# OVERSIGHT OF COST-REIMBURSABLE CONTRACTS

Federal Aviation Administration

Report Number: FI-2002-092 Date Issued: May 8, 2002



# Memorandum

Date:

U.S. Department of Transportation

Office of the Secretary of Transportation
Office of Inspector General

Subject: ACTION: Report on Oversight of

Cost-Reimbursable Contracts, FAA

FI-2002-092

From: Alexis M. Stefani

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Reply to

Attn of: Meche: x61496

May 8, 2002

To: Federal Aviation Administrator

This report presents our audit results on oversight of cost-reimbursable contracts in the Federal Aviation Administration (FAA). Our audit objective was to determine whether FAA was properly administering cost-reimbursable contracts in accordance with applicable acquisition regulations and guidance.

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Use of cost-reimbursable contracts is more risky for FAA because contractors generally have little incentive to control costs. Thus, contracting officer oversight is essential to protect the Government's interest. For Fiscal Year (FY) 2001, FAA awarded about 800 cost-reimbursable contracts totaling \$3.4 billion.

Until 1996, funding for independent audits of contracts was included in the Office of Inspector General (OIG) budget. FAA would request audits of specific contracts, and OIG would contract with the Defense Contract Audit Agency (DCAA) for audits to determine whether costs claimed by contractors were allowable. After FAA assumed the responsibility for funding its contract audits, the number of audits began to drop, going from 35 incurred-cost audits<sup>1</sup> in FY 1996 to only 10 in FY 2001. In June 2001, the House Committee on Appropriations addressed its concern with FAA and stated:

The Committee is very displeased to learn that FAA has decreased the number of requested audits by [DCAA].... Regrettably, the FAA has allowed its project managers to avoid these important audits. This is an intolerable situation which cannot be continued.

In October 1995, Congress exempted FAA from the Federal Acquisition Regulation (FAR) provisions applicable to most Federal agencies, and directed that FAA develop

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<sup>&</sup>lt;sup>1</sup> Incurred-cost audits include an independent examination of contractors' actual costs claimed in interim and final vouchers, overhead cost submissions, proposals for billing rates, and contract modifications.

a new procurement system. FAA implemented its new Acquisition Management System (AMS) in April 1996.

#### **RESULTS IN BRIEF**

Although procurement reform gave FAA more flexibility in how to acquire equipment and services, it did not exempt FAA from its responsibility to implement sound business practices, such as independent audits of contractors' incurred costs, to ensure goods and services are received that meet FAA needs at a reasonable cost. In fact, the congressional authors of procurement reform envisioned streamlined processes to shorten the procurement cycle, but strong accountability and oversight to protect the taxpayers' money. To the contrary, this is not what we found for FAA cost-reimbursable contracts.

In view of these serious findings, the amount of taxpayers' dollars involved, and the need for corrective actions, we called this report to the attention of the FAA Administrator. The FAA Administrator agreed that firm actions are necessary and committed to the specific 3-point corrective action plan described on page 4, in addition to a series of recommendations in our draft report. These actions, when implemented, will go a long way toward improving contract management and accountability of the taxpayers' money.

Our audit found that FAA is not properly administering cost-reimbursable contracts. FAA contracting officers are the Government's first line of defense against improper payments on high-dollar and high-risk cost-reimbursable contracts. Yet, we found that contracting officers exercised little effective oversight, and in most cases, lacked the basic information needed to properly manage, pay, and close contracts. We found every stage of contract management, from contract award to closeout,² was deficient, lacked accountability, and did not adequately protect FAA from fraud, waste, and abuse. Key deficiencies in both FAR and AMS contracts are:

• For the 54 cost-reimbursable contracts totaling \$3.6 billion that we selected, FAA searched for 6 months and could not locate all or significant parts of 22 contract files totaling \$274 million. Of the 22 files, 2 were inappropriately destroyed. Contractors must have been satisfied because there were no outstanding claims for payments on these missing contracts. However, the absence of contract files eliminates any chance to identify and recover improper payments.

<sup>&</sup>lt;sup>2</sup> Contract closeout generally involves the determination that incurred-cost audits are complete for all performance years of the contract; a final invoice has been submitted, Government property has been accounted for, subcontracts are settled; contract costs are reconciled; and contract funds are deobligated.

- For 19 of the 32 contract files FAA found, totaling \$585 million, FAA did not have the required evidence showing the contractor's accounting system was adequate for cost-reimbursable contracts. In one case, the contracting officer had a DCAA report that recommended an \$8 million contract modification for maintenance on the Data Link Processor system not be negotiated because of accounting system deficiencies. Despite DCAA's recommendation, FAA negotiated the modification and closed this \$30 million contract without an incurred-cost audit to determine whether the contractor was overpaid.
- For 21 of the 32 contracts, totaling \$1 billion, contractors did not provide their annual final direct and indirect costs, along with adjustment vouchers for differences between actual and billed costs for each year. For eight AMS contracts totaling \$71 million that used indirect rates, contract files contained no incurred-cost audits, no final indirect rates, and no adjustment vouchers. When FAA did not get the required information, the contracting officers simply paid amounts claimed or modified the contract to agree with amounts already paid.
- For 22 of the 32 contracts, totaling \$2 billion, FAA did not obtain incurred-cost audits as required. For example, one contract for system engineering and integration work on the National Airspace System Plan has not received annual audits for each year on the \$1.1 billion of costs incurred over 12 years. Another example involved a contract that was negotiated for \$600,000 where DCAA had recommended an incurred-cost audit. The contract file documented the contractor's poor performance and showed billings of about \$4 million. Despite DCAA's recommendation, FAA paid the entire amount without an audit.

When DCAA performed audits, the reports identified significant unallowable costs. For example, two DCAA reports questioned about \$4 million of costs, including charges for unsupported consultant fees, relocation costs containing unallowable custom-made drapes, and hospitality payments to foreign officials.

