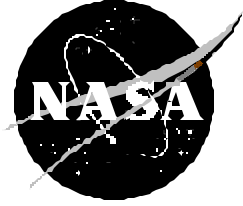


IG-00-033

**AUDIT
REPORT**

**RELIEF GRANTED TO CONTRACTOR FOR
OVERPAYMENT OF GENERAL AND
ADMINISTRATIVE COSTS**

April 20, 2000



National Aeronautics and
Space Administration

OFFICE OF INSPECTOR GENERAL

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Acronyms

ACO	Administrative Contracting Officer
CACO	Corporate Administrative Contracting Officer
CAS	Cost Accounting Standard
DCAA	Defense Contract Audit Agency
FAR	Federal Acquisition Regulation
G&A	General and Administrative

W

April 20, 2000

TO: A/Administrator

FROM: W/Inspector General

SUBJECT: INFORMATION: Relief Granted to Contractor for Overpayment of
General and Administrative Costs
Report Number IG-00-033

Background

Our office received a copy of a referral alleging that a NASA Administrative Contracting Officer (ACO)¹ exceeded the delegated authority under the contracting warrant and that certain actions did not safeguard the interests of the U.S. taxpayer. Specifically, the referral stated that the ACO did not ensure compliance with the terms of the payload ground operations contract at Kennedy, or the Federal Acquisition Regulation (FAR) and Costs Accounting Standards (CAS)² in regard to allocating G&A costs to unallowable costs.

The allegation referred to audit work performed by the Defense Contract Audit Agency (DCAA)³ and an audit report stating that the contractor was in noncompliance with FAR and CAS because it included unallowable bonus costs in its computation for billable General and Administrative (G&A)⁴ costs. This practice resulted in the contractor improperly billing the Government for G&A costs allocable to employee bonuses. The DCAA recommended that the contractor adjust its vouchers to exclude G&A costs allocable to unallowable costs already billed to the

¹ The ACO performs contract administration functions, which are listed in Federal Acquisition Regulation, Subpart 42.3, and include administration of Cost Accounting Standards.

² The 19 cost accounting standards, promulgated by the Cost Accounting Standards Board, are in 48 Code of Federal Regulations, Chapter 99. The standards are applicable to negotiated prime contracts and subcontracts with the U.S. Government in excess of \$500,000. The standards are numbered and referred to as CAS 401-418 and CAS 420.

³ The DCAA provides preaward and postaward contract auditing services, internal control system audits, and other support services to contracting officers from the Department of Defense, NASA, and other Federal agencies.

⁴ G&A costs are management, financial, or other costs that are for the general management and administration of a business.

Government and exclude those costs from all future billings. The NASA ACO disagreed with the DCAA and a former ACO determination, and on January 9, 1999, granted the contractor financial relief for the G&A costs associated with employee bonuses.

Recommendation, Management's Response, and OIG Evaluation

On February 14, 2000, we issued a draft report recommending that the Kennedy Center Director rescind the relief given to the contractor and seek recovery for the unallowable G&A costs paid to the contractor. Management nonconcurred with the recommendation, stating that the ACO's "relief granted" was actually an authoritative determination that, based on the contract proposal and the parties' advance agreement, employee bonuses were actually a distribution of fee and not a cost to the contract. The complete text of management's response to the draft report is in Appendix C, and OIG comments on the response are in Appendix D.

Based on management's response and a lack of clear language in the contract, we concluded that recovery of the estimated \$2 million in G&A costs associated with the bonuses is improbable. However, NASA could be vulnerable if a similar bonus provision is included in other contracts without clarifying language. Therefore, we revised the recommendation in this final report to address future contracts. We recommended that Kennedy should clarify under future contracts whether any costs paid from fee, direct and indirect, are allocable and allowable. We requested that management provide additional comments on this report.

[original signed by]

Roberta L. Gross

Enclosure

Final Report on Audit of Relief Granted to Contractor for Overpayment of
General and Administrative Costs

FINAL REPORT
AUDIT OF RELIEF GRANTED TO CONTRACTOR
FOR OVERPAYMENT OF GENERAL AND ADMINISTRATIVE COSTS

W

April 20, 2000

TO: AA/Director, Kennedy Space Center

FROM: W/Assistant Inspector General for Auditing

SUBJECT: Final Report on the Audit of Relief Granted to Contractor for
Overpayment of General and Administrative Costs
Assignment Number A9907200
Report Number IG-00-033

The subject final report is provided for your use and comments. Our evaluation of your response is incorporated into the body of the report. In response to management's comments and our further consideration, we revised the report recommendation. Therefore, we request management's comments on the revised recommendation by May 22, 2000. The recommendation will remain open for reporting purposes.

If you have questions concerning the report, please contact Mr. Chester A. Sipsock, Program Director, Environmental and Financial Management Audits, at (216) 433-8960, or Ms. Sandra Massey, Auditor-in-Charge, at (321) 867-4057. We appreciate the courtesies extended to the audit staff. The final report distribution is in Appendix E.

[Original signed by Lee T. Ball for Mr. Rau]

Russell A. Rau

Enclosure

cc:

B/Chief Financial Officer

B/Comptroller

BF/Director, Financial Management Division

G/General Counsel

H/Associate Administrator for Procurement

JM/Director, Management Assessment Division
M/Associate Administrator for Space Flight

bcc:

AIGA, IG, Reading Chrons

H/Audit Liaison Representative

M/Audit Liaison Representative

GRC/W/Audit Program Director

KSC/W/Audit Program Manager

KSC/HM-E/Audit Liaison Representative

NASA Office of Inspector General

IG-00-033
A9907200

April 20, 2000

Audit of Relief Granted to Contractor For Overpayment of General And Administrative Costs

Introduction

On February 16, 1999, a referral of fraud, waste, and abuse was made to the General Accounting Office with a copy to the NASA Office of Inspector General. The Inspector General agreed to address the referral. The allegation stated that a NASA administrative contracting officer (ACO)⁵ exceeded the delegated authority under the contracting warrant and that the actions did not safeguard the interests of the U.S. taxpayer. Specifically, the referral stated that the ACO did not ensure compliance with the terms of the payload ground operations contract at John F. Kennedy Space Center (Kennedy), or the Federal Acquisition Regulation (FAR) and Costs Accounting Standards (CAS)⁶ in regard to allocating general and administrative (G&A)⁷ costs to unallowable costs.

