

National Science Foundation

4201 Wilson Boulevard
Arlington, Virginia 22230

Office of Inspector General

MEMORANDUM

DATE: JAN 11 2007

TO: David Elizalde, Director
Division of Acquisition and Cooperative Support (DACCS)

FROM: Deborah H. Cureton
Associate Inspector General for Audit

SUBJECT: NSF OIG Audit Report No. 07-1-006, Cost Impact Analysis regarding Raytheon's CAS Noncompliance and Raytheon Polar Services Company's Cost Accounting Standards Board Disclosure Statement

At our request, Defense Contract Audit Agency (DCAA) prepared the attached letter assessing the financial impact on NSF's United States Antarctic Program (USAP) contract of a change that Raytheon Polar Services Company (RPSC) has proposed in the disclosed accounting practices that the contractor is obligated to follow in performing the USAP contract. If approved, NSF will incur an estimated [REDACTED] of increased indirect costs for the last five years of the contract. This amount is in addition to the [REDACTED] of indirect costs RPSC improperly claimed and we reported on in prior audits for the first five years of the USAP contract. The letter also discusses two other issues associated with RPSC's noncompliance with its Federal Disclosure Statement that we have also reported on previously.

Background Information

Previously we reported to your office¹ that RPSC did not comply with Federal Cost Accounting Standard (CAS) 418 which requires that RPSC consistently classify costs on the USAP contract as stated in its Disclosure Statement. In the contract NSF awarded to RPSC's parent company, Raytheon Technical Services Company (RTSC) in 1999, RTSC certified that RPSC would comply with the Disclosure Statement of the parent company, RTSC. However, since the inception of the USAP contract through December 31, 2004 (five years), RPSC did not comply

¹ Reference NSF OIG Audit Report No. 06-1-001, "Audit of Raytheon Polar Services Company's Noncompliance with Cost Accounting Standard 418, Allocation of Direct and Indirect Costs for Fiscal Years 2000 to 2002," dated March 21, 2006.

with RTSC's disclosed accounting practices for distinguishing direct costs from indirect costs. This resulted in RPSC improperly claiming [REDACTED] of indirect costs as direct costs from 2000 through 2004 in its incurred cost submissions to NSF for these five years. On August 22, 2006, the Defense Contract Management Agency (DCMA) issued a final determination of RPSC's noncompliance with CAS 418 and its disclosed accounting practices to RTSC for the three-year period ending December 31, 2002. DCAA also indicated that the condition causing the noncompliance remained in effect for years 2003 and 2004, although DCMA has not issued a finding of noncompliance for this two-year period.

To address the noncompliance, RPSC filed a new Disclosure Statement on April 17, 2006 with an effective date retroactive to January 1, 2005. In this new Disclosure Statement RPSC proposes to change its previous disclosed accounting practice to begin the process of making it allowable to [REDACTED]

[REDACTED]. As indirect costs, these [REDACTED] costs² were subject to indirect rate ceiling caps under the previous RTSC Disclosure Statement. This change would now allow RPSC to fully charge these previously unallowable indirect costs to the USAP contract as direct costs. Although required in order to make such a change, RPSC has not provided a cost impact proposal to enable NSF to assess the financial implications of this proposed change on the USAP contract. Therefore, to ensure NSF and the National Science Board are aware of the amount of increased costs that will result from this change to the USAP contract, we requested DCAA to provide an estimate of the amount of resulting increased costs from January 1, 2005 until the anticipated completion of the USAP contract in 2010. DCAA's calculation of the cost impact and other associated CAS issues are summarized below and provided in full in the attached letter.

Cost Impact of Proposed Change to RPSC Disclosed Accounting Practice

DCAA found that RPSC's new proposed Disclosure Statement to reclassify its [REDACTED] costs from indirect to direct costs will result in about [REDACTED] of increased costs to the NSF USAP contract from 2005 through 2010. If accepted by NSF this change would allow RPSC to continue direct charging [REDACTED] that were previously not allowable and for which RTSC was cited for a noncompliant accounting practice by DCMA. In addition, depending on how DCMA and NSF resolve the previously unallowable [REDACTED] [REDACTED] as well as the improper [REDACTED] and indirect costs over ceilings [REDACTED] reported in our prior audits, NSF could potentially incur as much as [REDACTED] more in indirect costs over the life of the USAP contract than was contractually agreed upon.

