

Audit of Raytheon Polar Services Company's Non-compliance with Cost Accounting Standard 418 - Allocation of Direct and Indirect Costs For Fiscal Years 2000 to 2002

**March 21, 2006
OIG-06-1-001**



**National Science Foundation
Office of Inspector General**

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ACRONYMS

ASBCA	Armed Services Board of Contract Appeals
CAS	Cost Accounting Standards
CASB	Cost Accounting Standards Board
CFAO	Cognizant Federal Agency Official
CFR	Code Federal Regulations
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
FAR	Federal Acquisition Regulation
FY	Fiscal Year
ODC	Other Direct Costs
OFPP	Office of Federal Procurement Policy
OMB	Office of Management and Budget
OPP	Office of Polar Programs
RTSC	Raytheon Technical Services Company
RPSC	Raytheon Polar Services Company
USAP	United States Antarctic Program
WBS	Work Breakdown Structure

INTRODUCTION

The attached Defense Contract Audit Agency (DCAA) Audit Report dated June 23, 2005 details the results of DCAA's audit of Raytheon Polar Services Company's (RPSC) compliance with the requirements of Cost Accounting Standard (CAS) 418- *Allocation of Direct and Indirect Costs*, in relation to costs claimed for payment by RPSC under NSF Contract No. OPP-0000373 from January 1, 2000 through December 31, 2002. The contract consists of a five-year base period and five option periods for a total of ten years and is valued at \$1.1 billion. The charges claimed against the contract average [REDACTED].

The United States Antarctic Program (USAP) has, since 1971 when NSF assumed full responsibility for USAP, provided a permanent presence and overseen U.S. scientific interests in Antarctica. Today, NSF's Office of Polar Programs (OPP) administers the USAP and oversees the operations performed under the USAP contract. The principal goals of the USAP are to (1) understand the Antarctic region and its ecosystems, (2) understand the effects of the region on global processes such as climate, as well as responses to those effects, and (3) use the region as a platform to study the upper atmosphere and space.

RPSC, located in Centennial, Colorado, is a part of the Raytheon Technical Services Company (RTSC) headquartered in Reston, Virginia. RPSC is under contract to the National Science Foundation to provide science, operations, and maintenance support to sustain year-round research programs.

AUDIT OBJECTIVES

The purpose of DCAA's audit was to evaluate whether RPSC complied with the Cost Accounting Standard Board's (CASB) rules, regulations, and standards, and any applicable Federal Acquisition Regulations (FAR) Part 31 requirements. Specifically, DCAA's audit objectives were to determine whether 1) RPSC complied with the requirements set forth in CAS 418- *Allocation of Direct and Indirect Costs* and 2) RPSC's written CASB Disclosure Statement of accounting policies and practices, for classifying costs as direct or indirect, was consistently applied in accordance with the CASB rules and regulations stated in 48 CFR Chapter 99, the FAR, and the terms of the contract between NSF and Raytheon.

The DCAA audit was conducted in accordance with the Comptroller General's *Government Audit Standards* and included such tests of accounting records and other audit procedures necessary to fully address the audit objectives.

BACKGROUND

The CAS 418-*Allocation of Direct and Indirect Costs*, was issued by the CASB. The original CASB was established in 1970 as an agency of Congress in accordance with a provision of Public Law 91379. It was authorized to (1) promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts in excess of \$100,000 and (2) establish regulations to require government contractors and subcontractors, as a condition of contracting, to disclose in writing its cost accounting practices, to follow the disclosed practices consistently and to comply with duly promulgated cost accounting standards.

Specifically, CAS 418-*Allocation of Direct and Indirect Costs* provides that:

- (1) a business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied;
- (2) indirect costs shall be accumulated in indirect cost pools which are homogeneous; and
- (3) pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationships of the pooled costs to cost objectives.

The responsibility for ensuring CAS 418 compliance and resolving all non-compliance issues rests with the Cognizant Federal Agency Official (CFAO). With respect to RPSC, the CFAO is the Defense Contract Management Agency's (DCMA) Divisional Administrative Contracting Officer for RTSC. The DCMA CFAO resolves any non-compliance issues by reviewing RPSC's efforts to bring RPSC into compliance with the CAS 418 requirements and making a final determination of compliance or non-compliance. If RPSC fails to comply with a CAS or to follow any cost accounting practice consistently, then according to FAR 52.230-2(a)(5), RPSC is required to agree to an adjustment of the contract price plus interest when failure to comply with CAS 418 results in any increased costs paid by the United States.¹

The determination of non-compliance will also trigger the requirement for the Contractor to submit a general dollar magnitude cost impact proposal within 60 days of

¹ FAR 52.230-2(a)(5) states that the contractor shall "Agree to an adjustment of the contract price or cost allowance, as appropriate, if the Contractor or a subcontractor fails to comply with an applicable Cost Accounting Standard or to follow any cost accounting practice consistently and such failure results in any increased costs paid by the United States. Such adjustment shall provide for recovery of the increased costs to the United States together with interest."

notification by the CFAO in accordance with FAR 52.230-6.² When this proposal is received, it will be audited. The cost impact is subject to negotiation and, if agreement cannot be reached, the CFAO can serve the Contractor with a notice of intent to disallow costs. Final resolution, if RPSC and DCMA/NSF do not reach agreement, is decided before the Armed Services Board of Contract Appeals (ASBCA).