The allegation referred to audit work performed by the Defense Contract Audit Agency (DCAA).⁸ On November 15, 1991, the DCAA issued an audit report stating that the payload ground operations contractor at Kennedy was in noncompliance with FAR and CAS because it included unallowable bonus costs in its computation for billable G&A costs. This practice resulted in the contractor improperly billing the Government for G&A costs allocable to unallowable base costs that included employee bonuses. The DCAA recommended that the contractor adjust its vouchers to exclude G&A costs allocable to unallowable costs already billed to the Government and exclude those costs from all future billings. On February 14, 1992, the DCAA notified the NASA ACO that the contractor continued to be in noncompliance with FAR and CAS. The ACO agreed with the DCAA and requested a cost impact proposal from the contractor.

⁵The administrative contracting officer performs contract administration functions, which are listed in Federal Acquisition Regulation, Subpart 42.3, and include administration of Cost Accounting Standards.

⁶The 19 cost accounting standards, promulgated by the Cost Accounting Standards Board, are in 48 Code of Federal Regulations, Chapter 99. The standards are applicable to negotiated prime contracts and subcontracts with the U.S. Government in excess of \$500,000. The standards are numbered and referred to as CAS 401-418, and CAS 420.

⁷G&A costs are management, financial, or other costs that are for the general management and administration of a business.

⁸The DCAA provides preaward and postaward contract auditing services, internal control system audits, and other support services to contracting officers from the Department of Defense, NASA, and other Federal agencies.

The subsequent NASA ACO disagreed with the DCAA and the former ACO determinations, and on January 9, 1999, granted the contractor financial relief for the G&A costs associated with employee bonuses.

Our overall objective was to determine whether NASA inappropriately granted relief to a contractor for overpayment of G&A costs billed to the Government under the payload ground operations contract. See Appendix A for details on our scope and methodology.

Results in Brief

We agreed with the DCAA that the contractor improperly billed the Government for G&A costs allocable to unallowable bonus costs. The bonuses were not reimbursable under the terms of the contract and, therefore, were unallowable. The G&A costs allocated to unallowable bonus costs should be identified and excluded from billings to the Government. Although the NASA ACO did not exceed delegated contracting authority, as alleged in the referral, the ACO inappropriately authorized reimbursement to the payload ground operations contractor for G&A costs associated with employee bonuses.

Without seeking legal, procurement, or audit advice, the ACO concluded that the costs associated with the employee bonuses should be reimbursed even though the bonuses were not reimbursed. The billing of G&A costs associated with the bonuses warranted a thorough review, including consultation with audit and legal resources as well as obtaining concurrence of the NASA Procurement Office at Kennedy. As a result of the ACO's autonomous action, NASA reimbursed the contractor an estimated \$2 million⁹ for G&A costs associated with employee bonuses incurred from 1987 through 1996.

On February 14, 2000, we issued a draft report recommending that the Kennedy Center Director rescind the relief given to the contractor and seek recovery for the unallowable G&A costs paid to the contractor. Management nonconcurred with the recommendation, stating that the ACO's "relief granted" was actually an authoritative determination that, based on the contract proposal and the parties' advance agreement, employee bonuses were actually a distribution of fee and not a cost to the contract.

Based on management's response and a lack of clear language in the contract, we concluded that recovery of the estimated \$2 million in G&A costs associated with the bonuses is improbable. However, NASA could be vulnerable if a similar bonus provision is included in other contracts without clarifying language. Therefore, we are revising the audit recommendation to address future contracts.

⁹ The DCAA estimated the \$2 million by comparing the G&A costs without bonuses in the G&A base (\$87,342,971) and with the bonuses in the G&A base (\$85,154,641). The difference of \$2,188,330 is the net increased G&A cost to the Government.

Background

On January 1, 1987, NASA awarded the payload ground operations contract (NAS10-11400) to McDonnell Douglas Astronautics Company,¹⁰ a division of McDonnell Douglas Space Systems Corporation. The contract was for management, services, and property necessary to support all payload activities for which Kennedy has responsibility. The basic contract and options have a total contract value of about \$1.9 billion and cover the 15-year period from January 1, 1987, through December 31, 2001. Unlike other contracts with the company, the payload ground operations contract provides that employee bonuses will be paid from fee. Therefore, NASA does not reimburse the contractor for employee bonuses under this contract.

On June 22, 1988, the corporate administrative contracting officer (CACO),¹¹ located at Huntington Beach, California, issued a report to McDonnell Douglas Space Systems Corporation citing the corporation¹² for being in noncompliance with CAS 405, Accounting for Unallowable Costs. The CACO cited the corporation for being in noncompliance with CAS 405 because the corporation billed the Government for G&A costs allocable to unallowable costs. See Appendix B for DCAA reports and other correspondence related to the noncompliance with CAS 405.

On November 15, 1991, the DCAA, Eastern Region, issued Audit Report No. 1311-91D44200051, citing the payload ground operations contractor for being in noncompliance with CAS 405 and referencing the prior report from the CACO. The contractor did not concur with the DCAA report and declined to make any changes in the accounting treatment of the employee bonuses until the CAS 405 issue was resolved at the corporate level. Resolution at the corporate level was delayed pending the outcome of contractor appeals related to CAS 405 and subsequent court rulings.¹³

In 1992, the NASA ACO at Kennedy issued a final determination that the payload ground operations contractor's billing of G&A costs allocable to unallowable costs (employee bonuses)

¹⁰The company is also known as the Kennedy Space Center Division under which the payload ground operations contract is performed.

