Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut
**1. REPORT DATE**
24 SEP 2010

**2. REPORT TYPE**

**3. DATES COVERED**
00-00-2010 to 00-00-2010

**4. TITLE AND SUBTITLE**
Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut

**5a. CONTRACT NUMBER**

**5b. GRANT NUMBER**

**5c. PROGRAM ELEMENT NUMBER**

**5d. PROJECT NUMBER**

**5e. TASK NUMBER**

**5f. WORK UNIT NUMBER**

**6. AUTHOR(S)**

**7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)**
Department of Defense Inspector General, 4800 Mark Center Drive, Alexandria, VA, 22350-1500

**8. PERFORMING ORGANIZATION REPORT NUMBER**

**9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)**

**10. SPONSOR/MONITOR’S ACRONYM(S)**

**11. SPONSOR/MONITOR’S REPORT NUMBER(S)**

**12. DISTRIBUTION/AVAILABILITY STATEMENT**
Approved for public release; distribution unlimited

**13. SUPPLEMENTARY NOTES**

**14. ABSTRACT**

**15. SUBJECT TERMS**

**16. SECURITY CLASSIFICATION OF:**

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**17. LIMITATION OF ABSTRACT**
Same as Report (SAR)

**18. NUMBER OF PAGES**
81

**19a. NAME OF RESPONSIBLE PERSON**
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MEMORANDUM FOR DIRECTOR, CONTRACTS, NAVAL SEA SYSTEMS COMMAND
DIRECTOR, CONTRACTS DIVISION, SHIPBUILDING DIVISION NAVAL SEA SYSTEMS COMMAND
SUPERVISOR OF SHIPBUILDING, CONVERSION AND REPAIR, GROTON, CONNECTICUT

SUBJECT: Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut (Report No. D-2010-6-003)

We are providing this report for your review and comment. We performed this review in accordance with DoD Instruction 7640.02, which requires that we monitor and evaluate systems in the Department of Defense for follow-up on contract audits.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Department of Navy comments were partially responsive. Please reconsider your responses to Recommendation A.1.e, A.2.b(iii), B.4, and C.1, including your response to each associated Finding, and provide additional comments to Recommendations A.1.b, A.1.c, A.1.d, and A.2.b. Please establish a suspense date of October 30, 2010.

Please ensure your comments conform to the requirements of DoD Directive 7650.3. Send your management comments in electronic format (Adobe Acrobat file only) to the email address cited in the last paragraph of this memorandum. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the /Signed/ symbol in place of the actual signature.

We appreciate the courtesies extended to our staff. Questions should be directed to Ms. Carolyn R. Davis at (703) 604-8877 (DSN 664-8877), Carolyn.Davis@dodig.mil.

[Signature]
Randolph R. Stone
Deputy Inspector General
for Policy and Oversight
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Results In Brief

What We Did
For semiannual reporting periods ending between September 30, 2004, and March 31, 2007, we evaluated the actions taken by contracting officials at the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut, to establish final indirect cost rates on cost reimbursable-type contracts. We reviewed certain Memoranda of Agreement for compliance with procurement regulations and performed an in-depth review of contracting officer actions taken to liquidate contract debts totaling $3.8 million.

What We Found
Final indirect cost rates established by contracting officials since the 1970s at the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut, did not comply with the Federal Acquisition Regulation and the Cost Accounting Standards. Groton contracting officials had not taken action to resolve an allegation of noncompliance with the Cost Accounting Standards reported by the Defense Contract Audit Agency. Groton contracting officials had not justified their actions when executing Memoranda of Agreement with the contractor with approved business clearance memoranda. Groton contracting officials had improperly liquidated contractor debt totaling $3,882,926 against two unpaid bills totaling $3,615,860. One unpaid bill was for a funding shortfall of $1,696,860 on a submarine overhaul contract and represented a potential Antideficiency Act violation. We concluded the other unpaid bill, said to equal $1,919,000 for contractor pension costs, was in effect consideration given to the contractor for agreeing to circumvent the legally binding requirements of an existing Advance Agreement on Pension Cost when entering into the SSN-23 SEAWOLF Contract. We find no provision in the Federal Acquisition Regulation that would allow for the use of such an arrangement as the basis for offsetting a legitimate contractor debt.

What We Recommend
We recommend the Department of Navy take vigorous action to recover $1,919,000 in contractor debt wrongly offset against an 'unpaid bill' for pension costs. We also recommend the Navy re-evaluate all aspects of the $3,882,926 debt liquidation for compliance with the Federal Acquisition Regulation in effect at the time. We recommend that contracting officials at the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut, negotiate final indirect cost rates in accordance with the Federal Acquisition Regulation and the Cost Accounting Standards and take action to demonstrate that past practices did not result in increased costs to the United States. We recommend they drop the use of the ‘Reservation of Rights’ practice which delays cost negotiation to future years, and re-evaluate the sufficiency of all existing Memoranda of Agreement and contract case files.
Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut

Results In Brief (cont’d)

Management Comments and Our Responses
The Navy concurred with 17 of 28 recommendations, concurred in principle with six, partially concurred with two, and nonconcurred with three recommendations. The Navy concurred in principle with our finding on final indirect cost rates and revised its practices. The Navy agreed to determine whether their noncompliance with Cost Accounting Standard 406 resulted in increased costs on US Government contracts, and to act upon a prior auditor allegation of contractor noncompliance with the Cost Accounting Standards. The Navy concurred in principle with our findings on business clearance memoranda and poor contract case file maintenance. The Navy did not concur with our finding and recommendation to discontinue use of the Reservation of Rights practice. The Navy budgeting office found that Groton officials had improperly authorized contract debt liquidation in the amount of $3,882,926, had violated the Purpose Statute, but did not violate the Antideficiency Act. A Navy official determined that the same debt liquidation was undertaken in good faith.

Regarding the $1,919,000 debt liquidation granted the contractor for pension cost, the Navy concurs in principle, but believes the treatment of pension costs in the negotiation of the SEAWOLF contract resulted in the lowest cost solution for the Government. We request that the Department of Navy reconsider its responses to Recommendations A.1.e, A.2.b(iii), B.4, and C.1, including your response to each associated Finding, and provide additional comments to Recommendations A.1.b, A.1.c, A.1.d, and A.2.b. Please establish a suspense date of October 30, 2010.
Introduction

Objective

The objective of the project was to evaluate the actions taken by contracting officials at the Supervisor of Shipbuilding, Conversion and Repair, Groton, to establish final indirect cost rates in accordance with Federal Acquisition Regulation 52.216-7, Allowable Cost and Payment. In addition, we evaluated certain 2004 Memoranda of Agreement entered into by senior Groton contracting officials to ensure that all actions complied with (i) the requirements of law, executive orders, regulations, and other applicable procedures and, (ii) ensured compliance with the terms of the contract and safeguarded the interests of the United States in its contractual relationships. See Appendix A for additional details regarding our scope.

Background

Naval Sea Systems Command. Naval Sea Systems Command is the largest of the Navy's five system commands and the Navy’s central activity for designing, engineering, integrating, building, and procuring ships and shipboard weapons and combat systems. The Naval Sea Systems Command awards nearly $24 billion in contracts annually for new construction of ships and submarines, ship repair, major weapon systems and services. The mission of Naval Sea Systems Command is to develop, deliver and maintain ships and systems for the United States Navy. The Contracts Directorate, headed by the Director of Contracts, Naval Sea Systems Command, is headquartered in Washington, District of Columbia. One component of the Contracts Directorate is the Shipbuilding Division. The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton, has a dual reporting relationship to the Director of Contracts through the Shipbuilding Division Director.

Supervisor of Shipbuilding, Conversion and Repair, Groton. The Supervisor of Shipbuilding, Conversion and Repair, Groton, is the liaison between the Department of the Navy and the contractor who is engaged in the design and construction of new nuclear powered submarines as well as the repair and modernization of submarines in the Fleet. The Supervisor's responsibilities include administering all contracts, outfitting the ships, assuring that the technical and quality assurance requirements of the contracts are fully met and that the final product delivered to the Fleet is ready to sail "in harms way.” The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton, has a direct reporting relationship to the Supervisor of Shipbuilding, Conversion and Repair, Groton, and a functional reporting relationship to the Director, Shipbuilding Contracts, Naval Sea Systems Command.