AUDIT RESULTS

DCAA's audit found that RPSC did not comply with CAS 418 and did not consistently classify costs charged to NSF under the USAP contract as stated in its CASB Disclosure Statement. Specifically, RPSC did not follow its disclosed definitions for billing indirect costs in the claims submitted to NSF for payment. Instead, RPSC classified indirect costs as direct costs of contract performance and incorrectly claimed them for payment. As a result, RPSC incorrectly claimed [REDACTED] on the NSF USAP contract for the period January 1, 2000 through December 31, 2002.³

The US Government requires, under the rules of the Office of Federal Procurement Policy's (OFPP)⁴ Cost Accounting Standards Board, that a contractor of RPSC's size disclose detailed definitions of its Overhead and General and Administrative costs to the government in its Cost Accounting Standard Board Disclosure Statement. Upon approval of the disclosed definitions by RPSC's cognizant federal agency, DCMA, RPSC agrees to only bill the government for costs according to the definitions in its CASB Disclosure Statement. The requirement that RPSC comply with CAS is incorporated into RPSC's NSF contract by FAR 52.230-2 (CAS Clause) and FAR 52.230-6 (CAS Administration Clause).

However, in the cost claims RPSC submitted to NSF, it did not follow its disclosed definitions for billing indirect costs. Instead, RPSC classified indirect costs as direct costs of contract performance and incorrectly claimed them to NSF for payment. In particular, RPSC stated in its [REDACTED]

[REDACTED] but nevertheless classified over [REDACTED] of such costs as direct costs. These misclassified indirect costs included [REDACTED] for facilities costs, such as the lease costs for RPSC's building in Centennial, Colorado, [REDACTED] for financial management department costs, and [REDACTED] for [REDACTED]

[REDACTED]. The DCAA auditors found that these common business infrastructure costs clearly benefit and support the overall operations of RPSC and enable

² FAR 52.230-6 states that the contractor shall "Submit to the Contracting Officer a description of any cost accounting practice change, the total potential impact of the change on contracts containing the CAS clause, and a general dollar magnitude of the change which identifies the potential shift of costs between CAS-covered contracts by contract type (i.e., firm-fixed-price, incentive, cost-plus-fixed-fee, etc.) and other contractor business activity ... within 60 days of the date the Contractor is notified by the Contracting Officer of the determination of noncompliance."

³ Previously reported in OIG Audit Report No. OIG-5-1-005 dated 31 March 2005.

⁴ OFPP coordinates efforts to improve Federal procurement law, policies, and practices, which affect all Federal and federally-assisted purchases of goods, property, and services.

it to carry out its multiple direct mission activities (e.g.; ship operations, supply operations, construction projects) for the USAP program.

Similarly, the DCAA auditors identified [REDACTED] of [REDACTED] [REDACTED] costs that were classified and charged as a direct General Management Work Breakdown Structure (WBS) costs, contrary to RPSC's CASB Disclosure Statement. According to RPSC's CASB Disclosure Statement definition, indirect costs include [REDACTED]. However, RPSC incorrectly classified and charged to NSF these [REDACTED] and [REDACTED].

By not classifying costs in accordance with the definitions stated in RPSC's CASB Disclosure Statement, DCAA estimates that RPSC charged NSF [REDACTED] of questionable contract costs.⁵ These are costs that should have been classified as Overhead or General and Administrative costs and therefore recovered through RPSC's indirect cost rate, subject to indirect cost ceilings, rather than charged as direct costs.

Also, by not complying with its CASB Disclosure Statement, RPSC is in violation of CAS 418 and FAR 52.230-2, which require RPSC to consistently classify costs charged to NSF under the USAP contract as stated in its CASB Disclosure Statement. By not billing NSF in accordance with CAS and the FAR, RPSC is now subject to receive a final determination of CAS non-compliance from the DCMA CFAO. In that instance, RPSC will also be subject to FAR 52.230-2(a)(5), which requires RPSC to reimburse NSF for all increased costs paid as a result of the CASB Disclosure Statement non-compliance, plus interest and FAR 52.230-6, which requires, RPSC to submit a cost impact proposal. The DCMA CFAO will resolve the non-compliance issue by reviewing RPSC's efforts to bring itself into compliance with the CAS 418 requirements. A final determination of non-compliance with RPSC's CASB Disclosure Statement will require that RPSC return to NSF the [REDACTED] of questionable contract costs plus interest.⁶

In its response to the draft of this report, RPSC indicated that it did not agree with the questioned costs. RPSC contends that these costs were claimed in accordance with instructions received from NSF officials, but RPSC was unable to provide any documentary support for this contention. Further, the DCAA auditors contacted the NSF Contracting Officer, who stated that no such instructions were provided to RPSC by NSF authorizing any deviation from RPSC's standard accounting practices as stated in its CASB Disclosure Statement.

⁵ First identified in NSF-OIG Audit Report No. OIG-5-1-005, dated March 31, 2005.

⁶ DCMA CFAO issued an Initial Noncompliance Letter to RTSC, dated September 28, 2005.

We recommend that NSF's Director of the Division of Acquisition and Cooperative Support:

Recommendation No. 1 - Coordinate with the DCMA CFAO in pursuing a final determination of CAS non-compliance by RPSC and obtaining a cost impact proposal from RPSC for the period of non-compliance in accordance with FAR 52.230-6.

NSF's Response - Agree with the recommendation in part and disagree with the recommendation in part. This office will coordinate any planned activities with the DCMA CFAO prior to initiating negotiations with RPSC on this and related audit matters; however, RPSC's compliance or non-compliance with CAS 418 has not been settled yet. Accordingly, it is premature to assume that a cost impact proposal will be required. DCCA anticipates accomplishing its initial coordinating activities with the DCMA CFAO in early-January 2006, and in any event not later than January 31, 2006.

OIG Comments – NSF's comments are responsive to the recommendation.

Recommendation No. 2 - Coordinate with the DCMA CFAO in recovering all increased costs plus interest paid by NSF as a result of the non-compliance in accordance with FAR 52.230-2(a)(5), which should include resolving the [REDACTED] [REDACTED] incorrectly claimed costs identified in OIG Report No. 05-1-005, Audit of Raytheon Polar Services Company's Costs Claimed for Fiscal Years 2000 to 2002, dated March 31, 2005.