¹¹ The CACO is a civil service employee who performs contract administration functions at the corporate level.

¹² The CACO informs the contractor of the initial determination of noncompliance. If the contractor disagrees with the determination, it may submit a rebuttal. After considering any additional information provided by the contractor, the CACO then issues a final determination, which the contractor may appeal.

¹³ Martin Marietta brought a similar CAS 405 noncompliance issue before the Armed Services Board of Contract Appeals. Although the Board ruled against the Government, a Federal Circuit Court decision on December 28, 1993, overturned the Board's previous decision, and the G&A costs allocated to unallowable costs again became unallowable.

was in noncompliance with CAS 405 and the contractor's disclosure statement.¹⁴ In addition, the ACO requested that the contractor submit a cost impact proposal.

Once the court issued its final ruling in favor of the Government in 1993, the CACO began negotiating a settlement with McDonnell Douglas at the corporate level for the CAS 405 violation. The CACO instructed the subsequent NASA ACO at Kennedy to address the CAS 405 issue relating to bonuses because the treatment of bonuses was unique to the payload ground operations contract¹⁵ under the ACO's administration.

Payment of Unallowable G&A Costs

Finding. NASA inappropriately reimbursed the payload ground operations contractor for G&A costs associated with employee bonuses. The terms of the contract excluded bonuses from reimbursement, which made them unallowable. Accordingly, the contractor should not have charged the associated G&A costs to the Government. Without seeking legal, procurement, or audit advice, the NASA ACO inappropriately concluded that the contractor should be reimbursed these costs even though the bonuses were not reimbursed. As a result, the contractor received an estimated \$2 million related to unallowable costs incurred from 1987 through 1996.

FAR Requirements for Treatment of G&A Costs Associated with Unallowable Costs

The FAR, Section 31.001, defines unallowable costs as any cost which, under the provisions of a contract, cannot be included in cost reimbursements under a Government contract to which it is allocable.¹⁶ Although the payload ground operations contract does not specifically state that employee bonuses are unallowable, it does state that "employee bonuses paid pursuant to the . . . employee bonus plan, dated January 1987, will be paid out of fee." The NASA acquisition team stated that NASA had experienced escalating employee bonus costs under previous contracts. Therefore, NASA decided that bonuses would not be reimbursed under the payload ground operations contract but would be paid from award fee.¹⁷ Because the bonuses were allocable, but not reimbursable under the contract, they met the FAR definition of unallowable costs.

¹⁴A disclosure statement is a written description of a contractor's cost accounting practices and procedures. Any business unit receiving a CAS covered contract or subcontract of \$25 million or more must submit a disclosure statement before contract award.

¹⁵Unlike other contracts, the payload ground operations contract provides that employee bonuses will be paid from fee. Therefore, NASA does not reimburse the contractor for employee bonuses under this contract.

¹⁶ FAR 31.201-4 states that a cost is allocable to a Government contract if it (a) is incurred specifically for the contract, (b) benefits both the contract and other work and can be distributed in reasonable proportion to the benefits received, or (c) is necessary to the overall operation of the business.

¹⁷Award fee is a monetary award paid to the contractor based on the Government's judgmental evaluation, which must be sufficient to provide motivation for excellence in contract performance.

As prescribed by FAR, Section 31.203(c), all items that would be part of the cost input base,¹⁸ whether allowable or unallowable, shall bear their pro rata share of G&A costs. Thus, the employee bonuses should be a part of the cost input base and bear a pro rata share of G&A costs. CAS 405 describes the practice for accounting for unallowable costs. This standard provides that any costs directly associated with unallowable costs are also unallowable. The unallowable costs should be identified and excluded from billings to the Government. Pursuant to CAS 405, the G&A costs allocated to unallowable bonus costs should be identified and excluded from billings to the Government.

NASA Grants Financial Relief to a Contractor

The NASA ACO did not formally document the ACO review of the proper accounting treatment of employee bonus costs and its applicability to CAS 405. The ACO review consisted of examining excerpts from the payload ground operations contract and the original contract proposal¹⁹ provided by the contractor. Based on the review, the ACO inappropriately concluded that because the contractor agreed to pay bonuses from award fee, the bonuses were not a cost under the contract. Therefore, the ACO decided that the costs could neither be characterized as unallowable nor subject to CAS 405. The NASA ACO did not agree with the DCAA that the contractor was in noncompliance with CAS 405 with regard to the bonuses.

In addition, the ACO inappropriately accepted the contractor's explanation that the accounting treatment for the bonuses paid from 1987 to 1991 was in error and that the impact was immaterial to the Government. Specifically, the contractor recorded the bonuses in a cost base that carried a share of G&A costs. The contractor contended that the bonuses should not have been included in the base and should not have carried a share of G&A costs. Accordingly, the contractor excluded the bonuses from the cost base for 1992 through 1996. In contrast to the DCAA's estimated impact of more than \$600,000 for 1987 through 1991, the contractor asserted that the impact to the Government was immaterial.²⁰ The ACO agreed with the contractor and on January 9, 1999, issued a letter relieving the contractor of the G&A costs associated with the bonuses.

Procurement or Legal Advice

Although the ACO did not exceed delegated contracting authority as alleged by the DCAA, the ACO did not follow FAR or Agency procedures before granting relief to the contractor.

¹⁸ The cost input base is the cost, except G&A costs, which is allocable to the production of goods and services during a cost accounting period.

¹⁹In response to NASA's request for proposal, McDonnell Douglas Astronautics Company submitted a cost-plus-award-fee proposal for performing the work specified under the payload ground operations contract.

²⁰In response to a November 1991 DCAA report, McDonnell Douglas Astronautics Company prepared a cost impact proposal identifying the G&A costs allocable to unallowable costs as \$21,803.