• For 19 of the 32 contracts, totaling \$2.9 billion, the contracts were overdue for closeout by up to 10 years, 13 of which still are open. As of April 2001, FAA had a backlog of about 1,400 cost-reimbursable contracts totaling \$6 billion when contractor performance had been complete for more than 3 years and contracts were not closed. In addition, FAA assigned to a closeout contractor<sup>3</sup> contracts with complex unresolved issues that required contracting officer action to protect the Government's interest. For example, one contract included a \$1.5 million demand for payment that had been unresolved since 1995.

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<sup>&</sup>lt;sup>3</sup>A closeout contractor is an outside company that provides closeout services for contracts and acts on behalf of FAA to accomplish the closeout procedures.

We concluded that FAA oversight of cost-reimbursable contracts is seriously inadequate. In our opinion, the combination of these major deficiencies in FAA's contract management represent a material weakness in internal controls. The Federal Managers' Financial Integrity Act of 1982 requires that this material weakness be reported to Congress and the Office of Management and Budget.

To adequately protect the Government's interest, the FAA Administrator needs to send a strong message to senior managers that complacency with contract management issues will no longer be tolerated. To this end, we are recommending that the FAA Administrator task the soon-to-be appointed Chief Operating Officer to work with FAA's Air Traffic Services Subcommittee to develop a comprehensive plan with specific performance goals for managing contracts to restore accountability.

Our recommendations addressed specific actions to: withhold payments for noncompliant contractors; establish a contract tracking system; determine whether contractors have adequate accounting systems; monitor and adjust billing rates each year; establish a central fund to obtain audits throughout contract performance; identify contracts that should be closed and reduce the backlog; and report the material weakness in internal controls.

In its initial response to our recommendations, FAA's primary corrective action was to issue memoranda to remind contracting officers of their responsibilities. More forceful action is needed to solve the problems we identified that could be costing taxpayers millions of dollars. Accordingly, we asked the FAA Administrator to take firm actions on our recommendations summarized above and on pages 12 and 13, to include three recommendations for reporting to the Deputy Secretary. The FAA Administrator committed to this 3-point plan in addition to the recommendations in our draft report.

- Report quarterly to the Administrator and the Air Traffic Services Subcommittee on progress made to reduce the current backlog.
- Notify all FAA contracting personnel, in writing, that the lax accountability over contracts as identified in the OIG report will not be tolerated. As part of this action, modify contracting personnel performance plans to specifically include the requirement for timely and effective execution of applicable procurement rules to the management of payment and close-out procedures.
- Determine the total number of open contracts for which contractor performance has been completed, identify which ones should have an incurred-cost audit, and implement a plan with specific milestones to properly audit and then close overdue contracts. Report on the current backlog until it is eliminated.

#### **BACKGROUND**

The FAR Part 16 and related guidance require contracting officers to actively administer cost-reimbursable contracts because these contracts pose the greatest risk for the Government since contractors do not have a strong incentive to control costs. To actively administer cost-reimbursable contracts, FAR requires that contracting officers obtain audits, determine whether contractors accounting systems are adequate to administer cost-reimbursable contracts, and make needed adjustments to costs during contract performance. FAR also requires that cost-reimbursable contracts be closed within 3 years after performance completion.

The AMS policy developed by FAA is similar to the FAR, but does not require that contracting officers obtain independent audits. FAA procurement guidance notes that contracting officers may close AMS contracts requiring the settlement of indirect cost rates within 36 months of the completion of the contract.

#### SCOPE AND METHODOLOGY

We interviewed appropriate FAA officials, reviewed pertinent Federal and FAA acquisition regulations and guidance, and analyzed contract files. To accomplish our audit objective, we reviewed contract documents to determine whether the required contract billing and closing procedures were followed. We also determined whether contracting officers had obtained independent audits of contract costs in accordance with applicable provisions.

We reviewed contract data based on a nonstatistical sample of 21 FAR contracts totaling about \$3.2 billion and 11 AMS contracts totaling about \$80 million. As of April 2001, we selected FAR contracts from about 1,400 cost-reimbursable contracts, valued at about \$6 billion, that were reported as complete for at least 3 years as of April 1998. We stratified the FAR contracts to review all completed contracts, valued more than \$100 million each, that FAA could locate. As of July 2001, FAA had 124 AMS contracts, valued at about \$600 million, that were reported as complete. We judgmentally selected 11 AMS contracts with values greater than \$500,000.

We did not perform tests of system general and application controls to confirm the reliability of the data contained in DOT and FAA contract information system databases, or the closeout contractor's database. We used other information to substantiate the reliability of the data supporting our conclusions and recommendations.

We performed the audit from April 2001 through December 2001 at FAA Headquarters. We conducted the audit in accordance with <u>Government Auditing Standards</u> prescribed by the Comptroller General of the United States.

#### RESULTS

FAA is not properly administering cost-reimbursable contracts in accordance with applicable acquisition regulations and guidance. The lack of accountability and poor controls over FAA contracts jeopardize the successful execution of every phase of cost-reimbursable contracts. We found little oversight of cost-reimbursable contracts as described below.

# **Inadequate Contracting Officer Oversight**

Contracting officers are the Government's first line of defense against improper payments on cost-reimbursable contracts. We found significant deficiencies in the contract management process for both FAR and AMS contracts.

## Maintaining and Tracking Contract Files

Contracting officers are not properly maintaining official contract files. As part of the 1996 DOT Appropriations Act, Congress directed FAA to obtain independent evaluations of its progress in implementing AMS. Two separate evaluations in September 1997 and July 1999 by a consulting firm contained critical comments on FAA's documentation standards. The first evaluation specifically found the contracting files "... lacked details documenting the contracting steps and the basis of decisions." As discussed throughout this report, contract files we reviewed did not contain required documentation.