NSF's Response - Agree with the recommendation in part and disagree with the recommendation in part. This office will coordinate all planned resolution activities with the DCMA CFAO prior to initiating negotiations with RPSC on this and related audit matters; however, RPSC's compliance or non-compliance with CAS 418 has not been settled. Accordingly any statement that RPSC has not complied with CAS 418 is premature. DCCA anticipates accomplishing its initial coordinating activities with the DCMA CFAO in early-January 2006, and in any event not later than January 31, 2006. DCCA anticipates that resolution discussions will be fluid and complex, making establishment of a firm schedule for coordination activities impractical; however, coordination with the DCMA CFAO will be accomplished, as circumstances require. We are hopeful that any resolution can be accomplished prior to March 31, 2006, but will not be bound by that date if more time is needed to negotiate a fair and equitable settlement of the audit issues.

OIG Comments – NSF's comments are responsive to the recommendation.

Recommendation No. 3 - Coordinate with the DCMA CFAO to ensure that RPSC establishes adequate policies and procedures including a monitoring program to comply with the requirements of CAS 418-*Allocation of Direct and Indirect Costs* and RPSC's CASB Disclosure Statement. The policies and procedures should institute additional control procedures and an internal monitoring program to ensure that costs are consistently applied and/or allocated as either direct or indirect in accordance with RPSC's disclosed cost accounting practices and the requirements of CAS 418.

NSF's Response – Agree with the recommendation, and we will incorporate it into our negotiating plan for the upcoming discussions with RPSC.

OIG Comments – NSF's comments are responsive to the recommendation.

Recommendation No. 4 - Withhold payment for any direct costs that are incorrectly claimed by RPSC, if RPSC continues its current billing practices.

NSF's Response –We agree with the essence of the recommendation. Beginning with the FY 2005 Program Plan, NSF has taken intermediate action to exclude proposed indirect cost recoveries in excess of the rate caps incorporated in Contract No. PRSS-0000373 from approved plan. Final action on indirect cost recoveries will be taken in conjunction with resolution of the pending audits following the completion of negotiations with RPSC.

OIG Comments – Although NSF's response addresses proactive steps taken to prevent RPSC billing NSF for indirect costs in excess of the contract limited indirect rate ceilings, our recommendation also addresses indirect costs that RPSC incorrectly classifies as direct costs. Therefore, the response from NSF does not alter our recommendations that NSF withhold payments for any indirect costs that are incorrectly claimed by RPSC as direct costs.



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FEB - 9 2006

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ATTN: Mr. Kenneth Stagner Auditor

Dear Mr. Stagner,

Thank you for the opportunity to provide comment on the discussion drafts of NSF OIG Audit Report No. OIG-05-1-009 and NSF OIG Audit Report No. OIG 05-2-010. Our comments on both draft reports are attached to this letter.

This office thanks you for your support of NSF acquisition programs. Inquiries regarding our comments may be addressed to the undersigned at 703/292-4593, or by e-mail to bbridwell@nsf.gov.

Sincerely,

A handwritten signature in black ink that reads "Bart Bridwell".

Bart Bridwell
Contracting Officer
Division of Contracts and Complex Agreements

cc: Chron
PRSS-0000373 File (Index 248.AA)

Comments – Draft Report OIG-05-1-009

Recommendation 1 – Agree with the recommendation in part and disagree with the recommendation in part. This office will coordinate any planned activities with the DCMA CFAO prior to initiating negotiations with RPSC on this and related audit matters; however, RPSC's compliance or non-compliance with CAS 418 has been not yet been settled. Accordingly, it is premature to assume that a cost impact proposal will be required. DCCA anticipates accomplishing its initial coordinating activities with the DCMA CFAO in early-January 2006, and in any event not later than January 31, 2006.

Recommendation 2 – Agree with the recommendation in part and disagree with the recommendation in part. This office will coordinate all planned resolution activities with the DCMA CFAO prior to initiating negotiations with RPSC on this and related audit matters; however, RPSC's compliance or non-compliance with CAS 418 has been not yet been settled. Accordingly any statement that RPSC has not complied with CAS 418 is premature. DCCA anticipates accomplishing its initial coordinating activities with the DCMA CFAO in early-January 2006, and in any event not later than January 31, 2006. DCCA anticipates that resolution discussions will be fluid and complex, making establishment of a firm schedule for coordination activities impractical; however, coordination with the DCMA CFAO will be accomplished, as circumstances require. We are hopeful that any resolution can be accomplished prior to March 31, 2006, but will not be bound by that date if more time is needed to negotiate a fair and equitable settlement of the audit issues.

Recommendation 3 – Agree with the recommendation, and we will incorporate it into our negotiating plan for the upcoming discussions with RPSC. We anticipate completing development of our negotiating plan not later than February 28, 2006.

Recommendation 4 – We agree with the essence of the recommendation. Beginning with the FY 2005 Program Plan, NSF has taken intermediate action to exclude proposed indirect cost recoveries in excess of the rate caps incorporated in Contract No. PRSS-0000373 from approved plan. Final action on indirect cost recoveries will be taken in conjunction with resolution of the pending audits following the completion of negotiations with RPSC.

Defense Contract Audit Agency Audit Report

Audit Report No.6161-2005T19200001-Cost Accounting Standard 418-Allocation of
Direct and Indirect Costs
Dated June 23, 2005

Performed By
Defense Contract Audit Agency
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DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 6161-2005T19200001



June 23, 2005

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SUBJECT: Report on Audit of Noncompliance with CAS 418 and Disclosed Cost Accounting Practices, Raytheon Polar Services Company

REFERENCES: Prime Contract No.: OPP-0000373

CONTRACTOR: Raytheon Technical Services Company (Cage Code 05WG2)
12160 Sunrise Valley Drive
Reston, VA 20191

REPORT RELEASE RESTRICTIONS: See Page 23

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SUBJECT OF AUDIT

Our continuous examination of the contractor's cost accounting practices during performance of contracts includes evaluating whether the contractor has complied with the CAS Board rules, regulations, and standards, and any applicable FAR Part 31 requirements. The contractor is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance based on our examination.