² This [REDACTED] of improperly claimed indirect costs from 2000 through 2004 is made up of [REDACTED] of indirect costs in noncompliance with CAS and [REDACTED] of indirect costs over indirect cost ceilings, as cited in the five DCAA audit reports (one for each year) referenced in DCAA's attached letter.

³ [REDACTED]

⁴ [REDACTED] does not include [REDACTED] of other direct and [REDACTED] questioned for 2000 through 2004. The total questioned costs for 2000 through 2004 [REDACTED] and the estimated increased costs for 2005 through 2010 [REDACTED] brings the total potential increased costs on the USAP contract to [REDACTED].

Initial Disclosure Statement for RPSC

DCAA also indicates that because RPSC is a separate organizational entity from RTSC, it considered the RPSC Disclosure Statement submitted to DCMA and DCAA in April 2006 to be an initial submission. However, while this is the first Disclosure Statement for RPSC as a separate organizational entity, this Disclosure Statement functions as a revised Disclosure Statement for the purposes of the USAP contract. This is because under FAR, a contract, as opposed to an organizational unit of an entity, is subject to Federal Cost Accounting Standards.³ DCAA agreed that the new Disclosure Statement from RPSC is to propose changes in RPSC's disclosed and established accounting practices impacting the USAP contract, as evidenced by DCAA's cost impact proposal calculation discussed above.

Disclosure Statement Changes Made to Correct the Noncompliance

DCAA states that since RTSC did not follow the Disclosure Statement it certified to under the NSF contract award, it is submitting the new Disclosure Statement to correct the noncompliance as opposed to making "voluntary changes" in accounting practice. Accordingly, DCAA states that recovery of increased costs should be pursued "*for any failure to comply with an applicable CAS or to follow a disclosed practice.*"⁴ FAR also provides for recovery of interest costs if a contractor fails to comply with an applicable CAS or to follow any cost accounting practice consistently.

Recommendations

We recommend that the Division Director, Division of Acquisition and Cooperative Support (DACS):

1. For the 2000 through 2004 contract period, work with the Defense Contract Management Agency (DCMA) to recover all indirect costs together with applicable interest that RPSC claimed in noncompliance with its Disclosure Statement including [REDACTED] of [REDACTED] of [REDACTED], and [REDACTED] of cost in excess of ceiling, for a total of [REDACTED] in indirect costs; and
2. For the 2005 through 2010 contract period, work with NSF's Office of Polar Programs (OPP) and DCMA to assess the desirability of RPSC's proposed change in disclosed accounting practice in light of the associated [REDACTED] of increased contract costs. If determined to be desirable in part or in total, negotiate a modification of the USAP contract with RPSC to formally reflect the change in contract terms and conditions for charging locally incurred costs.

³ Reference 48 CFR 9903.201, *CAS Applicability*.

⁴ Reference FAR 30.602-2, FAR 52.230-6(a)(3), and FAR 52.230-2(a)(5) regarding *noncompliance with CAS requirements*.

We consider the CAS issues and the cost impact amount of the change in disclosed accounting practice discussed in DCAA's attached letter to be significant. Accordingly, to help ensure that the findings are resolved within six months of issuance of the audit report, please coordinate with our office during the resolution period to develop a mutually agreeable audit resolution memorandum.

We are providing a copy of this memorandum to the Director of the Office of Polar Programs. However, since the responsibility for audit resolution rests with DACS, we ask that no action be taken concerning the report's findings without first consulting DACS at (703) 292-8242.

OIG Oversight of DCAA Analysis

The Office of Inspector General reviewed the letter prepared by DCAA and coordinated issuance of this letter to NSF. DCAA is responsible for the attached auditor's letter on RPSC and the conclusions expressed in the letter. The NSF OIG does not express any opinion on the conclusions presented in DCAA's letter.

If you have any questions about this report, please contact David Willems at (703) 292-4979 or Jannifer Jenkins at (703) 292-4996.

Attachment: DCAA Letter dated December 21, 2006

cc: Thomas Cooley, Director, BFA
Mary Santonastasso, Director, DIAS
Karl Erb, Director, OPP



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6161-Polar

December 21, 2006

Ms. Deborah H. Cureton, Associate Inspector General for Audit
National Science Foundation (NSF)
4201 Wilson Boulevard
Arlington, VA 22230

Subject: Polar Services Contract

Dear Ms. Cureton:

Our audit report on the recently submitted Polar Services CAS disclosure statement has generated several issues/concerns based on our meeting of December 13, 2006 as follows: (1) whether the Polar Services CAS disclosure statement is an initial or revised submission; (2) whether any changes included in the Polar Services CAS disclosure statement represent voluntary accounting changes; and (3) calculation of a cost impact/increased costs to the Government.

