U.S. Department of Energy
Office of Inspector General
Office of Audits and Inspections

# ASSESSMENT REPORT

## Audit Coverage of Cost Allowability for DM Petroleum Operations Company During October 1, 2011, Through March 31, 2014, Under Department of Energy Contract No. DE-AC96-03P092207

OAI-V-16-02

November 2015

**Department of Energy**
Washington, DC 20585

November 10, 2015

MEMORANDUM FOR THE PROJECT MANAGER, STRATEGIC PETROLEUM RESERVE PROJECT MANAGEMENT OFFICE

Debra K. Solmonson

FROM: Debra K. Solmonson, Director
Eastern Audits Division
Office of Inspector General

SUBJECT: INFORMATION: Assessment Report: "Audit Coverage of Cost Allowability for DM Petroleum Operations Company During October 1, 2011, Through March 31, 2014, Under Department of Energy Contract No. DE-AC96-03PO92207"

BACKGROUND

From 1993 through March 31, 2014, DM Petroleum Operations Company (DM) operated the Strategic Petroleum Reserve (Reserve) under a managing and operating contract with the Department of Energy (Department). The Reserve is the world's largest Government-owned emergency crude oil stockpile and currently stores about 695 million barrels of crude oil in a series of underground salt caverns along the coastline of the Gulf of Mexico. During the period of October 1, 2011, through March 31, 2014, DM expended and claimed $366,798,705 in costs incurred. On April 1, 2014, Fluor Federal Petroleum Operations assumed responsibility as the managing and operating contractor of the Reserve. The following table illustrates the costs claimed by DM from October 1, 2011, through March 31, 2014:

| Fiscal Year | Claimed Costs |
|---|---|
| 2012 | $148,905,728.76 |
| 2013 | $145,269,279.98 |
| 2014 | $72,623,696.56 |
| Total | $366,798,705.30 |

Because DM was an integrated management and operating contractor, its financial accounts were integrated with those of the Department, and the results of transactions were reported monthly according to a uniform set of accounts. DM was required by its contract to account for all funds advanced by the Department annually on its Statement of Costs Incurred and Claimed, to safeguard assets in its care, and to claim only allowable costs. Allowable costs are incurred costs that are reasonable, allocable, and allowable in accordance with the terms of the contract, applicable cost principles, laws, and regulations.

To help ensure that only allowable costs are claimed by the Department's integrated contractors and to make efficient use of available resources, the Office of Inspector General (OIG), the

Department's Office of Acquisition and Project Management, and the integrated management and operating contractors and other select contractors have implemented a Cooperative Audit Strategy (Strategy). The Strategy places reliance on the contractors' internal audit function (Internal Audit) to provide audit coverage of the allowability of incurred costs claimed by contractors. Consistent with the Strategy and as required by its contract, DM maintained an Internal Audit activity with responsibility for conducting audits, including audits of the allowability of incurred costs. In addition, DM was required to conduct or arrange for audits of its subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor. According to DM's Internal Audit Implementation Design, subcontract audits were primarily the responsibility of DM's Procurement Department.

To help ensure that audit coverage of cost allowability was adequate for the period of October 1, 2011, through March 31, 2014, the objectives of our assessment were to determine whether:

- Internal Audit conducted cost allowability audits that complied with professional standards and could be relied upon;
- DM conducted or arranged for audits of its subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor; and
- Questioned costs and internal control weaknesses affecting allowable costs that were identified in prior audits and reviews have been adequately resolved.

## RESULTS OF ASSESSMENT

Based on our assessment, we determined that we could not rely on the allowable cost–related audit work for costs incurred during October 1, 2013, through March 31, 2014. Specifically, we found DM had not ensured that the allowable cost review performed by an independent certified public accounting firm met the established procedures for conducting allowable cost reviews. Accordingly, we consider costs totaling $72,623,697 incurred during this period to be unresolved pending audit.

Nothing came to our attention to indicate that the allowable cost–related audit work performed by DM Internal Audit for costs incurred during October 1, 2011, through September 30, 2013, could not be relied upon. Specifically, we did not identify any material internal control weaknesses with DM's cost allowability audits performed for fiscal years (FYs) 2012 and 2013, which generally met Institute of Internal Auditors standards. Further, we found that costs totaling $58,102 questioned by Internal Audit during this period had been resolved or reimbursed to the Department, as required.

However, we identified weaknesses with subcontract auditing that need to be addressed to ensure that only allowable costs are claimed by and reimbursed to the contractor. Specifically, we found that DM did not conduct or arrange for periodic postaward audits of all of its cost-type subcontracts, including time and materials subcontracts. Consequently, $19,875,247 in subcontract costs incurred from October 1, 2011, through March 31, 2014, are considered unresolved pending audit.