EXECUTIVE SUMMARY

Raytheon Polar Services Company (RPSC) cost accounting practices are in noncompliance with CAS 418, Allocability of Direct and Indirect Costs and with disclosed cost accounting practices (i.e., Disclosure Statement). Specifically, costs that are disclosed as indirect are recorded and charged direct to the Polar Services contract. Recording and charging these costs direct to the contract results in 100 percent recovery through contract billings to the government (i.e., National Science Foundation).

SCOPE OF AUDIT

We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the contractor has complied with the requirements referred to above. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the cost accounting practices; and
- assessing the actual cost accounting practices and compliance of those practices with the disclosed cost accounting practices and applicable requirements.

We evaluated the contractor's cost accounting practices used to accumulate contract costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR); and
- CAS Board rules, regulations and standards.



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Our examination does not provide a legal determination on the RPSC compliance with the specified requirements.



In Audit Report No. 6161-2004T11070201, dated October 4, 2004 DCAA examined the SAP Accounting System and Control Environment and the related internal control policies and procedures. Based on our examination we concluded that the SAP Accounting System and Control Environment and the related internal control polices and procedures are adequate.

RESULTS OF AUDIT

In our opinion, during this period (January 1, 2000 through December 31, 2002) the contractor was in noncompliance with CAS 418, Allocation of Direct and Indirect Costs. In addition, the contractor was in noncompliance with its disclosed cost accounting practices. As of the date of this report, the condition causing the noncompliance has not been corrected.

This report is limited to the cited instance(s) of noncompliance. Accordingly, we express no opinion on whether other practices are proper, approved, or agreed to for pricing proposals, accumulating costs, or reporting contractor performance data.

STATEMENT OF CONDITIONS AND RECOMMENDATIONS

Our examination disclosed that the contractor's failure to comply with a cost accounting standards and failure to follow consistently disclosed cost accounting practices has resulted or may result in increased cost paid by the government. The areas of noncompliance and failure to follow disclosed practices are stated below:

CONDITION:

Raytheon Polar Services Company (RPSC) accounting practices relative to recording and billing selected costs is in noncompliance with one of the fundamental requirements of CAS 418.



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Specifically, CAS 418-40(a) requires that a business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect and they must be consistently applied. Our audit found that RPSC did not consistently apply its classification of costs on the Polar Services contract. In particular, RPSC is:

- recording and billing selected costs, disclosed as indirect, direct to the Polar Services contract. [REDACTED]
- reclassifying [REDACTED]. See pages 9-10 of this report for a complete list of the reclassified [REDACTED], respectively.

This practice is also in noncompliance with RTSC CAS Disclosure Statement, Revisions 4 through 9C, which were in effect during the fiscal year (FY) 2000 through 2002 time frame. In particular, Disclosure Statement Item No. 4.1.0 defines the purpose of Business Area Overhead pool as “[REDACTED]. The pool is in place to support a particular function.”

In addition, the major elements of costs disclosed as a part of the Business Overhead pool include:

- [REDACTED]
- [REDACTED]

RPSC proposed and RTSC discloses a separate overhead pool for the collection of [REDACTED].

The Polar Services contract is considered to have multiple final cost objectives due to the various reporting and funding sources of the customer, The National Science Foundation (NSF).

COST IMPACT:

During our audit of RPSC FY 2000 through 2002 incurred costs, we reclassified/questioned [REDACTED] related to this noncompliance as illustrated below.

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Indirect functions related to [REDACTED] charged direct to the Polar Services contract as follows:

<u>WBS Description</u>	<u>Fiscal Year</u>			<u>Total</u>
	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>Questioned</u>
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Costs allocated from [REDACTED] into the [REDACTED] [REDACTED] were reclassified by RPSC as direct costs to the Polar Services contract as follows:

<u>Allocation</u>	<u>Fiscal Year</u>			<u>Total</u>
	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>Questioned</u>
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

All costs reclassified/questioned were billed as direct costs. In addition, the contractor billed the allowable [REDACTED] ceiling amounts. Therefore, all costs reclassified/questioned as a direct charge would be in excess of the billed indirect ceilings (overhead and G&A). We will evaluate the impact of this noncompliance for fiscal years 2003 and 2004 as part of our respective RPSC Incurred Cost audits scheduled to be performed during GFY 2006.

RECOMMENDATION:

We recommend that the contractor institute additional control procedures to insure that costs are consistently applied and/or allocated as either direct or indirect in accordance with its disclosed cost accounting practices and based on the fundamental requirements of CAS 418. In addition, we recommend that the contractor develop and implement a plan to monitor the proper cost classification based on Cost Accounting Standards and its CAS Disclosure Statement of indirect and other direct costs at all levels of the RPSC business area responsible for cost classification.

CONTRACTOR'S REACTION:

[REDACTED]

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The contractor's written response to our conditions and recommendations is included as an appendix to this report and summarized in this section of the report.

The contractor does not agree that the [REDACTED] costs should be reclassified or disallowed. First, the contractor believes that Section 3.1.0 of its CAS Disclosure Statement [REDACTED]. Second, the contractor contends the parties expressly agreed that all [REDACTED] costs at Polar would be charged as direct costs to the General Management WBS and that they would not be subject to the overhead ceiling rate. Third, the contractor believes that the Polar contract, not the WBS, is the final cost objective based on the CASB definition of a final cost objective. Additionally, the contractor replied that individual tasks and CLINs under a contract do not necessarily represent final cost objectives nor is a contractor required to treat them as such for cost accounting purposes. Fourth, the contractor asserts that it is entitled to decide what a final accumulation point is in its accounting system. In the RTSC accumulation system, the Polar Services contract is the final cost objective according to the contractor.