More significantly, for the 54 cost-reimbursable contracts totaling \$3.6 billion that we selected for review, FAA searched for 6 months and could not locate all or significant parts of 22 contract files totaling \$274 million. Of the 22 files, 2 were inappropriately destroyed. Contractors must have been satisfied because there were no outstanding claims for payments on these 22 contracts. However, the absence of contract files eliminates any chance to identify and recover improper payments.

For the 32 contracts we were able to review, FAA located those files in a variety of places such as storage rooms, desk drawers, filing cabinets, or boxes with no specific designated location. The responsible contracting officers were not immediately known and, in some cases, there were no contracting officials with a working knowledge of the contract history. For example, FAA's database identified a \$107 million contract that was completed 8 years ago. FAA could not find the files, and we could not find information regarding the contract that would be useful in assessing this contract. In interviews, contracting officers complained about "inheriting" poorly maintained contract files for contracts they knew nothing about.

FAA places little emphasis on maintaining cost-reimbursable contract files. In the summer of 2000, FAA recognized a need to maintain better contract management information and purchased a database for \$36,000 that would capture, among other data elements, those contracts eligible for closeout. This was a step in the right direction. The product was delivered. Subsequently, FAA found its contract data were so inaccurate that it would corrupt the new database. FAA has not fully resolved this issue, and needs to complete this worthwhile initiative.

## Assessing Contractor Accounting Systems

Contracting officers are not obtaining assessments of contractor accounting systems, as required. FAR requires, as one of the first steps before awarding cost-reimbursable contracts, that contracting officers determine whether the contractor's accounting system is adequate to track incurred costs by contract. Although not as specific as FAR, AMS requires that the interest of United States taxpayers be protected on cost-reimbursable contracts by allowing contracting officers to decide whether a determination of the contractor's accounting system adequacy is necessary.

For 19 of the 32 contracts we reviewed, totaling \$585 million, FAA contract files did not include evidence that the contracting officer made a determination that the contractor's accounting system was adequate to record costs for cost-reimbursable contracts. The DCAA reports that were available on the contracts we reviewed indicated references to inadequacies in several contractor accounting systems. For example, on one FAR contract for maintenance on the Data Link Processor system, DCAA recommended the contracting officer not negotiate an \$8 million contract modification because of accounting system deficiencies. Despite DCAA's recommendation, FAA negotiated the modification without any explanation regarding the accounting problems, and without any additional verification. Eight years later, this \$30 million contract was closed without an incurred-cost audit.

For contractor accounting systems that have been deemed to be adequate, contracting officers can place some reliance that costs incurred by the contractor are properly recorded against cost-reimbursable contracts and supported by the accounting records. However, without such a determination, the Government has no assurance that it is being billed for appropriate and allowable costs.

# Monitoring Contractor Billings

Contractors submit periodic interim and final billings to FAA to receive payment for services provided throughout contract performance. The interim costs billed should be actual direct costs such as labor, and indirect costs, such as overhead costs, based on estimated billing rates. For FAR contracts, within 6 months after the close of each fiscal year, contractors must provide a certified incurred-cost submission stating that

they are billing only actual allowable direct and indirect costs incurred on each contract during that year. At the same time, contractors should submit an adjustment voucher, if necessary, to recover underpayments or reimburse the Government for overpayments due to differences between estimated and actual indirect costs.

Eight of the 21 FAR contract files contained adjustment vouchers, as required, which contractors submitted primarily to claim additional payments. However, for the other 13 FAR contracts, we found no evidence of adjustment vouchers being submitted to recognize differences between actual indirect rates and estimated billing rates during the prior year. This goes on year after year. To illustrate the fiscal impact, an adjustment voucher on the Voice Switching and Control System program was submitted to adjust the estimated indirect costs that were billed during the prior year. The actual indirect costs revealed FAA overpaid the contractor by \$275,000.

For AMS contracts, contractors are required to submit proposed final indirect rates 90 days after the close of each fiscal year. For eight AMS contracts, totaling \$71 million, that used proposed indirect rates, the contractors did not submit final indirect rates, had no incurred-cost audits and the contract files contained no adjustment vouchers to account for the differences between estimated and final indirect rates.

On two AMS contracts with the same contractor, the contract files documented that the contractor had been overpaid by \$40,000. FAA identified the overpayment, and the contracting officer determined that it was the accounting department's responsibility to "seize" the overpayment. The FAA accounting office sent an overpayment notice to the contractor in September 2000. As of September 2001, the contractor had not repaid the Government. We brought this unresolved issue to the attention of FAA's accounting office for appropriate action.

For the 32 contracts, we found documentation that 11 contractors had been involved in business acquisitions or mergers that require contract novations<sup>4</sup> to protect the Government's interest in existing contracts. For 8 of the 11 contracts, 5 of which are more than \$100 million, we found no evidence that novation agreements had been executed with FAA. The performance period for these 8 contracts ranged from 1984 to 2001. By the terms of a novation, FAA would not be required to pay added costs directly or indirectly related to the business change.

Contractors that fail to comply with important contract requirements, such as adjustments to interim billings for actual costs and final vouchers, should face monetary consequences. Rather than simply paying based on amounts claimed, FAA

<sup>&</sup>lt;sup>4</sup> Generally, a novation legally recognizes a new contractor and discharges the original contractor by agreement of all parties, including the Government. A novation also extinguishes an old obligation and establishes a new one based on the novation agreement.

contracting officers, as authorized in AMS contract clauses, should reduce the costs and fee to be paid that can be retained by contract terms until the contractor complies.

### Obtaining Incurred-Cost Audits

FAA is not requesting incurred-cost audits, as required, for FAR or AMS contracts. With few exceptions, the FAR requires that contracting officers obtain incurred-cost audits of contracts prior to closing cost-reimbursable contracts. AMS does not require audits, but permits contracting officers to request audits as desired. Regardless of whether the contract is subject to FAR or AMS provisions, the allowability and accuracy of total contract costs must be verified to ensure the Government only pays the appropriate amount for contractor services. Amounts recorded in contractor records and costs determined by contracting officers to be allowable must match contractor billings.