FAR and Agency Requirements for Contracting Officers. NASA established controls to ensure that procurement actions are in accordance with FAR requirements and in the best interest of the Government. Contracting officers are responsible for ensuring performance of all necessary actions for effective contracting, ensuring compliance with the terms of the contract, and safeguarding the interests of the U.S. in its contractual relationships. Those responsibilities are described in FAR 1.6. The FAR provides contracting officers wide latitude to exercise business judgment. However, FAR Section 1.602-2 provides that contracting officers request and consider the advice of specialists in audit, law, and other fields as appropriate. Further, the ACO's certificate of appointment²¹ for contracting officer authority specifies that any determinations made that conflict with the DCAA recommendations require the concurrence of the procurement officer or his deputy.

In addition, NASA Policy Directive 5101.1D, "Requirements for Legal Review of Procurement Matters," states that NASA legal counsel will provide advice and services to NASA on procurement matters that arise out of contract award and administration.

The ACO's 1999 action reversed the prior ACO's 1992 determination that the contractor was in noncompliance with CAS 405. In addition, the ACO's action conflicted with the audit recommendation contained in the 1991 DCAA report to exclude from reimbursement the G&A costs already billed to the Government. Prior to granting relief, the ACO did not obtain a NASA legal review or concurrence of the procurement officer or his deputy as required by the NASA directive and the contracting officer warrant. Notwithstanding these procurement requirements, the ACO believed that under the provisions of FAR 1.6, the ACO had wide latitude to address the CAS 405 issue and was not required to take any other actions.

Management's Response to Draft Recommendation

On February 14, 2000, we issued the draft of this report, which recommended that the Director, Kennedy Space Center, rescind the relief given to the contractor and seek recovery for the unallowable G&A costs paid to the contractor. Management nonconcurred with the recommendation, stating that the ACO's "relief granted" was actually an authoritative determination that, based on the contract proposal and the parties' advance agreement, employee bonuses were actually a distribution of fee and not a cost to the contract. The complete text of management's response is in Appendix C. Our comments on management's response are in Appendix D.

Need for Clear Language on Bonuses

²¹On March 17, 1997, the ACO was appointed Contracting Officer and was authorized to take actions with respect to contract administration services.

We maintain our position that the employee bonuses were unallowable under the contract and that a share of G&A should have been identified and excluded from billings to the Government. In the absence of clear contract language related to the allowability of the bonus costs and of evidence of the intent of the parties, resolution of the allowability issue rests solely on contract interpretation. Kennedy management concluded that the bonuses were not a cost under the contract based on the contract proposal and the parties' advance agreement. However, the contract proposal did not address the treatment of G&A costs associated with the employee bonuses and the parties' advance agreement was an oral agreement. As a result, we relied on the application of FAR and CAS provisions to determine the proper treatment of bonuses and associated G&A costs.

The payload ground operations contract did not clearly state that the costs for employee bonuses and any associated G&A costs would be unallowable. The DCAA reviewed the contract proposal and recommended that the following specific language be included in any contract resulting from the proposal.

Beginning 1 January 1987, incentive compensation and bonuses (except for the executive bonus plan) for direct/indirect employees shall not be an allowable cost, either direct or indirect, to this contract.

The contract did not include the recommended language, but stated only that "bonuses would be paid from fee." If the parties had clearly stated in the contract that the bonuses were unallowable, then the \$2 million G&A costs associated with the bonuses would have been recoverable by the Government.

Based on management's response and a lack of clear language in the contract, we concluded that recovery of the estimated \$2 million in G&A costs associated with the bonuses is improbable. However, NASA could be vulnerable if a similar bonus provision is included in other contracts without clarifying language. Therefore, we are revising our recommendation to address future contracts. We request that management provide additional comments on this report. The recommendation is considered unresolved and open for reporting purposes.

Recommendation for Corrective Action

The Director, Kennedy Space Center, should clarify in future contracts whether any costs paid from fee, direct and indirect, are allocable and allowable.

Appendix A. Objectives, Scope, and Methodology

Objective

Our overall objective was to determine whether NASA inappropriately granted relief to a contractor for overpayment of G&A costs billed to the Government under the payload ground operations contract.

Scope and Methodology

We limited our review to the alleged CAS 405 violation relating to G&A costs for employee bonuses paid by McDonnell Douglas Astronautics Company under the payload ground operations contract. We interviewed NASA procurement officials, DCAA representatives and contractor employees regarding the contract negotiation and award as well as accounting treatment for employee bonuses paid under the contract.

Management Controls Reviewed

We reviewed the following management controls:

- FAR, Subpart 1.6, “Career Development, Contracting Authority, and Responsibilities,” which describes the responsibilities for contract administration.
- FAR, Part 31, “Contract Costs, Principles, and Procedures,” defines unallowable costs.
- FAR, Subpart 31.2, “Contracts with Commercial Organizations,” which describes composition of total costs and lists factors for determining whether a cost is allowable.
- FAR, Subpart 42.3, “Contract Administration Office Functions,” which describes the functions delegated to an ACO.
- NASA Policy Directive 5101.1D, “Requirements for Legal Review of Procurement Matters,” which requires a NASA legal review of contract administration and award activities.

Audit Field Work

We performed audit field work from September 1999 to January 2000 at NASA Headquarters and Kennedy. We conducted the audit in accordance with generally accepted government auditing standards.

Appendix B. Reports and Correspondence Addressing CAS 405

DCAA Report of Noncompliance, Cost Accounting Standard 405, McDonnell Douglas Space System Company, Kennedy Space Center Division, Report No. 1311-91D44200051, November 15, 1991. The report states that when computing its billable G&A costs on its public vouchers, the contractor includes the unallowable base costs, including bonuses, in its computation even though it does not bill the Government for these costs. This practice results in the Government being billed for G&A costs allocable to unallowable base costs which is in noncompliance with CAS 405.40(a). The DCAA estimated a cost impact of \$584,84 through September 30, 1991. DCAA recommended that the contractor adjust its vouchers to exclude G&A cost allocable to unallowable costs already billed to the Government. The contractor responded that the CAS 405 noncompliance applies to an ongoing issue with the corporate office and, therefore, the contractor did not intend to make any changes locally until the issue was resolved.