Concerning the [REDACTED] the contractor asserts that the Polar business unit was not organized as a separate, stand-alone operation. As a result, Polar has in effect purchased certain systems and support services from [REDACTED] and charged the costs for these systems and services to the Polar Services contract in the form of [REDACTED]. In addition, the contractor stated that many types of cost [REDACTED]. If those [REDACTED] are treated as overhead, they cause the actual overhead costs to exceed the capped rates in a way that the contractor does not believe either party anticipated or intended.

Finally, the contractor is in the process of developing a separate CAS Disclosure Statement for Raytheon Polar Services. The Raytheon Technical Services Company CAS Disclosure Statement Revision 12 for Parts I-IV was recently issued exclusive of Raytheon Polar Services. The effective date for RTSC revision 12 is January 1, 2005.

AUDITOR'S RESPONSE:

The contractor's reaction did not include any information to change our opinion. CAS 418-40(a) requires Polar Services to have a written statement of accounting policies and practices for classifying costs as direct and indirect and to apply those policies and practices consistently. These policies and practices are included in the contractor's CAS Disclosure Statement applicable to FYs 2001-2002, Revision 9C, Item No. 3.1.0 (Direct vs. Indirect Criteria). We do not believe that this part of the contractor's disclosure statement allows it to charge normally indirect costs direct to the Polar Services contract including the criteria that

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states, “Notwithstanding whether a type of charge is marked ‘E’ or ‘F’ [referring to treatment code in Paragraph 3.2.0] when the circumstances of a particular procurement suggest that a normally indirect cost would be bid and accumulated as a direct cost, the method employed to avoid double counting and to maintain compliance with the requirements of CAS 402 will be:”

The Polar RFP required the contractor’s cost or pricing data to follow its disclosed cost accounting practices (CAS Disclosure Statement). As a result, the RFP (procurement) did not require any costs normally classified as indirect [REDACTED] to be treated as direct costs to the contract. The Polar RFP and its requirement for the contractor to follow disclosed cost accounting practices is consistent with the intent of the CASB when it published comments regarding this issue in Part II, Preambles to the Related Rules and Regulations Published by the Cost Accounting Standards Board, Preambles to Part 331, Contract Coverage, Comment No. 11, *Additional requirements by agencies*, states that:

“...concern was expressed that Federal agencies might require the submission of cost proposals in ways inconsistent with the cost accounting practices of some or all of the potential offerors. The Board recognizes that this has happened in the past, but it notes that Board rules, regulations, and Cost Accounting Standards are to be used by relevant Federal agencies as well as by subcontractors and contractors, and it believes that henceforth requests for proposals must be fully consistent with such rules, regulations, and standards, although of course the Federal agency may ask for supplementary information to accompany proposals if this is needed to meet the agency’s requirements.”

In addition, the contract does not include any requirement and/or terms that allows RPSC to charge normally indirect costs direct to the Polar Services contract. We were never provided written documentation that substantiated any implied agreement between RPSC and the NSF Contracting Officer that allowed RPSC to charge normally indirect costs direct to the Polar Services contract. In fact, RPSC notified the NSF Contracting Officer in a letter dated April 16, 2001 that it has liquidated advance payments in a manner inconsistent with its disclosure statement. Specifically, RPSC classified some normally indirect costs [REDACTED] as direct costs. As a result, the NSF Contracting Officer requested the NSF OIG to review the basis for these classifications by Polar Services and advise if the proposed allocations are consistent with applicable RTSC Disclosure Statement(s) and otherwise represent allowable, allocable, and reasonable costs of contract performance.

Lastly, we believe that the Polar Services contract has multiple final cost objectives in the form of Work Breakdown Structures (WBS) based on the following:

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(1) The contract has determined that the WBS is the final cost objective. There is a number of Restricted WBS such as [REDACTED] that require the contractor to separately accumulate, report, and bill costs to NSF. For each WBS, the contractor even tracks and reports by: obligated, advances, expenditures, available funds, and unliquidated advances in its financial reports to NSF.

(2) The contractor has determined that the WBS is the final cost objective and one of the final accumulation points. The CASB definition of a final cost objective states, "Final cost objective means a cost objective which has allocated to it both direct and indirect costs, and in the contractor's accumulation system, is one of the final accumulation points." The contractor's accounting system segregates, accumulates, and bills costs by WBS which includes both direct and indirect costs as required by the CASB definition of a final cost objective. Also, the contractor seems to imply that a contract is always the final cost objective. We disagree because contracts may require task orders/delivery orders which become final cost objectives. In this case, a contractor typically segregates, accumulates, and bills costs by individual task/delivery order. Also, these task/delivery orders typically have their own ceiling amounts and the contractor is responsible for complying with those ceiling amounts. These delivery/task orders would meet the CASB definition of a final cost objective, as well as the WBS, because they have allocated to it both direct and indirect costs, and in the contractor's accumulation system, it has determined these orders to be final accumulation points.

(3) The contractor applies a [REDACTED] to the base costs of each WBS for reporting and billing costs to NSF. As a result, the WBS has to be the final cost objective because CAS 410 requires that G&A expenses can only be allocated to final cost objectives. According to 48 CFR 9904.410-40(a), the basic requirement of CAS 410 is that G&A expenses be grouped into a separate indirect cost pool and allocated only to final cost objectives.

As part of our audit of the contractor's classification of direct and indirect costs, we found where RPSC judgmentally selected certain RTSC and Corporate allocations (flow-down costs) to charge direct to the Polar Services contract while others remained indirect. The contractor's actual and disclosed accounting practice is to accumulate all of these [REDACTED] in its overhead pool [REDACTED]. We reclassified to the overhead pool [REDACTED] that the contractor elected to charge direct to the Polar Services contract. We are not aware of any other [REDACTED] and charge the associated costs direct to the contract.

In summary, we believe the contractor is in noncompliance with CAS 418-40(a) and has not followed its disclosed accounting practices which is a requirement of that standard.