Defense Contract Audit Agency. The mission of the Defense Contract Audit Agency, while serving the public interest as its primary customer, is to perform all necessary contract audits for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department Components responsible for procurement and contract administration. The Agency issues reports resulting from several types of audits, such
as audits of costs incurred by Government contractors on cost reimbursable contracts. The Defense Contract Audit Agency performs this type of audit to determine whether the costs incurred by a contractor and charged on Government contracts are allowable, allocable, and reasonable based on applicable criteria in the Federal Acquisition Regulation, Defense Federal Acquisition Regulation Supplement, and Cost Accounting Standards. The Defense Contract Audit Agency issued eight incurred cost audit reports to Supervisor of Shipbuilding, Conversion and Repair, Groton, covering contractor fiscal years 1997 through 2004.


Findings

A. Noncompliant Method for Administering Indirect Cost Rates on Cost Reimbursable Type Contracts

The Business Operations Department, Supervisor of Shipbuilding, Conversion and Repair, Groton, does not comply with the Federal Acquisition Regulation and the Cost Accounting Standards when establishing final indirect rates\(^1\) for use in settling Government cost reimbursement type contracts. The Groton Business Operations Department uses a Post Audit Disallowance Factor\(^2\) in lieu of final indirect cost rates to remove unallowable costs from cost-reimbursable contracts subject to Federal Acquisition Regulation 31.2 - Contracts with Commercial Organizations. In 2004 the Groton Business Operations Department set aside $94 million in contractor costs recorded in fiscal years 1997 through 2001 for later negotiation and settlement, using a 'Reservations of Rights' practice. As reported in Department of Defense Inspector General Report No. D-2008-06-005, dated May 6, 2008, we found that Groton personnel had used the Post Audit Disallowance Factor to shift $15.4 million in unallowable corporate office costs recorded in contractor fiscal years 1997 through 1999 to fiscal year 2006 for settlement.

The Post Audit Disallowance Factor includes unallowable costs recorded by the contractor in prior cost accounting periods. This occurs when costs previously 'reserved' are determined in a later contractor cost accounting period to be unallowable but the original accounting period has been closed for cost accounting purposes. In this situation, personnel at the Groton Business Operations Department adjust the Post Audit Disallowance Factor for the next open contractor fiscal year. This practice shifts unallowable costs incurred in a prior cost accounting period to a future cost accounting period in violation of Cost Accounting Standard 406 - Cost Accounting Period.\(^3\) The use of the Post Audit Disallowance Factor is a

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\(^1\) On cost-reimbursable type government contracts, the government and contractor establish final indirect cost rates for each contractor fiscal year. The final indirect cost rates must exclude any contractor indirect costs that are found by the contracting officer to be unallowable or unallocable in accordance with Federal Acquisition Regulation Part 31.2 – Contracts with Commercial Organizations and the Cost Accounting Standards established by the Cost Accounting Standard Board. The final indirect cost rates established by the government are used to determine the final allowable cost on government cost reimbursable type contracts.

\(^2\) The factor represents all negotiated contractor unallowable costs regardless of how the costs had been originally classified by the contractor; i.e., as general and administrative expense, employee fringe benefits, or overhead. The Post Audit Disallowance Factor is applied to existing contracts using a direct labor cost base.

\(^3\) Cost Accounting Standard 406 - Cost Accounting Period, establishes criteria for the selection of the time period to be used as a cost accounting period for contract cost estimating, accumulating, and reporting. A fundamental requirement of Cost Accounting Standard 406 is that the same cost accounting period shall be used for accumulating costs in an indirect cost pool as for establishing its allocation base.
practice that is not compliant with the Federal Acquisition Regulation and the Cost Accounting Standards, but has been in use at Groton since the 1970s.

Noncompliance with Federal Acquisition Regulation 52.216-7 Allowable Cost and Payment. The use by the Groton Business Operations Department of a Post Audit Disallowance Factor in lieu of final indirect cost rates to segregate unallowable costs does not comply with Federal Acquisition Regulation 52.216-7 – Allowable Cost and Payment. The contract clause requires that each final indirect cost rate exclude unallowable costs, as shown in the records maintained by the contractor. However, under the Groton practice, contractor indirect cost rates included identified unallowable costs. In lieu of complying with Federal Acquisition Regulation 52.216-7 and excluding unallowable costs from each indirect cost rate, Groton used the Post Audit Disallowance Factor. As a result of this Contract Audit Follow-Up project, and as discussed further in the section below for Groton Proposed Corrective Action, the Groton Business Operations Officer has proposed discontinuing the use of the Post Audit Disallowance Factor.


\begin{quote}
Cost accounting standards promulgated under this section shall be mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with pricing and administration of, and settlement of disputes concerning, all negotiated prime contract and subcontract procurements with the United States in excess of the amount set forth in section 2306a(a)(1)(A)(i) of title 10, as such amount is adjusted in accordance with applicable requirements of law.
\end{quote}

Use of the Post Audit Disallowance Factor by the Groton Business Operations Department violates the provisions of Cost Accounting Standard 406 - Cost Accounting Period. For example, Groton contracting officials included $15.4 million in unallowable corporate office costs recorded by the contractor in fiscal years 1997 through 1999 in the Post Audit Disallowance Factor used to adjust contract costs in the contractor’s cost accounting period for 2006. Cost Accounting Standard 406 was effective as of April 17, 1992. The Groton practice for use of the Post Audit Disallowance Factor dates from the 1970s.

Measure of Materiality of Cost Impact, Violation of Cost Accounting Standard 406. Personnel in the Groton Business Operations Department could not demonstrate that the ongoing violation of Cost Accounting Standard 406 caused by use of the Post Audit Disallowance Factor has had a material or immaterial cost impact on Government contract

\textsuperscript{4} 41 U.S.C. 422 has been incorporated into the Federal Acquisition Regulation at 48 Code of Federal Regulations Chapter 99 (Federal Acquisition Regulation Appendix). Federal Acquisition Regulation Part 30 Cost Accounting Standards Administration describes policies and procedures for applying the Cost Accounting Standards Board rules and regulations.
prices and costs. Although they asserted an immaterial cost impact on individual indirect cost rates for a particular cost accounting period, they did not demonstrate their assertion using the criteria provided at Federal Acquisition Regulation 30.605 and 48 Code of Federal Regulations 9903.305 – Materiality.


- The contractor's practice of recording prior period indirect cost adjustments as a current year cost separation shop order is noncompliant with Cost Accounting Standards 401 and 402 and produces an inaccurate final rate presentation.
- The contractor should be required to bill costs for all contracts in the same accounting/billing period that the costs were recognized.
- The contractor should be required to record the prior period costs in the specific account, in the appropriate cost pool, and allocate the expense to final cost objectives through the applicable overhead, fringe benefit, or General and Administrative rate applicable to the cost accounting period in which the expense was recorded.

Groton Proposed Corrective Action. By memorandum to the Office of the Assistant Inspector General for Audit Policy and Oversight dated July 16, 2009, the Groton Business Operations Officer reported that he had initiated actions to improve (i) the process by which the Groton Business Operations Department and the contractor negotiate settlement of claimed contractor incurred costs, and (ii) the contractor’s practice for accounting for unallowable costs. Included in the action plan were the following:

- Discontinue the use of the Post Audit Disallowance Factor in its entirety.
- Require the contractor to begin submitting certified final indirect rate proposals using allowable indirect cost rates in compliance with Federal Acquisition Regulation 52.216-7.

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5 Criteria for determining whether amounts of costs are material or immaterial are provided at 48 Code of Federal Regulations 9903.305 – Materiality, and include the absolute dollar amount involved, the impact on Government funding, and the cumulative impact of individually immaterial items.

6 Federal Acquisition Regulation 30.605 – Processing Noncompliances, provides procedures a contracting officer must follow prior to making a contract price or cost adjustment under the applicable contract clauses. The first procedure is to either notify the auditor within 15 days of receiving a report of alleged noncompliance that the contracting officer disagrees with the alleged noncompliance, or issue a notice of potential noncompliance to the contractor.
• Limit the use of “Reservation of Rights” practice. The contracting officer will no longer move negotiated and settled costs forward into the next open accounting period after an incurred cost year has been settled and closed. Instead, the Groton Business Operations Department shall require the contractor to issue payment in the form of a check payable to the United States Treasury.

Office of Inspector General Comments, Groton Proposed Corrective Action. The Department of Defense Inspector General, Office of the Assistant Inspector General for Audit Policy and Oversight, believes the proposed corrective action plan, if implemented, will not go far enough to bring the business practices used by the Groton Business Operations Department into compliance with the Federal Acquisition Regulation and Cost Accounting Standards. The corrective action plan does not (i) address Cost Accounting Standards administration, and (ii) provides for the continued use of the ‘Reservation of Rights’ practice.