Letter from the prior ACO to Kennedy Space Center Division, McDonnell Douglas Space Systems Company, May 5, 1992. The letter communicates the ACO's final determination that the contractor's billing of G&A costs allocable to unallowable costs is in noncompliance with CAS 405 and the contractor's disclosure statement.²² The letter requests the contractor to submit a cost impact proposal.

Letter from McDonnell Douglas Space Systems Company, Kennedy Space Center Division, June 23, 1992. The contractor reiterated its strong disagreement with the determination of having noncomplied with CAS 405. The contractor submitted a cost impact proposal totaling \$21,803 associated with the NASA payload ground operations contract for 1987 through 1991. The letter characterized the cost impact as immaterial.

DCAA Audit Report on Cost Impact Proposal Associated with CAS 405 Noncompliance, Billing of G&A Costs Allocable to Unallowable Costs, McDonnell Douglas Space Systems Company, Kennedy Space Center Division, August 31, 1992. In the DCAA's opinion, the cost impact proposal associated with the CAS 405 noncompliance was inadequate because it excluded unallowable bonus and other costs related to travel. Further, adjusting for the contractor's error results in increased costs of \$898,660 to the Government; \$837,235 of that amount is associated with the payload ground operations contract.

²²A disclosure statement is a written description of a contractor's cost accounting practices and procedures. Any business unit receiving a CAS covered contract or subcontract of \$25 million or more must submit a disclosure statement before contract award.

Appendix B

Assist Audit on CAS 405 Cost Impact, March 15, 1995. The DCAA Titusville Branch Office, Florida, prepared the report for DCAA, Huntington Beach, California, to assist in DCAA's calculation of the CAS 405 Cost Impact at the corporate level for calendar years 1987 through 1994. The DCAA report reaffirms its findings to the contractor in August 1992. The report states that the cost impact prepared by the contractor is inadequate because it excludes the bonus costs from the cost base. Therefore, the costs for the bonuses did not receive their pro rata share of the G&A costs.

Appendix C. Management's Response

National Aeronautics and
Space Administration
John F. Kennedy Space Center
Kennedy Space Center, FL 32899



Reply to Attn of: HM

MAR 29 2000

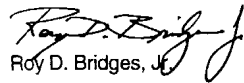
TO: NASA Headquarters
Attn: W/Assistant Inspector General for Auditing

FROM: AA/Director

SUBJECT: Draft Report on the Audit of Relief Granted for Overpayment of
General and Administrative Costs, Assignment Number A9907200

Regarding your letter dated February 14, 2000, subject as above, Kennedy Space Center (KSC) has assessed the recommendation made in the draft report. We nonconcur in the recommendation. Our specific comments are contained in the enclosure to this letter.

Whereas we nonconcur with the recommendation, we do appreciate the opportunity to respond to the draft report. Our Center Audit Closure Official (ACO) will follow standard Agency policy to resolve the nonconcurrency.


Roy D. Bridges, Jr.

Enclosure

cc:
KSC/OIG/S. Massey
HQ/JM/M. Myles
HQ/M/J. Rothenberg
HQ/MX/G. Gabourel
HQ/MX/A. Taylor

Appendix C

RECOMMENDATION 1

The Director, John F. Kennedy Space Center, should rescind the relief given to the contractor and seek recovery for the unallowable G&A costs paid to the contractor.

KSC RESPONSE

Nonconcur.

INTRODUCTION

Both the Defense Contract Audit Agency (DCAA) and the NASA Office of Inspector General (OIG) allege that The Boeing Company (formerly McDonnell Douglas Space Systems Company-Kennedy Space Center (MDSSC)) has violated promulgated Cost Accounting Standards (particularly CAS 405 – Accounting for Unallowable Costs). Both claim the violation is because MDSSC did not allocate G&A to employee bonuses paid by the contractor from fees earned under Contract NAS10-11400, Payload Ground Operations Contract (PGOC).

The PGOC is a cost-reimbursable (Cost Plus Award Fee) contract on which MDSSC was the successful offeror. The contract began in 1987, and is for a fifteen year period inclusive of all options. During the competition for the PGOC, MDSSC (apparently as a proposal strategy to enhance its likelihood of being the successful offeror) proposed that it would use a portion of the award fees that it earned on the PGOC above a performance threshold of 85 to pay bonuses to its employees.

CAS 405 ISSUE

The DCAA, Southwestern Region, issued Audit Report No. 4461-91A44200002, dated May 13, 1991. The audit report stated McDonnell Douglas Space System Company, Huntington Beach (MDSSC-HB) was noncompliant with CAS 405. The cited noncompliance pertained to review of the contractor's billing system which disclosed MDSSC-HB excluded unallowable costs from the General & Administrative (G&A) allocation bases during the period 1984 to 1986. As a result of MDSSC's exclusion, the government was billed for the pro rata share of G&A which should have been allocated to unallowable costs.

Enclosure

BACKGROUND

In 1984, MDSSC-HB created a Non-Reimbursed-Other pool to accumulate unallowable, non-G&A indirect expenses, rather than including them in the G&A Non-Reimbursed pool. However, the pool was still not included in the G&A base and did not receive an allocation of G&A.

Since MDSSC-HB handled the accounting for MDSSC-ES, MDSSC-KSC, and MDSSC-HVS during the 1984-1986 time period, the cited CAS 405 noncompliance was also applicable to these components.