1. Polar Services CAS Disclosure Statement

We believe the Polar Services CAS disclosure statement with an effective date of January 1, 2005 is an initial submission. This is the first CAS disclosure statement that Polar Services submitted as a separate entity of Raytheon Technical Services Company (RTSC). Prior to this submission, Polar Services was part of the RTSC CAS disclosure statement. This single CAS disclosure statement described the cost accounting practices of all RTSC entities including Polar Services. Therefore, we concluded that the Polar Services CAS disclosure statement was an initial submission and we only performed an initial adequacy audit of cost accounting practices. That is, we reviewed the initial CAS disclosure statement to determine whether it adequately described the cost accounting practices to be used for estimating, accumulating, and reporting contract costs. After the cognizant Federal agency official (CFAO), the contracting officer assigned to administer CAS, deems the initial CAS disclosure statement adequate, then we will perform an initial audit of compliance to determine whether the described cost accounting practices comply with CAS and FAR Part 31.

Ms. Deborah H. Cureton, Associate Inspector General for Audit
National Science Foundation (NSF)

2. Voluntary Accounting Changes

Any change a contractor makes in its cost accounting practices is generally referred to as a “voluntary change.” This would include a change in the contractor’s disclosed and established accounting practices. The definition of a voluntary change is broad and should be considered within the context of FAR 30.602, Changes to disclosed or established cost accounting practices.

FAR 30.602-1 applies when a contractor is required to make a change to comply with a new or modified Cost Accounting Standard. FAR 30.602-3 applies when a contractor makes a voluntary change from an existing compliant accounting practice to another compliant practice. FAR 30.602-2 applies to noncompliances with CAS requirements and practice changes needed to correct CAS noncompliances. In addition, FAR 52.230-6 requires a cost impact proposal for each of these changes (required, voluntary, and noncompliance) as well as an equitable adjustment of the contract price or accumulated costs.

We issued a CAS noncompliance audit report dated June 23, 2005 (Audit Report No. 6161-2005T19200001) where we determined that the contractor did not consistently apply its classification of costs on the Polar Services contract and, as such, was in noncompliance with CAS 418 and its disclosed accounting practices. As a result, any increased costs (either contract price and/or cost accumulation) should be pursued under FAR 30.602-2 and FAR 52.230-6(a)(3) because these FAR provisions specifically address CAS noncompliant accounting practices and any practice changes needed to correct noncompliances. Since the contractor did not follow the RTSC CAS disclosure statement regarding the classification of [REDACTED] which we reported as a CAS noncompliance, it would seem that any subsequent actual or perceived changes are being made to correct the noncompliance instead of a decision to voluntarily change an accounting practice from an existing compliant practice.

We do not believe that any actual or perceived changes resulting from CAS noncompliances (changing a noncompliant practice to a compliant practice) such as those that may involve the [REDACTED] or [REDACTED] would be subject to FAR 30.602-3 and represent voluntary changes. Instead, changes involving complaint practices that the contractor voluntarily makes usually for business reasons are subject to FAR 30.602-3. For example, a contractor decides to voluntarily change a disclosed and established G&A cost input base (complaint practice) to a value-added input base (another complaint practice) for business reasons.

3. Calculation of Cost Impact

The need for a cost impact proposal arises under two (2) sets of circumstances: (1) changes to a cost accounting practice, and (2) noncompliance with CAS. The purpose of the cost impact proposal in the case of a change to a cost accounting practice is to determine the cost shifts among CAS-covered contracts, and to estimate the appropriate adjustments, if any, to contract prices or cost allowances. In the case of noncompliance, the purpose of the cost impact proposal is to determine if the failure to comply resulted in increased costs to the government, and to estimate the appropriate adjustments, if any, to contract prices or cost allowances. For example, adjust the contract for what the price would have been if the CAS noncompliance had not occurred.