(i) Cost Accounting Standards Administration. The plan does not address actions necessary to achieve compliance with 41 USC 422 and Federal Acquisition Regulation Part 30, Cost Accounting Standards Administration. The allegations of noncompliance with Cost Accounting Standards 401 and 402 included in Defense Contract Audit Agency Report No. 02361-2003B17900017 need to be addressed by the Groton Business Operations Department as required by Federal Acquisition Regulation 30.605 – Processing Noncompliances. Additionally, the violation of Cost Accounting Standard 406 caused by the past use of the Post Audit Disallowance Factor as identified in this report needs to be examined to ensure the Government has not paid increased prices and costs on contracts subject to the Cost Accounting Standards.

(ii) Reservation of Rights. The use of the ‘Reservation of Rights’ procedure must be ended. “Reservation of Rights’ simply delays the negotiation of cost issues and pushes costs into future cost accounting periods in violation of Cost Accounting Standard 406. These delays jeopardize the Government’s position by risking the loss of government records and personnel familiar with the cost issue (see Findings B and C). All cost allowability and allocability issues except those specifically addressed by the Cost Principle at Federal Acquisition Regulation 31.205-47 – Costs Related to Legal and Other Proceedings7, must be addressed, negotiated and settled as a part of the settlement of the contractor’s fiscal year final indirect cost rates. The Federal Acquisition Regulation does not provide for the deferral of any other type of cost issue. The duty given the administrative contracting officer in Federal Acquisition Regulation Part 42.7 –

7 The cost principle provides that a contracting officer shall generally withhold payment of contractor costs incurred in connection with any proceeding brought by a Federal, State, local or foreign government for violation of law or regulation, including actions brought by a third party under the False Claims Act. However, the Cost Principle provides that, if in the best interests of the Government, the contracting officer may provide for conditional payment upon provision of adequate security, or other adequate assurance, and agreement by the contractor to repay all unallowable costs, plus interest, if the costs are subsequently determined to be unallowable.
Indirect Cost Rates, is to settle all indirect cost issues when establishing final indirect cost rates for a contractor’s fiscal year.8

Management Comments on the Finding and Our Response.

The Assistant Secretary of the Navy (Research Development and Acquisition), provided the Department of Navy response dated May 21, 2010. A summary of the comments is provided below. The full text of the response is provided in the Management Comments section of the report.

Management Comments: Noncompliant Method for Administering Indirect Cost Rates on Cost Reimbursable Type Contracts. The Department of Navy concurred with the finding.

Our Response. The Navy comments were responsive.

Management Comments: Noncompliance with Federal Acquisition Regulation 52.216-7 Allowable Cost and Payment. The Department of Navy concurred in principle, stating that Groton did comply with Federal Acquisition Regulation 52.216-7 Allowable Cost and Payment. In his response, The Assistant Secretary of the Navy (Research Development and Acquisition) stated that the disagreement between the Inspector General and the Groton Business Operations Department was a disagreement on the technique used to comply with the applicable Federal Acquisition Regulation, and that both techniques achieve the same result of excluding unallowable costs from indirect cost rates. He commented that in light of the Inspector General concern, the contractor has revised their billing practice to exclude unallowable costs by cost element, effective January 1, 2009.

Our Response. We disagree. The practice used by Groton to settle indirect rates using a Post Audit Disallowance Factor did not comply with Federal Acquisition Regulation 52.216-7 and Cost Accounting Standard 406.

Management Comments: Noncompliance with 41 U.S.C. 422 – Cost Accounting Standards Board. The Department of Navy concurred with the finding.

Our Response. The Navy comments were responsive.

Management Comments: Measure of Materiality of Cost Impact, Violation of Cost Accounting Standard 406. The Department of Navy did not concur. In his response, The Assistant Secretary of the Navy (Research Development and Acquisition) stated that

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8 Federal Acquisition Regulation 42.705-1(b)(5) states that the cognizant contracting officer shall conduct negotiations and prepare, sign, and place in the contractor general file a negotiation memorandum covering a reconciliation of all costs questioned, with identification of items and amounts allowed or disallowed in the final settlement as well as the disposition of period costing or allocability issues.
Groton firmly believes that the Government was not harmed by the practice of using the post audit disallowance factor. He stated that during the OIG review, Groton provided a cost impact demonstrating the immateriality. The Assistant Secretary of the Navy (Research Development and Acquisition) also provided that the contractor’s change in accounting and billing practices, effective January 1, 2009, has modified this practice to be consistent with the Inspector General recommendation.

Our Response. We disagree. Subsequent to receipt of the Department of Navy response, we held meetings with Naval Sea Systems Command contracting officials (Director for Contracts, Deputy Director of Contract Policy, and Director, Shipbuilding Contracts) to discuss the evidence supporting our draft report findings as well as what we perceived as factual inaccuracies with the Department of Navy response. We recommended the Department of Navy re-evaluate its nonconcurrence for the following reasons:

- The Department of Navy needs to apply the provisions of Federal Acquisition Regulation 30.6 to demonstrate objectively whether a noncompliant cost accounting practice resulted in a material or immaterial cost impact on Department of Defense Cost Accounting Standard-covered contracts. This action will obviate any need to rely upon a ‘firm belief’ that the Government was not harmed.

- The ‘cost impact demonstrating the immateriality’ referenced in the Department of Navy response: -
  
  (i) Was limited to an evaluation of the dollar impact across burden centers within the same cost accounting period and did not address the $15.4 million instance of noncompliance identified in Finding A of this report.

  (ii) Did not demonstrate materiality in accordance with 48 CFR 9903.305.

  (iii) Did not address the Cost Accounting Standard 406 noncompliance identified in this report.

  (iv) Did not originate as a part of an action to administer an allegation of a Cost Accounting Standard noncompliance, but instead arose from an October 13, 2000 Memorandum of Agreement with the contractor detailing procedures to be used to close contracts under Federal Acquisition Regulation 42.708 Quick-closeout procedure.

  (v) Was not accompanied by a contracting officer determination of noncompliance as required by Federal Acquisition Regulation 30.6. Such determination shall have stated that the cost accounting practice was noncompliant but immaterial, or noncompliant and requiring the submission of a general dollar magnitude cost impact calculation.
**Updated Management Comments:** Measure of Materiality of Cost Impact, Violation of Cost Accounting Standard 406. Subsequent to the May 21, 2010 Assistant Secretary of the Navy (Research Development and Acquisition) response, the Director, Program Analysis and Business Transformation, Deputy Assistant Secretary of the Navy, (Acquisition and Logistics Management) provided an update to the Department of Navy response dated August 27, 2010. The full text of the response is provided in the Management Comments section of the report.

The Director, Program Analysis and Business Transformation, responded that the Department of Navy concurs in principle with the finding. Upon receipt of a signed final report from the Inspector General asserting a Cost Accounting Standard 406 noncompliance, the Navy will process the alleged noncompliance in accordance with the procedures at Federal Acquisition Regulation 30.605.

**Our Response.** The Navy comments were responsive.

**Management Comments:** Failure to Make a Determination after Receipt of Report of Alleged Noncompliance from Auditor. The Department of Navy did not concur. In his response, the Assistant Secretary of the Navy (Research Development and Acquisition) stated the referenced Defense Contract Audit Agency Report on Agreed-Upon Procedures No. 02361 - 2003B17900017 was not issued as a Cost Accounting Standards noncompliance report (i.e., Reportable Audit), and therefore was not treated as such. He stated that the Defense Contract Audit Agency issued their report at the request of the Groton administrative contracting officer to evaluate the contractor’s financial system for potential improvement. He provided that subsequent to the issuance of the Agreed Upon Procedures report, the Defense Contract Audit Agency issued a report on the contractor’s Cost Accounting Standards Disclosure Statement, wherein the Defense Contract Audit Agency reported the contractor’s practices, as described, comply with applicable Cost Accounting Standards and Federal Acquisition Regulation Part 31 and are consistent with the contractor’s actual practices. The Assistant Secretary of the Navy (Research Development and Acquisition) provided that the Defense Contract Audit Agency has not issued a non-compliance audit relative to the original Agreed-Upon Procedures report.

**Our Response.** We disagree. Subsequent to receipt of the Department of Navy response, we held meetings with Naval Sea Systems Command contracting officials (Director for Contracts, Deputy Director of Contract Policy, and Director, Shipbuilding Contracts) to discuss the evidence supporting our draft report findings as well as what we perceived as factual inaccuracies with the Department of Navy response. We recommended the Department of Navy re-evaluate its nonconformance with this finding for the following reasons:

- The Department of Navy response fails to recognize that there is no provision in the Federal Acquisition Regulation that would release Groton from responding to a report of an allegation of Cost Accounting Standard noncompliance due solely to the type of report issued by the auditor. Federal Acquisition Regulation
30.602-2(a) simply required that "Within 15 days of the receipt of a report of alleged noncompliance from the cognizant auditor, the ACO shall make an initial finding of compliance or noncompliance and advise the auditor."