On September 13, 1991, the DCAA Contract Audit Coordinator (DCAA CAC) transmitted the audit report to all DCAA offices. The DCAA CAC recommended that all field audit offices take corrective action to remove G&A cost applicable to unallowable cost that was billed to the Government. As a result of the DCAA CAC recommendation, on November 15, 1991, the DCAA, Eastern Region, Titusville Branch Office issued Audit Report No. 1311-91D44200051, stating MDSSC-KSC was in noncompliance with CAS 405.

On December 2, 1991, the NASA-KSC ACO issued to MDSSC-KSC the Initial Determination of Noncompliance with CAS 405. The Final Determination of Noncompliance with CAS 405 was issued on May 5, 1992. Both the initial and final determinations of noncompliance pertained to MDSSC-KSC billing of G&A costs allowable to "unallowable costs" (not specifically bonuses). The KSC ACO informed MDSSC-KSC on December 30, 1992, that negotiations on the CAS 405 issue would be postponed due to the Government appeal to the U.S. Court of Appeals for the Federal Circuit from an ASBCA ruling pertaining to application of G&A to unallowables.¹

On April 18, 1994, the Corporate Administrative Contracting Officer (CACO) advised all the Division Administrative Contracting Officers (DACOs) that, since all major McDonnell Douglas Corporation (MDC) components had the outstanding CAS 405 noncompliance regarding its failure to include unallowables within its cost base, the CACO would settle all component issues at the corporate level.

During the pendency of the CACO negotiations of the CAS 405 issue with MDC, the CACO contacted the NASA-KSC ACO (1/26/99), indicating the portion of the CAS 405 issue pertaining to bonuses was unique to MDSSC-KSC division only and, therefore, recommending the KSC ACO resolve this issue. Thereafter, the remainder of the CAS 405 issue was negotiated and settled by the CACO.

After review of MDSSC's competitive proposal on the PGOC and the advanced agreement language placed in the resulting contract, the KSC ACO issued a letter to MDSSC addressing the remaining issue regarding G&A on the employee bonus distributions. The KSC ACO letter, although addressed in terms of "relief granted," was

¹ The ruling in Rice v. Martin Marietta Corp., 13 F.3rd 1563 (Fed.Cir. 1993), reversed the ASBCA ruling and held that there was no conflict (and therefore no preemption) between the applicable CAS and the FAR cost principles inasmuch as the CAS addressed allocation relative to the "tax gross up" costs, while the cost principles in the Defense Acquisition Regulations (DAR), one of the predecessors to the FAR, addressed "allowability." The "tax gross up" was set forth in the DAR cost principles as an "expressly unallowable cost."

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actually an authoritative determination that, based on MDSSC's proposal and the parties' advanced agreement, the employee bonus payments were actually a distribution of fee and not a cost (allowable or otherwise) to the contract. Based on that proposal and the Government acceptance of it, the advanced agreement language reflected in the contract merely assured that the contractor would treat the employee bonuses as proposed. There is no provision within the contract nor the FAR cost principles which makes the costs of such employee bonus payments expressly unallowable.

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This latter determination, provided by the KSC ACO to MDSSC-KSC, is not in disagreement nor inconsistent with the former KSC ACO determinations. The initial and final determinations issued by the former ACO applied generally to unallowable costs and G&A loading related thereto, and did not focus on or necessarily pertain to bonuses. With the exception of the bonus issue which the CACO recognized as unique to MDSSC-KSC and the KSC PGOC, the issue of unallowables and G&A allocations thereto was negotiated and settled by the CACO. As noted above, the unique issue relative to the proper treatment of the distribution and accounting for employee bonuses on the PGOC was referred to the KSC ACO. Had the KSC ACO negotiated the entire CAS 405 issue at the local level, the bonuses issue could have been settled at the same time as the issue relative to unallowables generally. It is also expected that, had the former ACO had opportunity to address the bonuses as a stand-alone issue at the time the CACO initially recommended settlement by the local ACO, the results would have been the same.

RATIONALE FOR AGENCY POSITION

The earlier DCAA recommendations and the more recent OIG audit report appear to misread both the contractual provision regarding employee bonuses and the applicability and function of the CAS 405.

There are two essential elements of a cost-reimbursable contract (cost and fee), discussed more fully below:

- **Cost:** The term "cost" is not specifically defined in the FAR, although the term is used to address types of costs and their treatment. Costs may be direct (labor, materials, subcontracts, and other direct costs incurred specifically in performance of contract requirements) or indirect (costs which may benefit more than one final cost objective, and a portion of such costs are allocable to the contract on a causal/beneficial relationship basis). Under a cost-reimbursable contract, the Government reimburses the contractor for the allocable, reasonable and allowable direct costs the contractor incurs in contract performance, along the Government's allocable share of allowable indirect costs. Cost principles relative to allowability are stated in Part 31 of the Federal Acquisition Regulation (FAR) and the NASA FAR Supplement (NFS). Treatment of costs is further governed by promulgated Cost Accounting Standards (CAS) which are addressed in FAR Part 30 and reflected in the FAR Appendix.
- **Fee:** The contractor receives, or may earn, some type of fee (in this case, award fee) depending upon the quality, quantity, timeliness and/or cost of its performance. Contractors may distribute or use earned fees for any number of purposes, generally without the need to provide any accounting for its disposition

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to the contracting agency. Such purposes include actions to (1) pay dividends to stockholders, (2) pay income taxes, (3) share earnings with the employees who were instrumental in the fees being earned, (4) buy back stock that has been previously issued, (5) build reserves for future projects or contingencies, or (6) whatever other purposes a contractor may choose. What a contractor elects to do with its earned fees is not governed by the FAR, NFS or CAS.

