs. Additional appropriations will be necessary and may be spent on conducting independent audits by the following:

- OIG audit staff
- DCAA
- IPA firms using the Department's existing Master Task Agreement
- Some combination of these options to provide flexibility

Planning for the transition to an independent audit strategy should consider that in the near-term, the OIG would need to evaluate each contractors' existing systems to determine whether sufficient information is being generated and in a form that can be properly audited under GAGAS.

We anticipate that once an independent audit program for contractor incurred costs is operational, the Department should recover as much as \$48.75 million per year. This figure is based on DCAA's experience in 2019 where the DCAA return on investment is 2.6 times⁷⁴ the amount of funds spent to conduct incurred cost audits.⁷⁵

2. Organize a working group to advance the transition to an independent audit strategy. The working group should consider the following issues:

- Coordination with contractors
- Communication with funding authorities
 - Congress
 - Office of Management and Budget budget examiners
- Budget considerations
 - The budgetary funds required to implement an independent audit strategy should be offset over time by substantial cost savings. In addition, restoring independence will reduce fraud, waste, and abuse, which will also likely provide substantial cost savings to the Department.

The working group should also guide efforts to modify the following items to remove references to the Cooperative Audit Strategy and replace those references with text to describe the independent audit requirements, including administrative procedures and Federal Register publication, when required:

- DEAR 970.5232-5(a)(b), Liability with respect to cost accounting standards

⁷⁴<https://www.dcaa.mil/Portals/88/FY2019%20DCAA%20Report%20to%20Congress.pdf?ver=XKAncoiKefo8TD5ch-OCxQ%3D%3D> p.7.

⁷⁵ \$18.75M x 2.6 = \$48.75M.

- DEAR 970.5232-3, Accounts, records, and inspection; Subcontracts; Internal Audit
- The Department's Financial Management Handbook (Chapter 23)
- The Department's Acquisition Guide
- The OIG Audit Manual

The working group should also coordinate with appropriate Department elements to consider modifications to financial guidance as follows:

- Require more complete cost submissions in the Statements of Costs Incurred and Claimed and related forms. At a minimum, the Department's current Statement of Costs Incurred and Claimed form needs to be replaced. The DOD's Model Incurred Cost Proposal may provide a template for this modification.
- Update Cost Accounting Standard Disclosure Statements and associated Department guidance to improve clarity and uniformity.

The working group should also coordinate with appropriate Department elements to request that Contracting Officers:

- Modify all existing M&O contracts via the contract modification process to remove the Cooperative Audit Strategy and remove the requirement for contractor internal audits of the Statements of Costs Incurred and Claimed.
- Incorporate new contract clauses to require GAGAS-compliant independent incurred cost audits in requests for proposals, solicitations, and all new contracts.

Appendix – Department’s Official Comments and OIG Response



The Deputy Secretary of Energy

Washington, DC 20585

March 24, 2021

MEMORANDUM FOR THE DEPARTMENT OF ENERGY INSPECTOR GENERAL

FROM:

DAVID HUIZENGA

A handwritten signature in blue ink that reads "David Huizenga".

ACTING DEPUTY SECRETARY OF ENERGY

SUBJECT:

Draft Office of Inspector General Special Project Report on
*“The Transition to Independent Audits of Management and
Operating Contractors’ Annual Statements of Costs Incurred
and Claimed”*

Thank you for the opportunity to review and comment on the draft Office of Inspector General (OIG) Special Project Report entitled *“The Transition to Independent Audits of Management and Operating (M&O) Contractors’ Annual Statements of Costs Incurred and Claimed.”*

The draft report’s primary recommendation is to transition from the current Cooperative Audit Strategy, which the OIG established 26 years ago to audit the Department’s M&O contractors, to a strategy that increases the reliance upon OIG auditors or other independent auditors. In our view, the Cooperative Audit Strategy has been an effective, efficient method of assessing the allowability of M&O contractor incurred costs. Nonetheless, the Department recognizes the OIG’s authority as the cognizant auditor to develop an alternate strategy for conducting M&O contract audits that addresses the OIG’s concerns about independence. The OIG’s proposal to perform additional audits per the Generally Accepted Government Auditing Standards has always been within the OIG’s purview.