- Existing Groton Business Operations Department records refute the claim made by the Department of Navy that the Defense Contract Audit Agency issued their report at the request of the Groton administrative contracting officer to “evaluate the contractor’s financial system for potential improvement.” Specifically, the August 20, 2003 Groton request to the Defense Contract Audit Agency for audit services stated:

  1. At this time our office would like to request your audit assistance in performing a comprehensive review of prior year overhead adjustments made by [the contractor] on an annual basis.

  2. Specifically, we would like your office to review said adjustments relative to
     - The requirements of CAS [Cost Accounting Standards]
     - GAAP
     - Share Ratios on Various Affected Contracts
     - Escalation Impact of Prior Year Adjustments
     - Billing Practices on Outdated or Inactive Contracts

- The contractor was using the same allegedly noncompliant practice reported by the Defense Contract Audit Agency on September 14, 2004 to record prior period adjusting journal entries totaling $14.1 million on its fiscal year 2006 accounting records. The Defense Contract Audit Agency alleged the contractor was in noncompliance with Cost Accounting Standards 401 and 402 and that the contractor should be required to bill costs for all contracts in the same accounting period that the costs were recognized.

We acknowledge that the Defense Contract Audit Agency issued on November 17, 2006 a report on the contractor's revised Disclosure Statement, and that this report did not include the same allegation of noncompliance. However, the SUPSHIP Groton administrative contracting officer responsible for Cost Accounting Standard administration could not demonstrate that she had ever addressed and resolved the previous allegations of noncompliance reported by the Defense Contract Audit Agency on September 14, 2004. The Federal Acquisition Regulation assigns responsibility for Cost Accounting Standard administration to the administrative contracting officer. The Groton administrative contracting officer should have acted on the September 14, 2004 report within 15 days of receipt. As of the date of our draft report, March 23, 2010, the SUPSHIP Groton administrative contracting officer had not met that responsibility.

**Updated Management Comments:** Measure of Materiality of Cost Impact, Violation of Cost Accounting Standard 406. In the August 27, 2010 management comments, the Director, Program Analysis and Business Transformation, responded that
the Department of Navy concurs in principle and that the Groton Business Operations Department had located a January 31, 2005 record requesting the contractor respond to the September 14, 2004 Defense Contract Audit Agency report.

Management Comments: Office of Inspector General Comments, Groton Proposed Corrective Action. The Department of Navy partially concurred with the finding on their corrective action plan for addressing Cost Accounting Standards administration and providing for the continued use of the Reservation of Rights practice. In his response, the Assistant Secretary of the Navy (Research Development and Acquisition) stated that Groton believes that use of Reservation of Rights is in compliance with the Federal Acquisition Regulation, but acknowledges the technique should only be used in the most compelling circumstances to settle issues that would unreasonably delay settlement of final rates. He stated that there is no prohibition in the Federal Acquisition Regulation against paying the cost conditionally and later retrieving any excess amount paid, with interest, if the cost is determined to be unallowable or unallocable.

Our Response. We disagree. Through its use of the ‘Reservation of Rights’ practice, Groton violated 41 U.S.C. 422 – Cost Accounting Standards Board and Cost Accounting Standard 406, as reported herein. In only one circumstance does the Federal Acquisition Regulation provide for the deferral of a cost issue into a future period; when settling costs related to legal and other proceedings (Federal Acquisition Regulation 31.205-47). The Federal Acquisition Regulation does not provide for the deferral of any other type of cost issue. We find no compelling reason to allow the ‘Reservation of Rights’ practice to continue as proposed by the Department of Navy.

Our attempts to engage Naval Sea Systems Command contracting officials regarding our draft audit report position on ‘Reservation of Rights’ have not been responsive. We request that the Navy reconsider and eliminate the use of its ‘Reservation of Rights’ practice as recommended.

Recommendations, Management Comments, and Our Response.

Recommendation A.

1. The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton:

   a. Implement the proposed corrective action plan identified in his July 16, 2009, memorandum to the Department of Defense Inspector General, Office of the Assistant Inspector General for Audit Policy and Oversight.

   Management Comments. The Department of Navy concurred with the recommendation.
Our Response. The Department of Navy comments were responsive.

b. Within 3 months of this issuance of this report, comply with the requirements of Federal Acquisitions Regulation Subpart 30.6 CAS Administration, and address the allegations of noncompliance included in Defense Contract Audit Agency Report No. 02361-2003B17900017, Report on Application of Agreed-Upon Procedures, Prior Year Overhead Adjustments, including each Statement of Conditions and Recommendations identified by Defense Contract Audit Agency in that report.

Management Comments. In his May 21, 2010 response, the Assistant Secretary of the Navy, (Research Development and Acquisition) responded that the Department of Navy did not concur with this recommendation. He commented that the referenced Defense Contract Audit Agency Agreed-Upon Procedure Report was not issued as a Cost Accounting Standard noncompliance audit report (i.e., Reportable Audit) and therefore was not treated as such. Further, he stated that the Defense Contract Audit Agency issued their report at the request of the Groton administrative contracting officer to evaluate the contractor’s financial system for potential improvement. And that subsequent to issuance of the Agreed-Upon Procedures Report, a complete Disclosure Statement audit was performed by the Defense Contract Audit Agency and the results of that audit did not disclose any issues or alleged Cost Accounting Standard noncompliance from the Agreed-Upon Procedures report.

However, in a subsequent response dated August 27, 2010, the Director, Program Analysis and Business Transformation, Deputy Assistant Secretary of the Navy, (Acquisition and Logistics Management) commented that the Navy concurs in principle with Recommendation A.1.b. He stated that the Groton Business Operations Department had located a January 31, 2005 record requesting the contractor respond to the September 14, 2004 Defense Contract Audit Agency report.

Our Response. We agree with the Navy’s change in position to a concurrence. However, the comments are not responsive in that they do not acknowledge intent by the Navy to take action to implement the recommendation and comply with the requirements of Federal Acquisitions Regulation Subpart 30.6 CAS Administration and fully address the allegations of noncompliance reported by the Defense Contract Audit Agency in Report No. 2361-2003B17900017. The Department of Navy needs to respond to this recommendation with action based milestones for compliance within 30 days of the issuance of this report.

c. Within 3 months of the issuance of this report, demonstrate using the criteria provided at Federal Acquisition Regulation Subpart 9903.305 – Materiality, that use of Post Audit Disallowance Factor for the period April 17, 1992, to the contractor’s fiscal year ending in 2009 did or did not result in a material cost impact on contracts covered by the Cost Accounting Standards clause.
Management Comments. In his May 21, 2010 response, the Assistant Secretary of the Navy, (Research Development and Acquisition) responded that the Department of Navy did not concur with the recommendation. He responded that the Defense Contract Audit Agency never issued a Cost Accounting Standards noncompliance audit and therefore the contractor had no requirement to provide a cost impact on a contract basis. He also stated that SUPSHIP Groton does not have the data available to determine the cost impact on a contract basis.

The Navy updated its response on August 27, 2010. The Director, Program Analysis and Business Transformation, commented that the Navy concurs in principle with Recommendation A.1.c and that upon receipt of a signed final report from DoDIG asserting a Cost Accounting Standard 406 noncompliance, the Navy will process the alleged noncompliance in accordance with the procedures at Federal Acquisition Regulation 30.605.

Our Response. We agree with the Navy’s change in position to a concurrence in principle. However, the comments are not responsive in that they do not acknowledge intent by the Navy to take action to implement the recommendation and comply with the requirements of Federal Acquisitions Regulation Subpart 30.6 CAS Administration and fully address the allegation of noncompliance with Cost Accounting Standard 406 included in this report. The Department of Navy needs to respond to this recommendation with action based milestones for compliance within 30 days of the issuance of this report.

d. For open years starting with the contractor’s fiscal year 2010, negotiate and settle contractor final indirect cost rates in accordance with Federal Acquisition Regulation 52.216-7 and Cost Accounting Standard 406.

Management Comments. The Department of Navy concurred with the recommendation.