Both DCAA and the OIG opined that, since "the contract excluded bonuses from reimbursement," the bonuses paid by MDSSC are "unallowable" costs and, in accordance with CAS 405, should have had G&A allocated to them, thereby reducing the amount of G&A to be reimbursed by the Government. DCAA and the OIG allege that, because G&A was not allocated to these bonuses, the Government has been overcharged by the amount of the G&A which they believe should have been allocated to the bonuses. As to the accounting for these costs, the DCAA infers that the contractor's decision to pay the bonuses out of fee was for the purpose of avoiding the allocation of G&A to bonuses.

Generally speaking, the cost accounting standards (CAS) do not determine allowability, but instead address allocability of costs. FAR 31.201-2(b) notes that "[c]ertain cost principles in this subpart incorporate the measurement, assignment, and allocability rules of selected CAS and limit the cost to the amounts determined using criteria in those selected standards. It is noted that the portion of FAR 31.205-6, Compensation for personal services, which addresses bonuses and incentive compensation (subsection (f)) does not explicitly incorporate the CAS. CAS 405 reflects similar limitations on its application. As stated therein,

This [405] Standard does not govern the allowability of costs. [Allowability] is a function of the appropriate procurement or reviewing authority.

CAS 405-20(b). In this case, the appropriate authority is the KSC ACO, not the DCAA or the NASA OIG.

An examination of the CAS further clarifies the intent behind CAS 405. As stated therein, the express purpose of CAS 405 is —

. . . to facilitate the negotiation, audit, administration and settlement of contracts by establishing guidelines covering:

- (1) Identification of costs specifically described as unallowable, at the time such costs first become defined or authoritatively designated as unallowable, and
- (2) The cost accounting treatment to be accorded such identified unallowable costs in order to promote the consistent application of sound cost accounting principles covering all costs.

(emphasis added). A fundamental requirement of the CAS is that "costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be 'unallowable directly associated costs,' shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract." CAS 405-40(a). "Expressly unallowable cost" is defined as "a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract is specifically named and stated to be unallowable" *(emphasis added)*. Case law has further clarified "expressly unallowable costs" to be the type of costs that a cost principle states is unallowable in its entirety, using direct or unmistakable terms so that the type of cost that is unallowable is

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"clear beyond cavil." Directly refuting the DCAA and the OIG position, the FAR cost principles provide that costs of employee bonuses under qualified arrangements are expressly allowable. The PGOC's contract provision which reflects MDSSC's agreement to make any such payments out of fee (whether viewed as a direct distribution of fee to employees or as a credit against an otherwise allowable cost) clearly does not meet the prerequisites to be classified as an "expressly unallowable cost," nor have the costs been mutually agreed to be "unallowable" between the parties. As to the latter, even if the Government was to attempt to presume that the parties had such an agreement, which it does not, a disagreement by MDSSC prior to some final disposition of the issue effectively defeats the argument that the parties are in "mutual agreement."

It is not uncommon for contractors in competitive environments to propose to share earned fees with their employees to (1) enhance the likelihood their proposals would be selected for award, (2) reward their employees for performance excellence without passing this additional compensation on to the taxpaying public as a contract cost, and (3) make the employees stakeholders in contract performance.

It is clear from a review of the proposal and contract files, Cost Accounting Standards, and FAR/NFS Part 31, that –

- Employee bonuses on the PGOC contract are a distribution of fees, not a contract cost designated as an unallowable cost.
- Notwithstanding the OIG's opinion to the contrary, G&A is not allocable to such fee distributions. The OIG's argument would similarly have contractors, subject to CAS, allocating G&A to dividends paid to stockholders, to income taxes paid to IRS and other taxing bodies, and to other uses of earned fees.

Finally, even if it is determined that MDSSC was in non-compliance with the applicable CAS as a consequence of the manner in which MDSSC accounted for or reported its "costs" (and corresponding credit) or fee distribution in its books, the CAS clause only requires MDSSC to agree to an adjustment if the non-compliance results in an increase in the cost or price the Government would otherwise have to pay under the contract. That does not appear to be the case here, and the ACO's decision to permit MDSSC to correct its reported "error" (or other non-compliance) did not prejudice the Government's interests or increase the costs otherwise payable under the contract.

CONCLUSION

Internal KSC Procurement Office guidelines provide the contracting officers should obtain the concurrence of the Procurement Officer or Deputy prior to making determinations that conflict with a DCAA recommendation. Although the NASA-KSC ACO did not fully follow these internal procedures, the ACO did not exceed the contracting authority delegated to her. The NASA FAR 1.6 provides contracting officers wide latitude to exercise business judgment. Since audit advice was contained in the original audit and reiterated in telecons, further advice from DCAA before making a determination unique to the distribution of fee as employee bonuses under the KSC PGOC was deemed unnecessary. Finally, audit reports and legal advice relative to contract administration are considered advisory. In this case, it appears that there was no conflict or disagreement between the contracting agency's representatives, including the ACO, and the contractor relative to treatment of these fee distributions. On the other

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hand, NASA-KSC is concerned that the implied attempt to interject the DCAA and OIG directly into contract administration and contracting officers' and administrative contracting officers' contract interpretation activities and determinations (such as cost allowability) would improperly restrict the contracting officers' delegated authority and would have a serious adverse impact on the negotiation process and the efficacy of contract settlements.

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OIG Comment 5

Based on a review of the proposal information and contract provision, there is no indication that the parties to the PGOIC agreed or otherwise intended by their advance agreement to require an allocation of G&A to the contractor's distribution of a share of its fee to employee bonuses. Further, there is nothing in the contract, the FAR cost principles, or other identified legal requirement that makes the costs of qualified employee bonus programs expressly unallowable. Based on the documentation and other information available to it, NASA-KSC concludes that any attempt to allocate MDSSC's G&A to that portion of its fee distributed to employees in the form of bonuses is counter to the PGOIC parties' apparent advanced agreement relative to such bonuses under the contract, inappropriate, and likewise indefensible. NASA-KSC also believes it is inappropriate to set a precedent that would require contractors to account for fee distribution to or profit sharing with their employees as a part of their G&A cost base.