The OIG budget included the funding for audits of contracts until 1996. FAA would request audits from DCAA through OIG. In FY 1996, FAA received 131 contract audit reports, which included 35 incurred-cost audits. After FAA took over financial responsibility for audits of its contracts, the number of audits began to drop. In FY 2001, FAA received 90 contract audits, of which only 10 were incurred-cost audits.

In May 2000, the House Committee on Appropriations Conference Report for the FY 2001 DOT Appropriations stated that the "... conferees did not transfer [audit] responsibility to the operating agencies for it to be neglected." A year later in June 2001, the House Committee on Appropriations specifically addressed its concern with FAA and stated:

The Committee is very displeased to learn that FAA has decreased the number of requested audits by [DCAA]. When this activity was transferred from the OIG to the modal administrations a few years ago, Congress expressed a clear view that the agencies were responsible for ensuring the timely completion of necessary DCAA audits. Regrettably, the FAA has allowed its project managers to avoid these important audits. This is an intolerable situation which cannot be continued.

For the 32 contracts we reviewed, we found that 22 contracts totaling \$2 billion were closed or eligible to be closed, but incurred costs billed to FAA had not been audited for accuracy. One contract for system engineering and integration work on the National Airspace System Plan, which remains open, has not received annual audits for each year as required for the \$1.1 billion of costs incurred over 12 years. The contract file showed incurred-cost audits were performed from the beginning of the contract in 1984 and stopped in 1989 although the contract still was open as of

December 31, 2001. Another contract file contained a DCAA audit report on the contractor's accounting system that recommended an incurred-cost audit. In closing the contract, the contracting officer's last contract modification stated that FAA would "allow the contract to expire" for a contractor whose performance was not acceptable. The contract originally was negotiated for \$600,000. We found this contractor billed FAA more than \$4 million. FAA paid the entire amount, and despite DCAA's recommendation, these costs were never audited.

Incurred costs should be audited annually if the cost-reimbursable contract is open for more than one fiscal year. Annual incurred-cost audits by DCAA often identify significant unallowable costs such as professional fees, travel, meals, and entertainment. For example, DCAA questioned \$2 million claimed by a contractor, which included costs for custom-made drapes, carpet and wallpaper claimed as relocation costs, and for airline commission credits received by the contractor that were not offset against the travel costs to reduce the amount billed to FAA. Another DCAA audit also questioned \$2 million of costs for such items as unsupported consultant fees and hospitality payments to foreign officials.

Contract audits are important because they provide a verification of the costs claimed by the contractor to its official records, and that costs claimed are allowable in accordance with applicable requirements, such as laws, regulations, standards, and contract terms. DCAA's recent experience reflects a 2-percent disallowance factor for unallowable costs found during its audits of contract costs. By applying this rate to the \$2 billion of incurred costs for the 22 contracts that had not been audited, we estimate that FAA could have potential improper payments of about \$40 million. For the \$6.6 billion of completed contracts, this amount could be \$132 million. Without audits to prevent a lax environment within contractor organizations, FAA has no assurance that improper payments do not exceed the 2-percent level. FAA needs to establish a performance goal and measure to increase audits of cost-reimbursable contracts.

# Closing Contracts

Contract closeout begins when the contract work has been complete. At this phase, all services have been performed and products were delivered as required by contract provisions. The closeout process requires close coordination among the FAA contracting office, the accounting office, the program office, and the contractor.

FAR and AMS provisions require that cost-reimbursable contracts generally should be closed within 3 years after contractor performance has been completed. As of April 2001, FAA had a backlog of about 1,400 cost-reimbursable contracts, totaling \$6 billion, that FAA records showed as open but contractor performance had been complete for more than 3 years. For 19 of the 32 contracts we reviewed, totaling

\$2.9 billion, FAA did not close the contracts within 3 years after contract performance was complete. The contracts were overdue for closing by up to 10 years, 13 of which remained open as of December 31, 2001. FAA needs to establish a performance goal and measure to reduce the backlog of contracts to be closed.

As required by FAR and AMS, FAA contracting officers have not requested that contractors submit their total contract costs in a final (completion) invoice accompanied by appropriate certificates or statements for 19 of the 32 contracts totaling \$2.5 billion. On one AMS contract for assistance on computer issues concerning the Year-2000 rollover, the contractor billed FAA about \$8 million under a cost-reimbursable contract. Rather than closing the contract as originally negotiated, the contracting officer issued a contract modification redefining the contract from a cost plus fixed fee to a firm-fixed price equal to the exact amount claimed by the contractor. FAA paid the claimed amount without an audit.

In closing contracts, Government property also must be satisfactorily accounted for by returning it to the Government, transferring it to another contract, or allowing the contractor to acquire the property. The property can be furnished by the Government or acquired by the contractor. For 11 of the 19 FAR contracts that included Government property, contract files contained no evidence that contractors properly accounted for the property.

To assist in closing completed contracts, FAA engages the services of closeout contractors. For the current closeout contractor, FAA assigned about 900 contracts, of which 600 are cost-reimbursable, and provided official contract files to the closeout contractor. FAA provided high-dollar contracts with complex, long-term unresolved issues that can only be adequately resolved by the contracting officer with the contractor. For example, one contract valued at \$190 million had an outstanding demand for payment issued by the contracting officer for \$1.5 million in 1995. We found the closeout contractor was totally unaware of the demand for payment until our inquiry. The closeout contractor had been requesting a final invoice, without success, for more than a year.

Official contract files, which include the closeout contractor's prepared closeout documents, are readied for storage at the contractor's offsite location. FAA does not review the files before they are sent to archives. In addition, two FAR contract files were never stored, but instead were inappropriately destroyed by the closeout contractor. The closeout contract does not authorize the disposal of records and the closeout documentation was not reviewed by FAA.