Our Response. The Navy comments were responsive. However, the comments do not acknowledge intent by the Navy to take action to implement the recommendation and comply with Federal Acquisition Regulation 52.216-7 and Cost Accounting Standard 406. The Department of Navy needs to respond to this recommendation with action based milestones demonstrating compliance for contractor year 2010 within 30 days of the issuance of this report.

e. Eliminate the ‘Reservation of Rights’ procedure from use in negotiating and settling final indirect cost rates.

Management Comments. The Department of Navy did not concur with the recommendation. The Assistant Secretary of the Navy, (Research Development and Acquisition) provided that the Naval Sea Systems Command firmly believes that in limited circumstances, Reservation of Rights is in the best interest of the Government
and permissible under the Federal Acquisition Regulation. In his response, The Assistant Secretary of the Navy, (Research Development and Acquisition) stated that Federal Acquisition Regulation 1.102(d) provides that “The role of each member of the Acquisition Team is to exercise personal initiative and sound business judgment in providing the best value product or service to meet the customer’s needs. In exercising initiative, Government members of the Acquisition Team may assume if a specific strategy, practice, policy or procedure is in the best interests of the Government and is not addressed in the Federal Acquisition Regulation, nor prohibited by law (statute or case law), Executive order or other regulation, that the strategy, practice, policy or procedure is a permissible exercise of authority.”

**Our Response.** We disagree and recommend the Department of Navy re-evaluate its nonconcurrency with this recommendation. The Department of Navy did not identify the “limited circumstances” wherein the ‘Reservation of Rights’ practice is in the best interest of the Government. The Department of Navy cites Federal Acquisition Regulation 1.102(d) as precedent for allowing Groton to continue use of the ‘Reservation of Rights’ practice. We note that Federal Acquisition Regulation 1.102(d) is predicated on a viable Acquisition Team. We did not find a viable acquisition team at Groton. We did not witness the exercise of “personal initiative” or “sound business judgment.” Nor did we observe where they had “provided best value product or service” to meet the needs of the US Government or taxpayer. The risks of allowing the ‘Reservation of Rights’ practice to continue outweigh any tangible benefit arising from use under unspecified “limited circumstances.” Further, the Department of Navy argues that existing law or regulation does not prohibit use of the ‘Reservation of Rights’ practice. The ‘Reservation of Rights’ practice used by Groton personnel violated 41 U.S.C. 422 – Cost Accounting Standards Board and Cost Accounting Standard 406. The ‘Reservation of Rights’ practice also violates Federal Acquisition Regulation 42.7 Indirect Rates and Department of Defense Instruction 7640.02 Policy for Follow-up on Contract Audit Reports (Department of Defense Inspector General Report No. D-2008-06-005, dated May 6, 2008, pages 3-6).

2. **The Director, Contracts Division, Shipbuilding Division, Naval Sea Systems Command:**

   a. **Oversee the actions taken by the Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton, in response to Recommendation A.1.**

   **Management Comments.** The Department of Navy concurred with the recommendation.

   **Our Response.** The Navy comments were responsive.
b. Perform a review of each Supervisor of Shipbuilding, Conversion and Repair contract administration office to determine whether the cognizant Business Operations Department:

   (i) Establishes contractor final indirect cost rates in accordance with Federal Acquisition Regulation 52.216-7.
   (ii) Administers cost accounting standards noncompliances in accordance with Federal Acquisition Regulation 30.6.
   (iii) Prohibits the use of the ‘Reservation of Rights’ practice as a tool in settling contractor final indirect rates for a contractor cost accounting period.

Management Comments. The Department of Navy concurred with the recommendations at A.2.b.(i) and A.2.b.(ii).
The Department of Navy did not concur with the recommendation in A.2.b.(iii), commenting that the Director, Shipbuilding Contracts Division supports the limited use of Reservation of Rights. The Assistant Secretary of the Navy, (Research Development and Acquisition) provided that approval for use of the ‘Reservation of Rights’ practice will require advance approval by the Director for Contracts, Naval Sea Systems Command.

Our Response. We disagree with the nonconcurrence on Recommendation A.2.b(iii) and recommend the Department of Navy re-evaluate its nonconcurrence. (See Our Response to Recommendation 1.e, above.) Adding advance approval by the Director for Contracts will only allow the continuance of a practice that violates the Federal Acquisition Regulation and Cost Accounting Standards. The Department of Navy needs to reconsider its response and provide additional comments within 30 days of the issuance of this report.

c. Take corrective action to gain compliance with Federal Acquisition Regulation 52.216-7 and Federal Acquisition Regulation 30.6 for noncompliances identified as a result of the review performed in response to Recommendations A.2.b.

Management Comments. The Department of Navy concurred with the recommendation.
Our Response. The Navy comments were responsive.

d. By November 30, 2010, provide the Assistant Inspector General for Audit Policy and Oversight a copy of the review results from Recommendation A.2.b. and any associated reports and corrective action plans related thereto.

Management Comments. The Department of Navy concurred with the recommendation.
Our Response. The Navy comments were responsive.
B. Settlement Agreements Wrongly Offset Contract Debts, Lack Sufficient Supporting Documentation

A former Deputy Officer, Groton Business Operations Department, executed settlement agreements that wrongly liquidated $3,882,926 in existing contract debts and potentially violated the Antideficiency Act. The former Deputy Officer used the $3,882,926 in liquidated contract debt to offset $3,615,860 in unpaid claims while allowing the contractor to retain the remaining $267,066 for use in offsetting future negotiated amounts. Both actions violated the Federal Acquisition Regulation. One unpaid claim of $1,696,860 represented amounts in excess of available funding on a contract. Coupled with incomplete contract case file records, Groton Business Operations Department personnel were unable to demonstrate that two Memoranda of Agreement executed with the contractor in 2004 complied with the terms of the contracts and safeguarded the interests of the United States Government. Because of this Contract Audit Follow Up project, the contractor paid the United States Treasury $267,066 owed to the U.S. Government since the culmination of the second Memorandum of Agreement in September 2004. Naval Sea Systems Command should reassess the action taken to liquidate $3,882,926 in contract debt and take action to recover the $3,615,860 in contract debt offset against unpaid claims. Additionally, the Assistant Secretary of the Navy should require the Navy Comptroller’s Office to initiate preliminary reviews and take potential corrective actions for this potential violation of the Antideficiency Act.

2004 Memoranda of Agreement. The former Deputy Officer, Groton Business Operations Department, determined that $965,257 in contractor claimed indirect costs for contractor fiscal years 1997 through 2001 were unallowable. Subsequently, during a global settlement of numerous contract issues, the former Deputy Officer offset these contract unallowable costs and other contract debts against two unpaid claims owed by the Government to the contractor.

The global settlements were recorded in two Memoranda of Agreement executed by the former Deputy Officer, a warranted contracting officer, and the contractor. The two memoranda are the Elements of the March 2004 Settlement, executed on March 22, 2004, and the 2004 Memorandum of Agreement, executed on September 30, 2004.

The following items illustrate the complexity of the September 30, 2004, Memorandum of Agreement:

- Thirty-three (33) contract issues were associated with this Agreement.

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9 This offset was made in lieu of adjusting the 'Post Audit Disallowance Factor', the noncompliant practice for establishing final indirect rates reported upon in Finding A.
• Both parties agreed that any of the 17 issues that were set aside in a ‘Reservation of Rights’ would be resolved in negotiations to take place in the future.
• Both parties desired to resolve several other outstanding issues relative to other Defense Contract Audit Agency audit reports, Cost Accounting Change cost impacts, and numerous other issues that both parties were unable to settle independently at the time.
• Both parties desired to establish Final Overhead Costs and Other Direct Labor Costs for fiscal years 1997 through 2001.
• The contractor agreed to reimburse the Government a total of $3,882,926 associated with five identified issues.
• The Government agreed to reimburse the contractor a total $3,615,860 associated with the settlement of two issues: pension costs and a contract funding short-fall.
• Both sides agreed that a balance of $267,066 still owed the Government would remain with the contractor and would be used to offset future negotiated amounts.

On inquiry, the former Deputy Officer, Groton Business Operations Department, advised the Department of Defense Inspector General auditors that the Agreements were a “means to clear old actions.” When asked if he had prepared business clearance memoranda\(^\text{10}\) to justify his actions, he stated that the 2004 Memoranda were below the dollar threshold for requiring a clearance and that he did not require an approved business clearance memorandum to execute either agreement.