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OIG Comment 6

If you have questions or concerns, please contact Mr. James E. Hattaway, Jr., Director of the Procurement Office, at 321-867-7212.

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Appendix D. OIG Comments on Management's Response

Kennedy management provided the following general comments in its response to our draft report. Our responses to the comments are also presented.

Management's Comment. There is no provision within the contract or the FAR cost principles that makes the costs of such employee bonus payments expressly unallowable. Generally speaking, the CAS does not determine allowability, but instead addresses allocability of costs. A fundamental requirement of CAS is that "cost expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract."

1. OIG Comments. Although we agree that the bonuses were not stated in the contract to be expressly unallowable, the parties mutually agreed that bonuses would not be reimbursed under the contract and they were, therefore, unallowable under the contract terms. We concluded that the bonuses were unallowable based on FAR 31.001, which states that unallowable costs are any costs which, under the provisions of a contract, cannot be included in cost reimbursements under a Government contract to which it is allocable. We further concluded that these costs were allocable because the bonuses benefited both the NASA contract and other contract work and could be distributed in reasonable proportion to the benefits received. This position is strengthened by the fact that the bonuses were allocable to other contracts with the Government.

Management's Comment. The latter determination provided by the ACO is not in disagreement or inconsistent with the former ACO determinations. The determinations of the former ACO applied generally to unallowable costs and G&A allocation related thereto and did not focus on or necessarily pertain to bonuses. It is also expected that, had the former ACO had the opportunity to address bonuses as a stand alone issue, the results would have been the same.

2. OIG Comments. The former ACO issued a final determination that the contractor's billing of G&A allocable to unallowable costs was in noncompliance with CAS 405 and the contractor's disclosure statement. DCAA records show that employee bonuses represented about 99 percent of the questioned unallowable costs for the reported period 1987 through 1991. Consequently, the majority of the CAS 405 noncompliance addressed by the former ACO's determination pertained to the bonuses.

Management Comment. Contractors may distribute or use earned fees for any number of purposes, generally without the need to provide any accounting for its disposition to the contracting agency. What a contractor elects to do with its earned fee is not governed by the FAR, NASA FAR Supplement, or CAS.

3. OIG Comments. We agree that the contractor may use or distribute fee for any number of purposes. However, the use of fee is not pertinent to the treatment of bonus costs. The fact that the contractor agreed to pay employee bonuses from fee does not change the nature of the bonuses as a contractor cost. Further, the contractor agreed to pay the bonuses from fee only because Kennedy indicated that it would not continue to pay the contractor's escalating bonus costs. In addition, the contractor used this strategy to enhance the likelihood of winning the contract award.

Management Comment. The ACO's decision to permit the contractor to correct its reported "error" did not prejudice the Government's interest or increase the costs otherwise payable under the contract.

4. OIG Comments. We disagree that the ACO's action did not increase the cost to NASA under the contract. By not requiring the contractor to include the bonuses in the base and bear a pro rata share of G&A, the contractor billed NASA about \$2 million related to the bonus costs incurred from 1987 through 1996.

Management Comment. Kennedy management is concerned that the implied attempt to interject the DCAA and OIG directly into contract administration activities would improperly restrict the contracting officer's delegated authority and would have a serious impact on the negotiation process and the efficacy of contract settlements.

5. OIG Comments. The Inspector General Act of 1978 established the Offices of Inspector General to provide independent and objective audits relating to the programs and operations of the Agency. While fulfilling that purpose, we avoid restricting the contracting officer's authority or affecting the negotiation process. For this audit, we reviewed negotiations and contract provisions that were already completed.

Management Comment. Kennedy management believes it is inappropriate to set a precedent that would require contractors to account for fee distribution to or profit sharing with their employees as a part of their G&A cost base.

6. OIG Comments. We are not suggesting that NASA require contractors to account for fee distribution. Rather, as prescribed by the FAR, NASA must consider the treatment of costs such as bonuses for allocability and allowability to the contract independent of how such costs are paid by the contractor.

Appendix E. Report Distribution

National Aeronautics and Space Administration (NASA) Headquarters

A/Administrator
AI/Associate Deputy Administrator
B/Chief Financial Officer
B/Comptroller
G/General Counsel
H/Associate Administrator for Procurement
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HS/Director, Program Operations Division
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JM/Director, Management Assessment Division
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Non-NASA Federal Organizations and Individuals

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Deputy Associate Director, Energy and Science Division, Office of Management and Budget
Branch Chief, Science and Space Programs Branch, Energy and Science Division, Office of Management and Budget
Associate Director, National Security and International Affairs Division, Defense Acquisitions Issues, General Accounting Office
Professional Assistant, Senate Subcommittee on Science, Technology, and Space

Chairman and Ranking Minority Member – Congressional Committees and Subcommittees

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Senate Subcommittee on VA, HUD, and Independent Agencies
Senate Committee on Commerce, Science, and Transportation
Senate Subcommittee on Science, Technology, and Space
Senate Committee on Governmental Affairs

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House Subcommittee on Space and Aeronautics, Committee on Science

House Subcommittee on Government Management, Information, and Technology

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**Report Title: Relief Granted to Contractor for Overpayment of
General and Administrative Costs**

Report Number: _____ **Report Date:** _____

Circle the appropriate rating for the following statements.

	Strongly Agree	Agree	Neutra l	Disagre e	Strongl y Disagre e	N/A
1. The report was clear, readable, and logically organized.	5	4	3	2	1	N/A
2. The report was concise and to the point.	5	4	3	2	1	N/A
3. We effectively communicated the audit objectives, scope, and methodology.	5	4	3	2	1	N/A
4. The report contained sufficient information to support the finding(s) in a balanced and objective manner.	5	4	3	2	1	N/A

Overall, how would you rate the report?

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Thank you for your cooperation in completing this survey.

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