## Challenges Facing FAA

In August 1996, the General Accounting Office reported that FAA needed a comprehensive strategy for its new acquisition management system that would define responsibilities for accountability and provide performance measures.<sup>5</sup> Our results show FAA has inadequate oversight and accountability, and in our opinion, the combination of these major deficiencies in contract management represent a material weakness in internal controls. The Federal Managers' Financial Integrity Act of 1982 requires that this material weakness be reported to Congress and the Office of Management and Budget.

To adequately protect the Government's interest, the FAA Administrator needs to send a strong message to senior managers that complacency with contract management issues will no longer be tolerated. To this end, the FAA Administrator should task the soon-to-be appointed Chief Operating Officer to work with FAA's Air Traffic Services Subcommittee to develop a comprehensive plan with specific performance goals to restore accountability over cost-reimbursable contracts.

#### RECOMMENDATIONS

We recommend that the FAA Administrator:

- 1. Task the Chief Operating Officer, in coordination with FAA's Air Traffic Services Subcommittee, to develop a comprehensive performance plan with specific performance goals to bring contract management under control.
- 2. Develop and maintain a contract tracking system to manage cost-reimbursable contracts.
- 3. Direct contracting officers to reduce the costs and fee to be paid that can be retained by contract terms for those contractors who do not provide required final indirect rates and final vouchers.
- 4. Determine, before contract award, whether contractor accounting systems are adequate to administer cost-reimbursable contracts and document the determination in contract files.
- 5. Monitor contractor interim and final billing rates each year and adjust contract payments to reflect actual contractor costs, where warranted.
- 6. Establish a central fund to obtain audits of contractor's interim and final costs and amend AMS policy to specifically require audits of major contracts.

<sup>&</sup>lt;sup>5</sup> Aviation Acquisition: A Comprehensive Strategy Is Needed for Cultural Change at FAA, Report Number GAO/RCED-96-159, August 22, 1996.

- 7. Identify all open contracts for which contract performance has been completed and implement a plan, with milestones, to properly close these contracts.
- 8. Direct contracting officers to resolve contract issues before assigning contracts to closeout contractors.
- 9. Establish performance goals and appropriate measures to increase audits and decrease the backlog of contracts to be closed.
- 10. Report the contract administration process to Congress and the Office of Management and Budget as a material weakness in internal controls under the Federal Managers' Financial Integrity Act of 1982

Based on FAA's response to our draft report, we added the following three recommendations to the final report for firm actions and reporting to the Deputy Secretary.

- 11. Report quarterly to the Administrator and FAA's Air Traffic Services Subcommittee on progress made to reduce the current backlog.
- 12. Notify all FAA contracting personnel, in writing, that the lax accountability over contracts as identified in the OIG report will not be tolerated. As part of this action, modify contracting personnel performance plans to specifically include the requirement for timely and effective execution of applicable procurement rules to the management of payment and close-out procedures.
- 13. Determine the total number of open contracts for which contractor performance has been completed, identify which ones should have an incurred-cost audit, and implement a plan with specific milestones to properly audit and then close overdue contracts. Report on the current backlog until it is eliminated.

#### MANAGEMENT RESPONSES AND OIG COMMENTS

A draft of this report was provided to the FAA Administrator on February 15, 2002. FAA responses and our comments are keyed to each recommendation.

Recommendation 1. FAA partially concurred. It is recommended that the Office of the Administrator be tasked with the development of an appropriate plan of action addressing the improvement of the contract management function. At this point in time, it is not clear what role the Office of the Chief Operating Officer will play in the management of the Agency's contracting function. Nor is it clear that such a tasking is under the purview of FAA's Air Traffic Services Subcommittee. What would appear to be appropriate would be a bottom-up review of the entire contract management function to include a determination of staffing-level requirements adequate to perform those contract administration functions addressed by the OIG.

What this report in part illustrates is that while the AMS may have eliminated or at least made optional many of the administrative functions to be performed by FAA contracting officers, the expectations on the part of the OIG and of the Department have not lessened.

OIG Response. FAA agrees it needs to develop an appropriate plan of action addressing improvement of the contract management function, but its planned actions are not specific. FAA states the problems we identified were caused, among other things, by staff reductions and the criteria used by OIG was either eliminated or made optional by AMS. Our findings were based on current FAR and AMS requirements. The Wendell H. Ford Aviation Investment and Reform Act for the 21<sup>st</sup> Century (AIR-21) clearly states that the Chief Operating Officer and FAA's Air Traffic Services Subcommittee functions are added to help FAA operate more like a business. AIR-21 assigns specific responsibilities to the Subcommittee for procurement and management of the air traffic control modernization. FAA needs to begin actively involving people with business experience to become part of the solution for major problems such as contract management. The FAA Administrator reconsidered FAA's initial response and agrees that the Subcommittee needs to be involved.

Recommendation 2. FAA concurred. The Office of Acquisitions has already developed a listing of all active contracts at the Washington Headquarters level. This listing is part of an interactive data management system that will address a long-standing need for a reliable and comprehensive contracts data management system. A performance element has been incorporated into personnel performance plans requiring individual contracting officers and contracting specialists to ensure that all data fields under their cognizance are current and complete. Supplemental guidance is being developed and will be incorporated into the toolset of the AMS that will make clear to FAA contracting professionals the processes and procedures expected to be adhered to in the management of all contract files. Guidance on the management of contracts and supporting documentation shall be prepared and incorporated into the AMS by June 30, 2002.

**OIG Response.** FAA actions taken and planned are reasonable.

Recommendation 3. FAA partially concurred. Contracting officers shall be reminded of their authority to withhold fee under AMS 3.2.4-6. FAA does not believe that it has the recourse to reduce costs to be paid if evidence is provided by the contractor, through a properly submitted voucher, that such costs have in fact been incurred and are in fact determined to be allowable and allocable under the contract.