The second recommendation focuses on implementation of the new strategy. As recognized in the draft report, developing and executing an effective transition plan will be important to minimize the risk to taxpayers and ongoing contract performance. The OIG should clearly convey to the Department’s M&O contractors, the Office of Management and Budget, and the Congress its intended path forward to facilitate an orderly transition. The Department is fully committed to working with the OIG on executing the new approach.

In addition to this response, the Department has technical comments regarding the Special Project Report that will be provided separately for your consideration and adjudication prior to release of the final report. If you have any questions regarding this response, please contact Ingrid Kolb, Director, Office of Management.

cc: Acting Under Secretary for Science and Energy
Acting Under Secretary for Nuclear Security

Office of Inspector General Response to the Department's Comments



Department of Energy
Washington, DC 20585

April 7, 2021

MEMORANDUM FOR THE DEPARTMENT OF ENERGY INSPECTOR GENERAL

FROM: Jonathan A. Black
Senior Advisor to the IG, on behalf of the Special Project Report team

SUBJECT: OIG Response to the Department's Official Comments to the Draft Special Project Report on "The Transition to Independent Audits of Management and Operating Contractors' Annual Statements of Costs Incurred and Claimed" (March 24, 2021)

The Office of Inspector General (OIG) Special Project Report team would like to thank the Department for its official comments to the OIG Special Project Report entitled "The Transition to Independent Audits of Management and Operating Contractors' Annual Statements of Costs Incurred and Claimed." The OIG greatly appreciates the Department's concurrence with the Recommendations of the Special Project Report. The OIG also appreciates the Department's commitment to supporting the OIG's efforts to make the transition to an independent audit program. The success of this transition will depend in large part on the cooperation and support of the Department, as described in more detail in the Recommendations section of the Special Project Report. While it is appropriate for the Inspector General, as the cognizant Federal auditor, to play an important role, this change must proceed as a coordinated effort to achieve an orderly transition in fiscal year 2022.

Moreover, as the Department knows, this transition simply will not happen without funding. For that reason, the OIG has requested the Department's full support in its efforts to acquire the needed budgetary resources to implement an independent audit strategy in fiscal year 2022.

The Department included in its general comments a statement that the Cooperative Audit Strategy has been, in its view, effective and efficient. We note that the longevity of the Cooperative Audit Strategy is not evidence that it has been working effectively and efficiently.

On the issue of effectiveness, numerous OIG and GAO reports have chronicled the issues and deficiencies associated with the Cooperative Audit Strategy, as discussed in the Special Project Report. In addition, the OIG recently compared DCAA incurred cost auditing *recoveries* with the Management and Operating contractors' internal auditors' incurred *questioned costs* during the 2019 and 2020 timeframe. We noted that questioned costs are typically higher than actual recoveries. However, we found that DCAA's rate of recoveries was approximately 6 times that of the Management and Operating contractors' questioned cost rate. While this "back of the envelope" comparison is certainly not conclusive, it does suggest that independent Federal auditors are generally more effective when conducting incurred cost audits. The reason is independence.

Office of Inspector General Response to the Department's Comments

On the issue of efficiency, we again examined DCAA. In 2019, DCAA reported that it spent \$279,118,000 for incurred cost audits. DCAA's net recovery was \$736,485,000 – 2.6 times as much as was spent for these audits. While incurred cost auditing under GAGAS is likely to “pay for itself,” we also note that annual incurred cost audits add substantial value beyond the documented monetary recoveries. For example, annual incurred cost audits facilitate real time course corrections that limit the duration of fraud, waste and abuse. By more quickly identifying problems, GAGAS compliant audits protect both the contractors and the Federal government from having to evaluate and correct multiyear issues, which is a burdensome and expensive process for all parties. Annual incurred cost audits also act as a powerful deterrent to fraud, waste and abuse, stopping such activities before the activities begin.

In closing, the OIG Special Project Report team is looking forward to implementing an independent audit strategy that will be greatly beneficial to the Department's Management and Operating contractors by increasing the resources available for continued success in science, technology and other critically important areas.

FEEDBACK AND MEDIA INQUIRIES

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