**Noncompliant Offset of Contract Debt for Unpaid Bills.** The September 30, 2004, Memorandum of Agreement and supporting records demonstrate that the former Deputy Officer liquidated the following contract debts against two unpaid amounts due the contractor on existing contracts:

\(^{10}\) A properly executed business clearance memorandum would have included the contractor’s proposal and/or claim for the items negotiated in each Agreement, and would have demonstrated that the settlements reached were fair and reasonable and conformed to Department of Defense acquisition procedures and regulations. They would have showed all significant facts considered in reaching the final business decision, served as a historical record of the business/pricing aspects of the settlement as well as the baseline for potential defective pricing actions.
<table>
<thead>
<tr>
<th>Item Description</th>
<th>Contractor Debts</th>
<th>Unpaid Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect cost settlement, 1997 through 2001.</td>
<td>$965,257</td>
<td></td>
</tr>
<tr>
<td>Interest assessment, indirect cost settlement, 1997 through 2001.</td>
<td>$307,775</td>
<td></td>
</tr>
<tr>
<td>Interest and penalties, indirect cost settlements, 1989 through 1992.</td>
<td>$193,154</td>
<td></td>
</tr>
<tr>
<td>Contract overpayment, Contract No. N00024-95-C-2101.</td>
<td>$709,540</td>
<td></td>
</tr>
<tr>
<td>Price adjustment, change in a contractor Cost Accounting Standards practice.</td>
<td>$1,707,200</td>
<td></td>
</tr>
<tr>
<td>Pension costs on Contract No. N00024-96-C-2108, a SEAWOLF class submarine.</td>
<td>$1,919,000</td>
<td></td>
</tr>
<tr>
<td>Funding short-fall, Contract No. N00024-00-C-8501, a fixed price contract for submarine overhaul.</td>
<td>$1,696,860</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 3,882,926</strong></td>
<td><strong>$ 3,615,860</strong></td>
</tr>
<tr>
<td><strong>Difference, Contract Debt Allowed to Remain with Contractor</strong></td>
<td><strong>$ 267,066</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Retrieval of Monies Remaining with the Contractor.** Federal Acquisition Regulation 32.602(a) prohibits the contracting officer from allowing a contractor to retain contract debts\(^{11}\) to cover amounts that may become payable in future periods. At the culmination of the debt liquidation described above, the former Deputy Officer allowed $267,066 in contract debt to remain with the contractor to be “used to offset future negotiated amounts.”

On July 16, 2009, the Groton Business Operations Officer advised the Department of Defense Inspector General, Office of the Assistant Inspector General for Audit Policy and Oversight, by letter that the contractor had issued a check payable to the U.S. Treasury for $267,066. The check was dated June 24, 2009, and represented the contract debt remaining with the contractor at the culmination of the September 30, 2004, Memorandum of Agreement.

**Violation of Contracting Officer Responsibilities, Contract Debt.** The former Deputy Officer violated paragraph (a)\(^{12}\) of Federal Acquisition Regulation 32.602 (see Department of

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\(^{11}\) Federal Acquisition Regulation 32.601 provides at paragraph (a) that contract debts are amounts that – (1) Have been paid to a contractor to which the contractor is not currently entitled under the terms and conditions of the contract; or (2) Are otherwise due from the contractor under the terms and conditions of the contract. Paragraph (b) provides examples of contract debts, which includes but is not limited to price adjustments resulting from changes in a Cost Accounting Standard cost accounting practice, and duplicate or erroneous payments.

\(^{12}\) Federal Acquisition Regulation 32.602(a) states “The contracting officer has primary responsibility for identifying and demanding payment of contract debts except those resulting from errors made by the payment office. The contracting officer shall not collect contract debts or otherwise agree to liquidate contract debts (e.g., offset the
Navy Response comments, Finding B, and Department of Navy response comments, Recommendation B.4) by liquidating contract debts totaling $3,882,926 and offsetting this amount against $3,615,860 in unpaid bills, in this case unpaid amounts on two contracts, as follows:

**Contract No. N00024-96-C-2108.** In Finding C of this report, we describe the substance of the $1,919,000 in unpaid contractor pension costs said to exist on a submarine contract.

**Contract No. N00024-00-C-8501.** A $1,696,860 funding short-fall on Contract No. N00024-00-C-8501, a fixed price contract for submarine overhaul. As detailed below, the former Deputy Officer settled eight unadjudicated change order proposals for an amount that exceeded the available funding on the contract by $1,696,860.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Price, Contract No. N00024-00-C-8501, as of June 27, 2002</td>
<td>$21,216,943</td>
</tr>
<tr>
<td>Contractor Proposed Price, Eight Change Order Proposals</td>
<td>$2,684,579</td>
</tr>
<tr>
<td>Settlement Price, Eight Change Order Proposals</td>
<td>$2,317,171</td>
</tr>
<tr>
<td>New Price, Contract No. N00024-00-C-8501</td>
<td>$23,534,114</td>
</tr>
<tr>
<td>Funding Available on Contract</td>
<td>$21,837,254</td>
</tr>
<tr>
<td><strong>Funding short-fall</strong></td>
<td><strong>$1,696,860</strong></td>
</tr>
</tbody>
</table>

Rather than obtain additional funding through the upward obligation process, the former Deputy Officer circumvented internal controls and offset the unpaid amount by liquidating existing contract debt. By liquidating these contracts debts himself, the former Deputy Officer violated paragraph (b) 13 of Federal Acquisition Regulation 32.602 by authorizing the liquidation of contract debts, a responsibility specifically assigned to the government payment office.

**Potential Violation of 31 U.S.C. 1341 Limitations on Expending and Obligating Amounts.** Public statute 31 U.S.C. 1341(a)(1) states,

> “An officer or employee of the United States Government or of the District of Columbia government may not – (A) make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation...”

On inquiry regarding the reason for the delay in negotiating the eight unadjudicated change orders, the former Deputy Officer advised the Department of Defense Inspector General amount of the debt against existing unpaid bills due the contractor, or allow contractors to retain contract debts to cover amounts that may become payable in future periods).”

13 Federal Acquisition Regulation 32.602(b) states “The payment office has primary responsibility for -- (3) Authorizing the liquidation of contract debts in accordance with agency procedures.”
auditors that lack of available funding had caused the delays, and that all funding had expired. To get new funding would have required going through the “upward obligation process.” When asked to confirm the accuracy of the statements made by the former Deputy Officer, the current Groton Business Operations Officer acknowledged that using offsetting funds was not appropriate and in hindsight, the proper approach would have been to use the upward obligation process.

By authorizing and approving the settlement of the eight change order proposals for a price of $2,317,171, the former Deputy Officer may have obligated the U.S. Government for an expenditure that exceeded the amount of funding available on the contract by $1,696,860, potentially violating 31 U.S.C. 1341(a)(1)(A). Additionally, the potential exists that the actions taken by the former Deputy Officer violated other provisions of the Antideficiency Act, including those identified in Financial Management Regulation, Volume 14, Chapter 2, paragraph 020103.

**Failure to Execute Business Clearance Memoranda.** The decision by the former Deputy Officer to forego preparing and obtaining approved business clearance memoranda prior to executing either 2004 Agreement violated Federal Acquisition Regulation 1.602-1 – Authority, and Federal Acquisition Regulation 1.602-2 – Responsibilities. Personnel in the Groton Business Operations Department had insufficient records and evidence to demonstrate that either 2004 Agreement (i) complied with all requirements of law, executive orders, regulations, and all other applicable procedures, and (ii) ensured compliance with the terms of the contract and safeguarded the interests of the United States.

**Failure to Maintain Contract Files.** The Groton Business Operations Department did not have case file documentation available for either 2004 Agreement that met the criteria at Federal Acquisition Regulation 4.801. The Groton Business Operations Officer stated that case files had existed for all contract actions involved in both settlement agreements, but that some contract files were subsequently misplaced or discarded. He also stated that Groton

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14 Federal Acquisition Regulation 1.602-1 – Authority, at subparagraph (b) requires in part that “No contract shall be entered into unless the contracting officer ensures that all requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, have been met.” A business clearance memorandum is a means to gain clearance and approval.

15 Federal Acquisition Regulation 1.602-2 – Responsibilities, states in part that “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 United States in its contractual relationships.”

16 Federal Acquisition Regulation Subpart 4.8 prescribes requirements for establishing, maintaining, and disposing of contract files. Federal Acquisition Regulation 4.801 provides at subparagraph (a) that "The head of each office performing contracting, contract administration, or paying functions shall establish files containing the records of all contractual actions." At paragraph (b) it provides that "The documentation in the files (see 4.803) shall be sufficient to constitute a complete history of the transaction for the purpose of --

(1) Providing a complete background as a basis for informed decisions at each step in the acquisition process;
(2) Supporting actions taken;
(3) Providing information for reviews and investigations; and
(4) Furnishing essential facts in the event of litigation or congressional inquiries.
Business Operations Department does not have a separate policy or procedure that implements Federal Acquisition Regulation 4.801.