Contracting officers shall be reminded of the requirement to obtain and negotiate final indirect rates and of their option to withhold payment of fixed fee until all requirements with respect to final determination of allowable costs are met. A

modification to the AMS shall be made to make the withholding of such amounts of fixed fee mandatory under cost reimbursable contracts containing indirect rates requiring final determination. The estimated completion date is June 30, 2002.

OIG Response. FAA's primary planned action is to issue memoranda "reminding" contracting officers of their responsibilities. While a reminder is an appropriate first step, this action establishes no procedures to verify that contracting officers are complying with requirements, and identifies no actions to be taken when FAA oversight detects noncompliance by its contracting officers or the contractors.

**Recommendation 4.** FAA concurred. Contracting officers will be reminded to include in a pre-award survey of prospective contractors, a determination of adequacy of the contractor's accounting system in place to support the collection of costs. Written evidence shall be required to be included in the contract file. The estimated completion date is June 30, 2002.

OIG Response. FAA's primary planned action is to issue memoranda "reminding" contracting officers of their responsibilities. While a reminder is an appropriate first step, this action establishes no procedures to verify that contracting officers are complying with requirements, and identifies no actions to be taken when FAA oversight detects noncompliance by its contracting officers.

Recommendation 5. FAA concurred. See response to Recommendation 3. Contracting officers shall be reminded of the provision in AMS 3.2.4-5 and of the need to make the appropriate adjustment in overall contract expenditures to reflect actual amounts incurred.

OIG Response. FAA's primary planned action is to issue memoranda "reminding" contracting officers of their responsibilities. We recommended monitoring rates each year and adjusting them based on actual costs. While a reminder is an appropriate first step, this action establishes no procedures to verify that contracting officers are complying with requirements, and identifies no actions to be taken when FAA oversight detects noncompliance by its contracting officers or the contractors.

Recommendation 6. FAA partially concurred. FAA does concur with the need to develop a mechanism different from that currently in place to fund the conduct of pre-award, incurred cost, and final closeout audits. The AMS will be modified to direct the inclusion in all acquisition program baselines, of estimated costs for the conduct of those support audits required throughout the life of the program. Expected costs will be clearly identified during the conduct of the investment analysis and reserved in the program baseline for only the stated purpose of conducting audits of program costs. In accordance with the FY 2002 House report, FAA intends to require the full audit of all proposals received in support of awards in excess of \$100 million,

and at least 15 percent of contracts under \$100 million shall be audited. The estimated completion date is June 30, 2002.

OIG Response. FAA's proposed actions for future contracts are reasonable. However, FAA needs to specify how and when it will implement these audits on its active contracts. FAA also does not specify what actions it will take regarding the more than 1,400 completed contracts that have not been closed.

Recommendation 7. FAA concurred. FAA has made significant progress in identifying and accounting for the large backlog of completed contracts awaiting closeout. By June 30, 2002, a thorough review of the existing list will be made and any additions will be identified and incorporated. Guidance for the closeout of completed contracts shall be expanded and incorporated into the AMS by June 30, 2002. FY 2002 Performance Plans for Branch Managers and warranted contracting officers have been modified to include a requirement to close an average of three contracts per contracting officer during the current performance cycle.

OIG Response. FAA had more than 1,400 contracts that were overdue for closeout. Using all 98 contracts professionals in the Contract Management Division, FAA's proposed plan to close out an average of three contracts per Branch Manager and warranted contracting officer during the current performance cycle will result in closing only about 300 contracts per year. Assuming contracting officers comply with the new requirement, the current backlog will not be eliminated for about 5 years, while more contracts will become backlog. FAA needs to make a special one-time effort to clear the backlog, establish procedures to keep it from recurring, and provide a target completion date when the current backlog will be eliminated.

Recommendation 8. FAA concurred. Contracting officers are expected to retain for closeout, all complex contracts with unresolved issues. Outstanding issues are to be resolved by the contracting officer with first-hand knowledge of the circumstances. The Manager of the Contracts Division shall issue a directive by March 30, 2002.

OIG Response. FAA's planned action is to issue a directive "reminding" contracting officers of their responsibilities. While a reminder is an appropriate first step, this action establishes no procedures to verify that contracting officers are complying with requirements, and identifies no actions to be taken when FAA oversight detects noncompliance by its contracting officers.

**Recommendation 9.** FAA concurred. See response to Recommendation 7.

<u>OIG Response.</u> Our recommendation was to have FAA include specific performance goals and performance measures to track the number of audits required and requested, and progress on eliminating the backlog. FAA's planned action to have contracting

officers close three contracts during the current performance cycle does not satisfy the intent of our recommendation.

Recommendation 10. FAA partially concurred. FAA does not consider the findings of this review, conducted on dated and in some cases archived contracts, to be conclusively indicative of all contracts administered at FAA. A significant majority of the contracts reviewed were awarded and managed under the FAR. To make a determination as to the material deficiency of the entire contract administration process based upon a review of contracts, many of which were administered by contract administrators who have retired or otherwise left the Agency and/or which were awarded in support of organizations that no longer exist, would be unsupported. FAA reasserts its offer to the OIG to review a larger sampling of contracts currently under active administration, particularly those for significant programs managed under the Integrated Product Development System. We are convinced that the findings of such a review would vary significantly from those derived from a review of dated contracts stored for closeout.

OIG Response. FAA's comments are nonresponsive. Notwithstanding its partial concurrence, FAA does not agree that its contract administration process is a material deficiency. FAA states that a majority of the contracts OIG reviewed were FAR contracts administered by contracting officers who had retired or otherwise left FAA, and had OIG reviewed a larger sampling under active administration, OIG results would vary significantly. We disagree. Procurement reform did not authorize FAA to ignore FAR requirements on existing FAR contracts. Notwithstanding that only 11 AMS contracts were reviewed, we found the same deficiencies in AMS and FAR contracts. Specifically:

- 91 percent of AMS contracts we reviewed did not have a determination of adequacy of the contractor's accounting systems. For one AMS contract that DCAA had determined the contractor's accounting system was inadequate, FAA still closed the \$4 million contract without an incurred-cost audit.
- 73 percent of the AMS contracts we reviewed did not have incurred-cost audits.
- 73 percent of the AMS contracts we reviewed did not obtain annual final indirect rates or adjustment vouchers to allow determination of proper payments of actual costs.
- 55 percent of the AMS contracts we reviewed did not have the required final (completion) invoice.