**External Cost Review**

DM had not ensured that the work performed by an independent certified public accounting firm met the established procedures for conducting allowable cost reviews. According to the Strategy, an audit of allowability of costs should be comprehensive and performed in accordance with the audit program approved by the OIG. However, when DM subcontracted with the accounting firm to review costs incurred for the period of October 1, 2013, through March 31, 2014, the procedures lacked significant audit steps from the OIG-approved audit program. As a result, the independent firm did not conduct a risk assessment to determine the scope of the review, perform a follow-up review of findings and recommendations identified in other audits, hold discussions with senior management to identify vulnerabilities, nor conduct comprehensive testing of internal controls.

Further, the independent firm did not perform "drill-down" procedures to verify that the accounting system's controls were working properly. Rather, the firm relied on controls maintained within the accounting system to determine whether purchase orders were appropriately approved. While the Strategy required deviations from the OIG audit program to be approved by the Contracting Officer after consultation with the OIG and Chief Financial Officer, DM did not obtain this approval. As a result, we determined that the independent firm's cost review did not provide sufficient assurance of comprehensive audit coverage, as required. Accordingly, we consider the entire $72,623,697 incurred for the period October 1, 2013, through March 31, 2014, as unresolved pending audit.

In addition, we question $19,420 incurred by DM for the services performed by the public accounting firm as potentially unallowable because the engagement did not meet the requirements of the Strategy.

**Time and Material Subcontract Audits**

DM had not conducted or arranged for audits of its time and material-type subcontracts when costs incurred were a factor in determining the amount payable to the subcontractor, as required by contract clause I-130, Department of Energy Acquisition Regulation 970.5232-3(c), *Audit of Subcontractors' Records*, and their internal policies and procedures. In particular, we identified 135 time and material-type subcontracts, with costs totaling $19,875,247, incurred during October 1, 2011, through March 31, 2014, which had received neither closeout nor interim audit coverage during the period under review. These costs are unresolved pending audit.

| Fiscal Year | Unresolved Costs[1] |
|---|---|
| 2012 | $7,126,453 |
| 2013 | $8,126,631 |
| 2014 | $4,622,163 |
| Total | $19,875,247 |

[1] The FY 2014 subcontract costs are included in the unresolved costs of $72,623,697 discussed above.

## RECOMMENDATIONS

We recommend that the Project Manager of the Strategic Petroleum Reserve Project Management Office direct the Contracting Officer to:

1. Ensure an allowable cost audit of DM's expenditures during the period October 1, 2013, through March 31, 2014, is conducted and any questioned costs are resolved prior to closeout of the contract.

2. Use a risk-based approach to ensure adequate audit coverage of time and materials subcontract costs considered unresolved pending audit.

3. Determine the allowability of $19,420 incurred by the accounting firm for the audit of costs incurred during the period October 1, 2013, through March 31, 2014.

## MANAGEMENT AND AUDITOR COMMENTS

Strategic Petroleum Reserve management concurred with the OIG's recommendations and their planned actions are responsive to our recommendations. Management comments are included as Attachment 1.

## SCOPE AND METHODOLOGY

This assessment was performed from September 2014 to November 2015, at the Strategic Petroleum Reserve Project Management Office in New Orleans, Louisiana. The assessment was limited to Internal Audit's activities, relevant criteria, prior audits and reviews, subcontract audits, resolution of questioned costs, and internal control weaknesses that affected costs claimed by DM on its Statements of Costs Incurred and Claimed for October 1, 2011, through March 31, 2014. This assessment was conducted under OIG project number A14OR059. To accomplish our objectives, we:

- Assessed allowable cost audit work conducted by Internal Audit and its independent certified public accounting firm. This included a review of audit reports, workpapers, auditor qualifications, independence, and compliance with applicable professional auditing standards.

- Reviewed policies, procedures, and practices identifying subcontracts requiring audit and arranging for audits.

- Assessed whether DM conducted or arranged for audits of its subcontractors.

- Evaluated resolution of questioned costs and control weaknesses affecting cost allowability that were identified in prior audits and reviews conducted by the OIG, DM Internal Audit, and other organizations.

We conducted our assessment in accordance with generally accepted Government auditing standards for attestation engagements. Those standards require that we plan and perform the assessment to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objectives. An assessment is substantially less in scope than an examination or audit in which the objective is an expression of an opinion on the subject matter and accordingly, for this assessment, no such opinion is expressed. Because our assessment was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our assessment. We relied on a limited amount of computer-processed data to accomplish our objectives, and validated the data by comparing a sample of subcontract purchase orders to cost data within the accounting database. We determined that the data was sufficiently reliable for the purposes of our assessment.