Without business clearance memoranda and complete case file documentation to support the actions taken by the former Deputy Officer, Groton Business Operations Department personnel were not able to demonstrate that the 2004 Agreements represented effective contracting, ensured compliance with the terms of the contract, and safeguarded the interests of the United States in its contractual relationships.

**Management Comments on the Finding and Our Response.**

The Assistant Secretary of the Navy (Research Development and Acquisition), provided the Department of Navy Response dated May 21, 2010. A summary of the comments is provided below. The full text of the response is provided in the Management Comments section of the report.

**Management Comments: Violation of Contracting Officer Responsibilities, Contract Debt.** The Department of Navy did not concur. In his comments, the Assistant Secretary of the Navy (Research Development and Acquisition) stated that the provisions at Federal Acquisition Regulation 32.602 cited by the Inspector General were not in the Federal Acquisition Regulation in 2004 when these actions occurred. The provisions were added to the Federal Acquisition Regulation by Federal Acquisition Circular (FAC) 2005-27 dated September 17, 2008, with an effective date of October 17, 2008. The Assistant Secretary of the Navy (Research Development and Acquisition) stated that Groton has and will continue to comply with the revised Federal Acquisition Regulation provisions. He stated that the former Deputy Officer exercised his authority in good faith under Federal Acquisition Regulation 1.102, the provisions of Federal Acquisition Regulation Part 32 that were in effect at the time of the Agreement, and DoD Directive 7640.2. The Assistant Secretary of the Navy (Research Development and Acquisition) provided that, “Federal Acquisition Regulation 32.606(d) in effect in 2004 when these actions occurred stated “Except in cases in which an agreement has been entered into for deferment of collections (32.613) or bankruptcy proceedings against the contractor have been initiated, the contractor shall be required to liquidate the debt by – (1) cash payment in a lump sum on demand; or (2) credit against existing unpaid bills due the contractor.”

The Assistant Secretary of the Navy (Research Development and Acquisition) also stated that DoD Directive 7640.02 provides “The responsibility for reaching agreement with the contractor is the contracting officer’s, and he has wide latitude and discretion in that regard.”

**Our Response.** First, we disagree with the Department of Navy position that Groton has complied with the revised Federal Acquisition Regulation provisions. Groton was not in compliance with the revised provisions of Federal Acquisition Regulation 32.602(a) when we initiated our oversight project in 2009. Federal Acquisition Regulation 32.602(a) as revised prohibited the contracting officer from allowing a
contractor to retain contract debts to cover amounts that may become payable in future periods. We found that the contractor had retained $267,066 in contract debts since the culmination of the September 30, 2004, Memorandum of Agreement. As noted in that agreement, the amount retained was to be “used to offset future negotiated amounts.” Groton was clearly in violation of Federal Acquisition Regulation 32.602(a) as revised; hence, the contractor’s June 24, 2009 payment of $267,066 to the U.S. Treasury.

Second, we disagree with the Department of Navy position that the former Deputy Officer exercised his authority in good faith under the provisions of Federal Acquisition Regulation Part 32 that were in effect at the time of the Agreement. We believe the Department of Navy should reconsider its nonconcurrence with this Finding. The Department of Navy provided no factual basis to support its claim that the former Groton Deputy Officer “…exercised his authority in good faith under Federal Acquisition Regulation 1.102, the provisions of Federal Acquisition Regulation Part 32 that were in effect at the time of the Agreement, and DoD Directive 7640.2.”

Subsequent to receipt of the Department of Navy response, we evaluated whether the actions taken by the former Deputy Officer, Groton Business Operations Department to offset contract debts totaling $3,882,926 against $3,615,860 in unpaid bills complied with the requirements of Federal Acquisition Regulation 32.606(d) in effect on September 30, 2004. We requested specific records and documentation from the Naval Sea Systems Command to substantiate compliance. In response, the Director, Shipbuilding Contracts advised the DoD OIG auditors that Groton had no additional documents that would be responsive to our request and that Groton had provided all available records to the DoD OIG during the course of the review.

Based upon the review of our existing records obtained during the course of this oversight review, we found Groton had never provided any records to demonstrate that the former Deputy Officer:

- Had complied with Federal Acquisition Regulation 32.606(c) in effect on September 30, 2004 and established a control record for each of the five contract debts totaling $3,882,926, including –

  (3) A description of the debt,
  (4) The amount of debt and the appropriation to be credited,
  (5) The date the debt was determined,
  (6) The dates and demands for payment, and
  (9) The status of collections, including (i) actions reported to the disbursing officer, and (ii) funds requested to be withheld by the disbursing officer.

- Had complied with Federal Acquisition Regulation 32.606(b) in effect on September 30, 2004 and fairly considered both the Government’s claim for payment of the five outstanding debts totaling $3,882,926, as well as the two outstanding unpaid bills against the Government totaling $3,615,860.
• Had complied with Federal Acquisition Regulation 32.605(a) in effect on September 30, 2004 by fully cooperating with contract financing offices, disbursing officials, and auditors, to:

(2) Ascertain the correct amount of the debt;
(3) Act promptly and effectively to collect the debt.

Additionally, as detailed in Finding C, we find that the ‘unpaid bill’ for pension costs that was used by the former Deputy Officer to offset $1,919,000 of contractor debt was in effect consideration given to the contractor for agreeing to circumvent the requirements of the 1986 Advance Agreement Pension Cost when entering into Contract No. N00024-96-C-2108. We find that neither Federal Acquisition Regulation 1.102, DoD Directive 7640.02, nor any other provision in the Federal Acquisition Regulation allow for such action by a contracting officer.

We note that the Director, Budget Policy and Procedures Division, Office of Budget, Assistant Secretary of the Navy (Financial Management and Comptroller) in her August 20, 2010 comments (see the Management Comments section of the report) reported that

“SUPSHIP contracting officials [improperly authorized] contract debt liquidation on various Ship Construction Navy (SCN) contracts in the amount of $3,882,926.” [emphasis added]

The provisions of Federal Acquisition Regulation 32.606(d) that governed debt liquidation on September 30, 2004 did provide that the contracting officer had primary responsibility for debt liquidation, including offsetting debts against existing unpaid bills. However, Naval Sea Systems Command contracting officials were not able to demonstrate that the former Deputy Officer, Groton Business Operations Department acted responsibly to protect the Government’s interest when offsetting $3,882,926 in contractor debt against $3,615,860 in unpaid bills. They did not demonstrate that the former Deputy Officer:

• Cooperated with contract financing offices, disbursing officials, and auditors to ascertain the correct amount of the debt, as required by Federal Acquisition Regulation 32.605(a)(2),

• Established a control record for each of the five contract debts in accordance with totaling $3,882,926 as required by Federal Acquisition Regulation 32.606(c), and

• Fairly considered both the Government’s claim for payment of the five outstanding debts totaling $3,882,926 and the contractor’s claim of two outstanding unpaid bills totaling $3,615,860, as required by Federal Acquisition Regulation 32.606(b).
Management Comments: Potential Violation of 31 U.S.C. 1341 Limitations on Expending and Obligating Amounts. By Memorandum dated August 20, 2010, the Director, Budget Policy and Procedures Division, Office of Budget, Assistant Secretary of the Navy, (Financial Management and Comptroller) responded to this finding. The full text of the response is provided in the Management Comments section of the report.

In her comments, the Director stated that the actions taken by the former Deputy Officer, Groton Business Operations Department violated the Purpose Statute, 31 U.S.C. § 1301(a), but did not result in an Antideficiency Act violation. She provided the following explanation:

“To offset expired funding and a funding short-fall of $1,696,860 on a [fiscal year 2001] O&M,N [Operations & Maintenance, Navy] funded submarine overhaul contract, N00024-00-C-8501, SUPSHIP contracting officials improperly authorized contract debt liquidation on various SCN [Ship Construction Navy] contracts in the amount of $3,882,926. These liquidated [Ship Construction Navy] contract debts owed to the Department of Navy were used to offset a total of $3,615,860 in unpaid claims owed the contractor for settlement of two issues; (1) pension costs related to a [Ship Construction Navy] funded submarine nuclear refueling overhauls contract (N00024-96-C-2108) and (2) the aforementioned funding shortfall for the [Operations & Maintenance, Navy] funded submarine overhaul contract (N00024-00-C-8501). The use of liquidated [Ship Construction Navy] funds to offset debts owed to the contractor for the [Operations & Maintenance, Navy] funded contract resulted in a violation of the Purpose Statute, 31 U.S.C. § 1301(a). However, the obligation of funds from the [Ship Construction Navy] appropriation to offset [Operations & Maintenance, Navy] funds owed the contractor did not result in an ADA [Antideficiency Act] violation. This is because there are sufficient balances legally available from the current appropriation [fiscal year 2010 Operations & Maintenance, Navy] available for the same purpose.”