- 27 percent of the AMS contracts we reviewed did not have the required novation agreements.
- 18 percent of the AMS contracts we reviewed had improper payments.

These results on the AMS contracts show the problem is lack of oversight and inadequate contract management by the contracting officers, and not that contracts are administered under FAR or AMS rules. OIG review of more AMS contracts will not change these findings. The complete text of FAA comments is in the Appendix.

#### **ACTION REQUIRED**

Actions taken and planned for Recommendation 2 are reasonable, and no further response to that recommendation is necessary. However, in accordance with DOT Order 8000.1C, we request firm action plans and additional comments within 30 days on the remaining recommendations. We also request that FAA comment on the reasonableness of the \$132 million in potential unallowable costs that could be identified by incurred-cost audits.

We appreciate the courtesies and cooperation of FAA representatives. If you have questions concerning this report, please contact me at (202) 366-1992, or John Meche at (202) 366-1496.

# **EXHIBIT. MAJOR CONTRIBUTORS TO THIS REPORT**

# THE FOLLOWING INDIVIDUALS CONTRIBUTED TO THIS REPORT.

<b>Name</b>	Title		
Keith L. Cosper	Program Director		
Joanne Wallis	Project Manager		
Linda Toms	Senior Auditor		

### APPENDIX. MANAGEMENT COMMENTS



# Memorandum

Federal Aviation Administration

Subject:

**INFORMATION:** Draft Report on Oversight of

Cost-Reimbursable Contracts, FAA

Date: March 4, 2002

Crom:

Assistant Administrator for Financial Services and Chief Financial Officer

Reply to Attn. of:

To: Deputy Assistant Inspector General for Financial, Information Technology, and Departmentwide Programs

As requested in your memorandum dated February 15, attached are the Federal Aviation Administration's comments.

If you have questions or need further information, please contact Ron Page, Manager, Budget Policy Division, ABU-100. He can be reached at (202) 267-9960.

Chris Bertram

Attachment

# Federal Aviation Administration's (FAA) Response to the Office of Inspector General's (OIG) Draft Report on Oversight of Cost-Reimbursable Contracts

<u>OIG Recommendation 1</u>: Task the Chief Operating Officer, in coordination with the Management Advisory Committee's Air Traffic Services Subcommittee, to develop a comprehensive performance plan with specific performance goals to bring contract management under control.

**FAA Response**: Partially concur. It is recommended that the Office of the Administrator be tasked with the development of an appropriate plan of action addressing the improvement of the contract management function at the FAA. At this point in time, it is not clear what role the Office of the Chief Operating Officer (COO) will play in the management of the Agency's contracting function. Nor is it clear that such a tasking is under the purview of the Management Advisory Committee's Air Traffic Services Subcommittee. What would appear to be appropriate would be a bottom-up review of the entire contract management function to include a determination of staffing-level requirements adequate to perform those contract administration functions addressed by the Office of Inspector General.

It should be noted that as a result of the National Performance Review, staffing levels in the Contracts Management Division were cut by one third from 150 to 98 contracts professionals. At the time it was believed that the simplified processes implemented under the Acquisition Management System (AMS) would allow for the ability to "do more with less". What this report in part illustrates is that while the AMS, as mandated by Congress, may have eliminated or at least made optional many of the administrative functions to be performed by FAA contracting officers, the expectations on the part of the IG and of the Department have not lessened. If anything, with the majority of contracting officers serving as active participants in non-traditional team roles called for under the Integrated Product Development System (IPDS), those same contracting officers are in fact doing far more in support of over-all programmatic requirements.

**OIG Recommendation 2**: Develop and maintain a contract tracking system to manage cost-reimbursable contracts.

**FAA Response**: Concur. As indicated in the OIG's report, the Office of Acquisitions has already developed a listing of all active contracts awarded and administered at the Washington Headquarters level. This listing is part of an interactive data management system that as it is refined, will address a long-standing need for a reliable and comprehensive contracts data management system. A performance element has been incorporated into personnel performance plans requiring individual Contracting Officers and Contracting Specialists to enter the system on a regular basis and to ensure that all data

fields (contract file entries) under their cognizance are current and complete. In addition, supplemental guidance is being developed and will be incorporated into the toolset of the Acquisition Management System (AMS) that will make clear to FAA contracting professionals the processes and procedures expected to be adhered to in the management of all contract files. Procedures to audit the Headquarters' Global Contracts Listing will be established to assess the accuracy and completeness of the data contained therein with semi-annual audits to be completed by 30 June and 31 December of each calendar year. Guidance of the management of contracts and their supporting documentation shall be prepared and incorporated into the AMS by 30 June 2002.

<u>OIG Recommendation 3</u>: Direct contracting officers to reduce the costs and fee to be paid that can be retained by contract terms for those contractors who do not provide required final indirect rates and final vouchers.

**FAA Response**: Partially concur. Contracting officers shall be reminded of their authority to withhold fee under AMS 3.2.4-6 entitled Fixed Fee that provides:

"Payment of the fixed fee shall be made as specified in the Schedule; provided, that after payment of 85 percent of the fixed fee, the Contracting Officer <u>may</u> withhold further payment of fee until a reserve is set aside in an amount that the Contracting Officer <u>considers necessary</u> to protect the FAA's interest. This reserve shall not exceed 15 percent of the total fixed fee or \$100,000, whichever is less."