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In accordance with FAR 52.230-6(a), within 60 days of the contractor's agreement to the initial finding of noncompliance or the CFAO determination of noncompliance, the contractor is to provide a general dollar magnitude of the noncompliance identifying the potential impact on the funds of each affected government agency and department.

The CAS non-compliances were discussed with [REDACTED] as part of the exit conference to the incurred cost audit however, an exit conference specific to this CAS noncompliance was not held with the contractor. We provided a condition & recommendation memorandum to the contractor's representative, [REDACTED] on April 14, 2005. We received the response to the memorandum on May 17, 2005 from [REDACTED]. The contractor disagrees with the cited instances on non-compliance and has provided the same response as was provided for the originating incurred cost audit. The contractor's response is included as an appendix to this report.

Pages 9-10 have been redacted in their entirety.

CONTRACTOR'S ORGANIZATION AND SYSTEMS

I. Organization

RTSC headquarters is located in Reston, VA. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Pages 12-21 have been redacted in their entirety.

Pages 12 through 18 have been redacted in their entirety

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

CAS 405: Audit Report No. 6162-2003T19200204, dated June 5, 2003, indicates that the contractor's cost accounting practices are in noncompliance with CAS 405, Accounting for Unallowable Costs, and FAR Part 31. Specifically, RTSC is not adequately complying with established controls to properly classify and record unallowable costs. In addition, RTSC is

Audit Report No. 6161-2005T19200001

not adequately complying with Raytheon Company policies and procedures for specific cost elements that were designed for controlling cost and determining/documenting cost allowability and compliance with government regulations. On December 12, 2004, the DACO withdrew his initial finding of noncompliance on this issue; stating that “Any potential cost impact associated with the Initial Finding will be resolved as part of the annual Incurred Cost negotiations.” Nevertheless, we will continue to report DCAA’s CAS 405 noncompliance audit report until after accomplishment of follow-up compliance and transaction testing performed as part of DCAA’s comprehensive audit of RTSC during FY 2005 to ensure that the reported instances of noncompliance have ceased to exist.

CAS 418: Audit Report No. 6162-2003T19200205, dated June 5, 2003, indicates that the contractor’s cost accounting practices are in noncompliance with CAS 418, Allocability of Direct and Indirect Costs. [REDACTED]

[REDACTED] On December 12, 2004, the DACO withdrew his initial finding of noncompliance on this issue stating that “Any potential cost impact associated with the Initial Finding will be resolved as part of the annual Incurred Cost negotiations.” Nevertheless, we will continue to report DCAA’s CAS 418 noncompliance audit report until after accomplishment of follow-up compliance testing performed jointly during DCAA’s in-process FY 2005 CAS 418 Compliance and Indirect and Other Direct Cost Internal Control System examinations (reference DCAA Audit Assignment Nos. 6161-2005T19403300 and 6161-2005T14980300 respectively) to ensure that the reported instances of noncompliance have ceased to exist.

[REDACTED]

Pages 21 has been redacted in its entirety

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AUDIT REPORT AUTHORIZED BY:

/Signed/

LARRY TATEM
Branch Manager
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Audit Report No. 6161-2005T19200001

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

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Copy furnished thru CFAO

[REDACTED]

[REDACTED]

[REDACTED]



CONTRACTOR'S WRITTEN RESPONSE

This file contains the contractor's written response to the CAS noncompliances. There are two (2) files contained within this correspondence. The contractor submitted the first file, B0SJ01.1Final.DOC which contains the response submitted for the originating incurred cost audit. The second file contains the cover letter for the condition and recommendation response to include further clarification by the contractor.



**Raytheon Technical
Services Company**

12160 Sunrise Valley Drive
Reston, Virginia
20191-3461 USA

May 17, 2005

To: Defense Contract Audit Agency
Attn: Larry Tatem
Mid-Atlantic Region Herndon Branch Office
Building 2, 3rd Floor
171 Elden Street, Suite 315
Herndon, VA 20170-4810

Subject: CAS 418 Noncompliance – Raytheon Polar Services Company

Reference: DCAA Audit Report 6161-2005T19200001 dated April 14, 2005

In response to the subject audit report RTSC respectively disagrees that Raytheon Polar Services Company (RPSC) was in noncompliance with CAS 418 during the period noted in the audit report. I have attached the original response to the DCAA Audit Report No. 6161-2004P10160205 that provides our position with respect to the appropriateness of allocating costs to this contract.

As a matter of update, RTSC has issued its Disclosure Statement (DS) Revision 12 for Parts I – IV exclusive of RPSC. A separate DS for RPSC is currently being reviewed and will be issued accordingly. This change was prompted by the joint discussions with both DCAA and DCMA with the intent to provide improved clarity to both Disclosure Statements recognizing that RPSC has unique circumstances relative to [REDACTED]. Additionally, discussions with the National Science Foundation (NSF) and the Inspector General have been ongoing to resolve any misunderstanding between RTSC and the customer.

Sincerely,

[REDACTED]

Cc:

[REDACTED]

Re: Response to DCAA Draft Audit Report No. 6161-2004P10160205

This letter is the response of Raytheon Technical Services Company LLC (RTSC) to DCAA Draft Audit Report No. 6161-2004P10160205 dated August 24, 2004. In simple terms, the Draft Audit Report questions the allowability of approximately [REDACTED] in costs allocated to National Science Foundation (NSF) Contract No. OPP 0000373 (the Contract) in 2000-02. The questioned costs fall into three broad categories: 1) approximately [REDACTED] in costs incurred by RTSC's Polar Services division (Polar) and charged as direct costs of the Contract; 2) approximately [REDACTED] in indirect costs in excess of the caps on overhead and G&A included in the Contract; and 3) approximately [REDACTED]. We believe that it is important to note at the outset that the [REDACTED] unallowable over-ceiling costs identified in the Draft Audit Report have neither been billed to NSF nor recovered in any way and that Polar has no intention of attempting to recover those costs. We disagree with the conclusions in the Draft Audit Report on the other two issues for the reasons stated below.