Strategic Petroleum Reserve Management waived an exit conference on this assessment.

This report is intended for use of Department and DM contracting officers and field offices in the management of their contracts, and is not intended to be and should not be used by anyone other than these specified parties.

Attachments

## MANAGEMENT COMMENTS

**Department of Energy**
Strategic Petroleum Reserve Project Management Office
900 Commerce Road East
New Orleans, Louisiana 70123

October 26, 2015

MEMORANDUM FOR DEBRA K. SOLMONSON, DIRECTOR,
EASTERN AUDITS DIVISION
OFFICE OF INSPECTOR GENERAL, IG-371

FROM: WILLIAM C. GIBSON, JR., PROJECT MANAGER,
STRATEGIC PETROLEUM RESERVE, FE-44

10/27/15

SUBJECT: Management Comments on Draft Report: "Audit Coverage of Cost Allowability for DM Petroleum Operations Company, During October 1, 2011, Through March 31, 2014, Under Department of Energy Contract No. DE-AC96-03PO99207"

Thank you for the opportunity to comment on the subject report. As indicated below by our concurrence with each of your recommendations, we are in substantial agreement with the draft audit report. However, we would like to put the issues raised by your audit into context.

DM Petroleum Operations Company's (DM's) contract ended on March 31, 2014, a year past the original completion date of March 31, 2013. The contract was extended by the Government through a series of short-term extensions because of additional time needed to complete the competitive procurement process for the follow-on contract. DM was succeeded by Fluor Federal Petroleum Operations (FFPO) effective April 1, 2014, at which time, with the exception of a few key personnel, all DM personnel, including the internal audit staff, transitioned to FFPO. Because DM no longer had an internal audit staff, it sought to have FFPO audit the period October 1, 2013 through March 31, 2014, in conjunction with FFPO's audit of the period April 1, 2014 through September 30, 2014. Because FFPO was not required under its contract to audit the prior contract, it declined the request, leaving DM no choice but to contract separately for the audit. Under the circumstances, we and DM believed that the audit DM commissioned for the last six months of its contract would be adequate. Of course, if we knew then what we know now, we would have made different arrangements.

The Office of Inspector General (OIG) issued Special Report—Management and Operating Contractors' Subcontract Audit Coverage, DOE/IG-0885, in April 2013. Building on the results of this audit, the Department issued Acquisition Letter 2014-01—Management and Operating Contractor's Audit Coverage of Cost-Reimbursement Subcontracts in October 2013. Both of these documents addressed time and material subcontracts; and while neither established new requirements, each clearly signaled that practices that may have been tolerated in the past might not be acceptable going forward. DM recognized the Department's new emphasis on this topic and included audit of time and material subcontracts as a specific item in its FY 2014 Annual Audit Plan. However, DM's contract ended before it could implement this audit.

At present, DM has no employees and exists on paper only. The few administrative matters that are pending contract closeout are being handled by a single official of Jacobs Engineering, the majority owner of DM. Thus, it will not be feasible to make use of DM resources to address the issues raised in the draft audit. Instead, we will leverage other available resources, such as FFPO, to the extent appropriate and funds are available.

**Response to Report Recommendations**

**Recommendation 1:** Ensure an allowable cost audit of DM's expenditures during the period October 1, 2013 through March 31, 2014, is conducted and any questioned costs are resolved prior to closeout of the contract.

***Management Response:***

1. ***Concur*** – We concur with the recommendation. The Contracting Officer will ensure that an acceptable incurred cost audit has been performed and that questioned costs are resolved prior to closeout of the contract.

**Recommendation 2:** Use a risk-based approach to ensure adequate audit coverage of time and materials subcontract costs considered unresolved pending audit.

***Management Response:***

2. ***Concur*** – We concur with the recommendation. The Contracting Officer will ensure that a risked-based audit approach is implemented to address the unresolved subcontract costs. Since some of the subcontracts identified by the OIG were still active at the end of the DM contract, they were transferred to FFPO. It may be possible for FFPO to address the unresolved items as part of the subcontract closeout process.

**Recommendation 3:** Determine the allowability of $19,420 incurred by the accounting firm for the audit of costs incurred during the period October 1, 2013 through March 31, 2014.

***Management Response:***

3. ***Concur*** – We concur with the recommendation. The Contracting Officer will determine cost allowability in accordance with FAR 31.201-2.

If you have any questions, please contact Stephen Gauthe at (504) 734-4327.