The accounting practices included in the Polar Services initial CAS disclosure statement may eliminate the CAS noncompliances, but it does not eliminate the requirement to determine whether there is a cost impact to the Government, including any impact of the noncompliance on cost accumulations and/or on contract price based on FAR 30.602-2 and FAR 52.230-6(a)(3).

We believe the CAS noncompliance associated with the [REDACTED] [REDACTED] resulted in an impact on cost accumulations only. We did not find any evidence where the contractor classified these costs differently as part of the contract price. That is, the contractor's disclosed and established practice is to classify flowdown costs as an indirect cost and we believe these costs were treated the same in determining the contract price. Our assumption is based on a letter that RTSC forwarded to NSF several months after contract award where it wanted to start charging [REDACTED] direct to the Polar Services contract. Therefore, the cost impact should reflect the period when the contractor started accumulating and/or charging these flowdown costs direct to the Polar Services contract until it discontinued this noncompliant practice. In other words, the period that the CAS noncompliance impacted accumulated costs.

We believe the CAS noncompliance associated with [REDACTED] [REDACTED] resulted in an impact on contract price. The contractor's disclosed practice is to [REDACTED] [REDACTED]. This assumption is based on the contractor having billed [REDACTED] costs direct to the Polar Services contract since the start of contract performance and continues to do so today. As a result, this CAS noncompliance has an impact on the contract price for the entire anticipated period of performance. This CAS noncompliance impacted estimated costs and ultimately the contract price.

6161-Polar

December 21, 2006

Ms. Deborah H. Cureton, Associate Inspector General for Audit
National Science Foundation (NSF)

We have computed cost impacts of the CAS noncompliance associated with the Raytheon Corporate/RTSC flowdown costs and local management costs (see Enclosure). The contractor has never provided a cost impact for our review so we have estimated the cost impacts based on the best data available.

If you have any questions, please contact me at telephone (703) 735-3460 or my e-mail address: larry.tatem@dcaa.mil.

Sincerely,

/Signed/

LARRY TATEM
Branch Manager

Enclosure

Polar Services Contract
CAS Noncompliance – [REDACTED]
Estimated Cost Impact

<u>Fiscal Year</u>	<u>Audit Report Reference</u>	<u>Cost Impact</u>
2000	6161-2000P10100001	[REDACTED]
2001	6161-2001P10100001	[REDACTED]
2002	6161-2002P10100001	[REDACTED]
2003	6161-2003P10100201-S1	[REDACTED]
2004	6161-2004P10100201-S1	[REDACTED]
Total		[REDACTED]

Note: The cost accumulations included in the cost impact for the noncompliance related to the flowdowns were taken directly from the incurred cost audit reports. There is no projection of these costs into future periods beyond the period of noncompliance. This impact constitutes increased costs to the Government because the reclassification of [REDACTED] to a complaint accounting practice (i.e., indirect rather than direct) causes the adjusted indirect rate to exceed the contract's respective ceiling rate.

Polar Services Contract
CAS Noncompliance – [REDACTED]
Estimated Cost Impact

<u>Fiscal Year</u>	<u>Audit Report/Note</u>	<u>Cost Impact</u>
2000	6161-2000P10100001	[REDACTED]
2001	6161-2001P10100001	[REDACTED]
2002	6161-2002P10100001	[REDACTED]
2003	6161-2003P10100201-S1	[REDACTED]
2004	6161-2004P10100201-S1	[REDACTED]
2005	Note 1	[REDACTED]
2006	Note 1	[REDACTED]
2007	Note 1	[REDACTED]
2008	Note 1	[REDACTED]
2009	Note 1	[REDACTED]
2010	Note 2	[REDACTED]
Total Cost Impact		[REDACTED]

Note 1: We estimated the cost impact for fiscal years 2005 through 2009 by projecting the increase in the costs incurred for the initial four (4) years of the contract through the period of performance. The projection was calculated based upon the average percent increase resulting in a [REDACTED] increase per year. The [REDACTED] increase was then added to the previous years' amounts consecutively through calendar year 2009.

Note 2: We estimated the final year of the contract in the same manner as 2005 through 2009 with the exception that the contract period of performance ends on March 31, 2010. We therefore only included the equivalent of three (3) months costs for FY 2010. This impact constitutes increased costs to the Government because the reclassification of [REDACTED] costs to a complaint accounting practice (i.e., indirect rather than direct) causes the adjusted indirect rate to exceed the contract's respective ceiling rate.