Background

The Contract is a cost-reimbursement contract for services in support of the NSF scientific mission in Antarctica. Polar won the contract in a competition conducted in 1999. Polar's predecessor, Antarctic Support Services (ASA), had only one contract and charged all of its costs direct to that contract. ASA had no indirect costs. Because it was a joint venture, its "parents" did not allocate "home office" costs to ASA. When ASA needed support from its corporate parents, it "purchased" that support and charged the costs direct to the predecessor contract. Although NSF's RFP for the Contract did not specifically require that all costs be charged directly to the Contract, it was apparent that the RFP contemplated that a successor contractor would have a similar structure with minimal indirect costs. As a result, RTSC's proposal was designed to minimize indirect charging and maximize direct charging.

[REDACTED]

that are classified as indirect costs and allocated to all the contracts in that business unit. In 1999 when RTSC was preparing the proposal for the Contract, there were a few RTSC business units that were stand-alone organizations, like the contemplated Polar business unit. Like ASA, those business units charged virtually all of their costs as direct costs. Those business units were not included in the allocation base for most Raytheon corporate and RTSC costs, so they had very

¹ Because the Draft Audit Reports makes changes in both the overhead pool and in the base used to allocate the overhead pool, we do not agree with the precise amounts calculated by DCAA for each category of costs. For example, because DCAA has erroneously reclassified certain [REDACTED] Polar from direct costs to overhead and because of an undetected error in the 2000 submission, the amount subject to the overhead cap in the DCAA report is overstated. On the other hand, we also discovered undetected errors in the incurred cost submission for 2002 that would increase the amount of overhead rendered unallowable by the cap. When the 2000 and 2002 submissions were corrected, the amount of unallowable over-ceiling cost will be approximately [REDACTED]. For clarity, we have used the amounts in the DCAA Draft Audit Report in this response, but those amounts are incorrect.

low indirect cost rates. RTSC's proposal assumed that the Polar business unit would be organized on the same basis and that it would [REDACTED]

Based on its expectations about the way that Polar would be organized, RTSC's proposal [REDACTED]

[REDACTED]. RTSC did not expect that its actual overhead and G&A expenses would exceed the contractual caps by more than [REDACTED].

NSF accepted RTSC's proposal and the Contract contemplates that [REDACTED] normally charged as indirect costs would be charged directly to the Contract. [REDACTED] the terms of the Contract, the Polar business unit has consistently classified all costs incurred in the Polar business unit as direct costs. In fact, NSF directed that Polar charge the locally incurred management costs for Polar to the General Management CLIN in the Contract and Polar has complied with that direction.

After the Contract was awarded to Polar late in 1999, ASA protested the award. Polar began performance of the Contract shortly after award, but the protest continued for much of 2000. The protest and uncertainty about the validity of the Contract created some confusion during 2000. The initial award was for a period of five years, with an option for another five years. NSF has exercised that option and the Contract is currently expected to extend until 2010.

[REDACTED]. As a result, the costs allocated to the Contract from Raytheon and RTSC substantially exceeded the [REDACTED] overhead cap included in the Contract. Because NSF directed that Polar use the ASA Annual Program Plan (APP) to report its costs at the outset of the Contract in early 2000 and because Polar complied with that direction, [REDACTED]

After considering various alternatives in early 2001, RTSC decided that some of the costs being [REDACTED] had expected to incur [REDACTED] and charge direct to the Contract. Polar decided to reclassify some of the costs [REDACTED] as other direct costs (ODCs) and to charge those costs directly to the Contract rather than including them as overhead costs subject to [REDACTED] in the Contract. Polar notified NSF of that decision in a letter dated April 16, 2001, and identified the types of cost that had been classified as ODCs in that letter. In response to that letter, NSF told Polar that the allowability of its ODCs would be determined after the costs had been audited. The Draft Audit Report, prepared over three years thereafter, is the first time that any Government representative has objected to the approach adopted by Polar in 2001. Polar appreciates this opportunity to explain the rationale for its classification of the costs as ODCs.

Polar did not classify as ODCs any costs allocated to the Contract [REDACTED], nor did it classify all of the [REDACTED] to the Contract as ODCs. In fact, the total amount that Polar has claimed and recovered on the Contract during the initial 5-year term of the Contract is approximately [REDACTED] than the actual costs recorded as indirect costs on the Contract. That [REDACTED] on the Contract reflects the benefit that NSF has realized as a result of the contractual caps on G&A and overhead.

We now turn to the issues raised in the Draft Audit Report.

[REDACTED]

We do not believe that DCAA was privy to the contractual agreement reached by the parties, so DCAA may not appreciate the connection between that agreement and the disclosed and approved practice used by Polar to implement that agreement. The parties clearly and explicitly agreed that all [REDACTED] costs would be charged as direct costs on the Contract, including costs that would normally be indirect. In discussions after award, NSF instructed Polar to charge normally indirect costs to the [REDACTED] and Polar has complied with that instruction. RTSC's disclosed practice was and is that [REDACTED].

Because the parties had specifically agreed that the costs at issue would be charged direct, there was and is a contractual requirement to charge them direct. In addition, RTSC's disclosed practice [REDACTED]. The costs at issue exclusively benefit and are identified to the Polar contract. Accordingly, Polar has complied with the requirements of the Contract, the instructions of its customer, and [REDACTED].

[REDACTED] makes sense in a situation like this where there is only one contract in the business unit and where all [REDACTED] will ultimately be charged to that contract, whether charged directly or indirectly.

The DCAA Draft Audit Report asserts that Polar may not charge the costs at issue directly to the Contract because there are multiple “final cost objectives” within the Contract. Under this interpretation, because the Contract has multiple final cost objectives, Polar is required to collect its normally indirect costs in an overhead pool and allocate those costs as overhead to the various final cost objectives within the Contract. The effect of the DCAA position is to include [REDACTED] in the costs [REDACTED].