The withholding of fee in accordance with 3.2.4-6 is clearly an available inducement for use in ensuring contractor compliance with the requirement to provide proposals for final indirect rates and ultimately, final vouchers. The FAA does not believe however, that we have the recourse to reduce costs to be paid if evidence is provided by the contractor, through a properly submitted voucher, that such costs have in fact been incurred and are in fact determined to be allowable and allocable under the contract.

Contracting Officers shall be reminded of the requirement to obtain and negotiate final indirect rates under cost-reimbursable contracts in accordance with AMS 3.2.4-5. They shall further be reminded of their option to withhold payment of fixed fee in accordance with AMS 3.2.5 until all requirements of the contract with respect to final determination of allowable costs are met. A modification to the AMS shall be made to modify the language of AMS 3.2.4-5 to make the withholding of such amounts of fixed fee mandatory under cost reimbursable contracts containing indirect rates requiring final determination. Estimated completion date: 30 June 2002.

<u>OIG Recommendation 4</u>: Determine, before contract award, whether contractor accounting systems are adequate to administer cost-reimbursable contracts and document the determination on contract files.

**FAA Response**: Concur. Contracting Officers will be reminded of the AMS requirement to include in a pre-award survey of prospective contractors, a determination of adequacy of the contractor's accounting system in place to support the collection of costs under cost reimbursable contracts. Written evidence of the determination shall be required to be included in the resultant contract file. Estimated completion date: 30 June 2002.

<u>OIG Recommendation 5</u>: Monitor contractor interim and final billing rates each year and adjust contract payments to reflect actual contractor costs, where warranted.

**FAA Response**: Concur. See response to Recommendation 3 above. Contracting Officers shall be reminded of the provision in AMS 3.2.4-5 that requires that:

"The Contractor shall, within 90 days after the expiration of each of its fiscal years, or by a later date approved by the Contracting Officer, submit to the cognizant Contracting Officer responsible for negotiating its final indirect cost rates and, if required by agency procedures, to the cognizant audit activity proposed final indirect cost rates for that period and supporting cost data specifying the contract and/or subcontract to which the rates apply. The proposed rates shall be based on the Contractor's actual cost experience for that period. The appropriate Government representative and Contractor shall establish the final indirect cost rates as promptly as practical after receipt of the Contractor's proposal."

Contracting Officers will be further reminded of the need to make the appropriate adjustment in overall contract expenditures to reflect actual amounts incurred.

<u>OIG Recommendation 6</u>: Establish a central fund to obtain audits of contractor's interim and final costs and amend AMS policy to specifically require audits of major contracts.

<u>FAA Response</u>: Partially concur. The FAA does concur with the need to develop a mechanism different from that currently in place to fund the conduct of pre-award, incurred cost, and final closeout audits. The AMS will be modified to direct the inclusion in all acquisition program baselines, of estimated costs for the conduct of those support audits required throughout the life of the program. Expected costs will be clearly identified during the conduct of the Investment

Analysis and reserved in the program baseline for only the stated purpose of conducting audits of program costs.

It should be further noted that in accordance with language contained in the FY02 House Report, the FAA intends to require the full audit of all proposals received in support of awards in excess of \$100 million. In addition, at least 15 percent of contracts under \$100 million dollars shall be audited.

<u>OIG Recommendation 7</u>: Identify all open contracts for which contract performance has been completed and implement a plan, with milestones, to properly close these contracts.

**FAA Response**: Concur. The FAA has made significant progress in identifying and accounting for the large backlog of completed contracts awaiting closeout. By 30 June 2002, a thorough review of the existing list will be made and any additions to that list will be identified and incorporated. Guidance for the closeout of completed contracts shall be expanded and incorporated into the AMS by 30 June 2002. FY02 Performance Plans for Branch Managers and warranted contracting officers have been modified to include a requirement to close an average of three contracts per contracting officer during the current performance cycle.

<u>OIG Recommendation 8</u>: Direct contracting officers to resolve contract issues before assigning contracts to closeout contractors.

**FAA Response**: 8. Concur. Contracting Officers are expected to retain for closeout, all complex contracts with unresolved issues. The contract closeout contractor is in place to address the substantial backlog of dated contracts and is not to accept for action, any contract other than those of a relatively small dollar value not requiring extensive audit, reconciliation and closeout activities. Outstanding issues are to be resolved by the contracting officer with first-hand knowledge of the circumstances. The Manager of the Contracts Division shall issue a directive to that affect by 30 March 2002.

**OIG Recommendation 9**: Establish performance goals and appropriate measures to increase audits and decrease the backlog of contracts to be closed.

**FAA Response**: Concur. See FAA Response to OIG Recommendation 7.

<u>OIG Recommendation 10</u>: Report the contract administration process to Congress and the Office of Management and Budget as a material weakness in internal controls under the Federal Managers' Financial Integrity Act of 1982.

FAA Response: Partially concur. As discussed with the IG, the FAA does not consider the findings of this review, conducted on dated and in some cases archived contracts, to be conclusively indicative of all contracts administered at the FAA. A significant majority of the contracts reviewed were awarded and managed under the FAR. It was the understanding of the FAA that the audit was to be conducted on the state of the FAA's closeout process, not on the entire contract administration function. As discussed with the IG, to make a determination as to the material deficiency of the entire contract administration process based upon a review of contracts, many of which were administered by contract administrators who have retired or otherwise left the Agency and/or which were awarded in support of organizations that no longer exist, would be unsupported. The FAA reasserts its offer to the Office of the Inspector General to review a larger sampling of contracts currently under active administration. particularly those for significant programs managed under the Integrated Product Development System (IPDS). We are convinced that the findings of such a review would vary significantly from those derived from a review of dated contracts stored for closeout.

We would further note that the Congress is already aware of the perceived failure on the part of the FAA to acquire appropriate audit support. As discussed above, we intend to comply with the language as contained in the House report and require the full audit of all proposals received in support of awards in excess of \$100 million. In addition, at least 15 percent of contracts under \$100 million dollars shall be audited.