There are at least three fundamental problems with this position. First, and most important, it is completely inconsistent with the understanding of the parties and the requirements of the Contract. The parties expressly agreed that all [REDACTED]. Even if DCAA were correct about the existence of multiple final cost objectives, the assertion that the costs at issue should be subject to the overhead cap would be inconsistent with the parties’ express and clear agreement.

The second problem with the DCAA position is that the Contract is a single final cost objective. The term “final cost objective” is defined in the CAS regulations as follows:

Final cost objective means a cost objective which has allocated to it both direct and indirect costs, and in the contractor’s accumulation system is one of the final accumulation points.

48 C.F.R. § 9904.402-30(a)(4). Under that definition, the contractor is entitled to decide what is a final accumulation point in its system. In RTSC’s accumulation system, [REDACTED] under [REDACTED].

In most circumstances, contracts are final cost objectives. While we agree with DCAA that there are circumstances in which a single contract could encompass multiple final cost objectives, this is clearly not one of them. In our experience, contracts that include multiple final cost objectives are contracts that cover two or more distinct and disparate activities, such as production of goods and a separate design task to develop a variant of that product. [REDACTED].

Finally, the parties intended and expressly agreed that the [REDACTED] identified as unallowable indirect costs would be charged direct to the contract. There is no basis to disallow that direct cost.

Costs in Excess of the Indirect Cost Caps

The Draft Audit Report also identifies as unallowable and “claimed over ceiling” approximately [REDACTED] in costs that have been allocated to the Contract. We agree with DCAA that the costs at issue are not allowable. We also agree that the costs have been *allocated*

to the Contract, as is required by the relevant regulations and [REDACTED], but we disagree that they have been “claimed” and they certainly have not been recovered. The costs are included in the actual incurred cost submission and they are charged to the Contract on Polar’s books of account because they are actual costs and they must be recorded on the books, but we are aware of no evidence that the costs have ever been included in any billing or otherwise “claimed” by Polar. Polar has no intention of claiming or attempting to recover those costs. While the Draft Audit Report is correct that the costs are unallowable, it fails to acknowledge that Polar has treated them as unallowable. Moreover, by labeling the costs as “claimed” the Draft Audit Report creates the erroneous impression that Polar has somehow tried to recover the costs. There is no issue about these costs and the final Audit Report should acknowledge that fact.

RTSC made a deal with NSF about the unallowability of indirect costs in excess of the caps included in the Contract. Polar has lived up to that deal and is not complaining about the impact of the caps on indirect costs as they were reasonably anticipated when the caps were proposed and negotiated. What we disagree with is the application of the caps to [REDACTED] that were expressly excluded from the application of the caps in RTSC’s proposal, discussed in the section above, and application of the caps to costs that RTSC anticipated incurring locally, discussed in the next section.

Other Direct Costs

The final category of costs addressed in the Draft Audit Report raises more complicated issues, but it is equally without merit. The principal reason that we requested additional time to respond to the Draft Audit Report was because we wanted to be sure that we understood the issues related to ODCs and were comfortable with the Company’s position on those issues. We retained outside counsel and a major accounting firm to review the Company’s position. Their review is now substantially complete and they have concluded that the Company’s position reflects a fair attempt to implement the original intent of the Contract in light of the way that circumstances have changed since award.

As explained above, the proposal for the Contract and the rate caps in the contract were based on express assumptions about the nature of the costs that would be included in the capped overhead rates. RTSC’s [REDACTED]

[REDACTED] The cost proposal for the Contract originally assumed that there would be similar arrangements for the Polar business unit and that such costs would be incurred locally and charged directly to the Contract, as provided in the Contract and in [REDACTED].

[REDACTED]
[REDACTED]. As a result, Polar has in effect purchased certain systems and support services from [REDACTED].

[REDACTED]. As a result, many types of cost that RTSC expected to [REDACTED] and charge direct to the Contract have instead been charged as [REDACTED]. If those [REDACTED] are treated as overhead, they cause the actual overhead costs to exceed the capped rates in a way that we do not believe either party anticipated or intended. When Polar realized late in 2000 what had happened, it reviewed the various options available to it and decided that the best way to implement the parties' intent would be to reclassify appropriate overhead costs as ODCs, charged directly to the contract as the parties expected and intended.

It is important to note that Polar did not reclassify any [REDACTED], even though the actual [REDACTED] rate has substantially exceeded the capped rate [REDACTED]. Nor has Polar reclassified all of the overhead costs in excess of the capped rates. Even after the reclassification of some overhead costs, the actual rates are still substantially in excess of the capped rates. NSF has received the benefit of the corporate and RTSC systems and support, but it would not be required to pay for that benefit if the costs were classified as overhead.

In order to correct that obvious inequity and to implement what we believe to have been the intent of both parties, we attempted to identify costs [REDACTED] that were, in essence, replacements for costs that both parties had anticipated would be incurred [REDACTED] and charged direct to the Contract. We believe that we have reclassified costs fairly in a way that is consistent with the parties' original intent, but we also recognize that the reclassification involved an exercise of judgment and that reasonable people might disagree about how that judgment should be exercised. We disclosed what we intended to do and why we intended to do it fully and completely to NSF in a letter dated April 16, 2001. NSF neither accepted nor rejected our solution to the problem we were facing, but indicated that the appropriateness of the reclassifications would have to be determined after an audit. Now, over three years later, there has finally been an audit. We do not believe that the DCAA position that all of the costs at issue must remain in overhead, no matter what the parties intended or what is fair in the circumstances, is a supportable position.

Conclusion

The audit findings concerning [REDACTED] and "claimed over ceiling" costs should be withdrawn. They are demonstrably wrong. The audit finding that none of the ODCs at issue are properly classified as direct costs is also incorrect, but we recognize that the amounts so classified are a matter of judgment and we fully expect them to be the subject of negotiation between the parties.