Our Response. The Navy comments were responsive.

Management Comments: Failure to Execute Business Clearance Memoranda. The Department of Navy concurred in principle with this finding. The Assistant Secretary of the Navy (Research Development and Acquisition) responded that a consolidated business clearance memorandum should have been prepared to demonstrate compliance with the applicable Federal Acquisition Regulation provisions, but that Groton did obtain legal advice on many of the underlying issues and prepared business case documentation for the individual items covered by the 2004 MOA.
Our Response. We consider the Department of Navy comments non-responsive. We reiterate our finding that the decision by the former Deputy Officer to forego preparing and obtaining approved business clearance memoranda prior to executing either 2004 Agreement violated Federal Acquisition Regulation 1.602-1 – Authority, and Federal Acquisition Regulation 1.602-2 – Responsibilities.

Management Comments: Failure to Maintain Contract Case Files. The Department of Navy concurred with the finding.

Our Response. The Navy comments were responsive.

Recommendations, Management Comments, and Our Response.

Recommendation B.

1. The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton:

   a. Within 3 months of the issuance of this report, establish and implement policies and procedures that ensure that all Groton contracting officers have met the requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, prior to executing all future Memoranda of Agreement with the contractor.

   b. Within 3 months of the issuance of this final report, perform a review of all existing Memoranda of Agreement to ensure that each one meets the requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, prior to its execution with the contractor.

   c. Immediately issue a directive memorandum to all Groton Business Operations Department contracting officers and contracting personnel advising them of their duty to comply with Federal Acquisition Regulation 32.602 – Responsibilities, Federal Acquisition Regulation 1.602-1 – Authority and Federal Acquisition Regulation 1.602-2 – Responsibilities, when contracting for the United States.

Management Comments. The Department of Navy concurred with the recommendations.

Our Response. The Navy comments were responsive.

2. The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton:
a. Within 3 months of this issuance of this report, establish and implement policies and procedures that ensure that the Groton Business Operations Department establishes and maintains contract case files containing the records of all contractual actions sufficient to constitute a complete history of the transaction for the purpose of:

(1) Providing a complete background as a basis for informed decisions at each step in the acquisition process;

(2) Supporting actions taken;

(3) Providing information for reviews and investigations; and

(4) Furnishing essential facts in the event of litigation or Congressional inquiries.

b. Within 6 months of the issuance of this final report, perform a review of all existing case file records to determine that each contains a record of all contractual actions sufficient to ensure a complete history of the transaction.

c. Immediately issue a directive memorandum to all Groton Business Operations Department contracting officers and contracting personnel advising them of their duty to comply with Federal Acquisition Regulation Subpart 4.8 – Government Contract Files, when performing contracting duties for the United States.

**Management Comments.** The Department of Navy concurred with the recommendations.

**Our Response.** The Navy comments were responsive.

3. The Director, Contracts Division, Shipbuilding Division, Naval Sea Systems Command:

a. Oversee and document oversight of the actions taken by the Groton Business Operations Officer described in above in items B.1 and B.2 to ensure:

(1) The actions are effectively and efficiently performed, and

(2) The Groton Business Operations Department has sufficient resources available to accomplish the tasks within the time frames specified.

b. By November 30, 2010, report to the Assistant Inspector General for Audit Policy and Oversight the results of the actions, including documentation, taken by the Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton in response to Recommendations B.1 and B.2.

**Management Comments.** The Department of Navy concurred with the recommendations.

**Our Response.** The Navy comments were responsive.
4. The Director of Contracts, Naval Sea Systems Command:

   a. Reassess the action taken by the former Deputy Officer, Groton Business Operations Department to liquidate $3,882,926 in contract debt owed to the United States Government and take action to recover the $3,615,860 in contract debt offset against unpaid bills on Contract Nos. N00024-00-C-8501 and N00024-96-C-2108 (see Recommendation C.1)

   (1) Ascertain that $3,882,926 of debt is the correct amount owed to the US Government in accordance with Federal Acquisition Regulation 32.605(a)(2) in effect on September 30, 2004.

   (2) Determine that the Government’s claim for payment of $3,882,926 was determined in accordance with Federal Acquisition Regulation 32.6 in effect on September 30, 2004. Where indicated, take action to collect from the contractor any amounts found still outstanding.

   (3) Evaluate and fairly consider in accordance with Federal Acquisition Regulation 32.6 in effect on September 30, 2004 the contractor’s claims for payment under the eight contractor proposed change orders, Contract No. N00024-00-C-8501 said to support one unpaid bill totaling $1,696,860. Where necessary, retrieve from the contractor any contract debts found still outstanding.

   b. Re-evaluate the existing management controls at the Groton Business Operations Department for collecting contract debts and make improvements that ensure all contract debts are collected in accordance with the regulatory procedures provided in Federal Acquisition Regulation, Subpart 32.6.

   c. Within 3 months of the issuance of this final report, provide the Assistant Inspector General for Audit Policy and Oversight a memorandum detailing the results from Recommendations B.4.a and B.4.b, above.

Management Comments. The Department of Navy concurred in principle with the recommendations. The Assistant Secretary of the Navy (Research Development and Acquisition) responded that the Naval Sea Systems Command Director for Contracts has reviewed the action taken by the former Deputy Officer, Groton, to liquidate $3,882,926 in contract debt against unpaid bills on the two contracts cited, and believes those actions were undertaken in good faith. The Assistant Secretary of the Navy (Research Development and Acquisition) stated the Federal Acquisition Regulation provisions at 32.602(a) addressing offsets were added in 2008, four years after the offset arrangement was agreed to by the former Deputy Officer. He provided that the Director of Contracts will provide a report within 3 months of the issuance of the final Inspector General report detailing the results of that assessment.

Our Response. We appreciate that the Department of Navy concurred in principle; however, we consider the comments nonresponsive. For the following reasons, we disagree with the conclusions reached by the Naval Sea Systems Command Director for
Contracts. The actions taken by the former Deputy Officer were inappropriate and do not rise to the level of actions taken in “good faith”.

- **No Written Report.** The Naval Sea Systems Command Director for Contracts did not support the results of his reassessment with a written report. Consequently, a third party cannot perform an objective review of the facts and documentation he relied upon and reach the same conclusion or determine that the actions taken by the former Deputy Officer, Groton, were undertaken in good faith.

- **No Records Demonstrating Compliance.** The Naval Sea Systems Command Director for Contracts advised the DoD OIG auditors that he relied upon the same records that were provided to the DoD OIG during the course of our oversight review as the basis for his conclusion. However, we found we had never been provided with any records to demonstrate that the former Deputy Officer had complied with the provisions of Federal Acquisition Regulation 32.6 in effect on September 30, 2004.

- **Pension Cost.** We find that the ‘unpaid bill’ for pension costs that was used by the former Deputy Officer to offset $1,919,000 of contractor debt was in effect consideration given to the contractor for agreeing to circumvent the legally binding requirements of the December 1986 *Advance Agreement Pension Cost* when entering into Contract No. N00024-96-C-2108. We do not consider that any provision in the Federal Acquisition Regulation allow for the use of such an arrangement as the basis for offsetting a legitimate contractor debt.

- **Improper Debt Liquidation.** The Director, Budget Policy & Oversight, Office of Budget, Assistant Secretary of the Navy (Financial Management and Comptroller) reported that Groton contracting officials had improperly authorized contract debt liquidation on Ship Construction Navy contracts in the amount of $3,882,926, and that this action resulted in a violation of the Purpose Statute, 31 U.S.C. § 1301(a).

5. As prescribed in DoD Financial Management Regulation, Volume 14, Chapter 3, the Assistant Secretary of the Navy, Financial Management and Comptroller direct the Navy Comptroller Office to initiate preliminary reviews and possible corrective actions for the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut that potentially violated the Antideficiency Act as defined by the DoD Financial Management Regulation. We specifically refer to action taken by the former Deputy Officer, Groton Business Operations Department, to authorize a contract debt liquidation to offset expired funding and a funding short-fall of $1,696,860 on Contract No. N00024-00-C-8501. This action authorized an expenditure in excess of the funds available under the contract and potentially violated provisions of the Antideficiency Act, including the Statutes at 31 U.S.C. 1341 and 31 U.S.C. 1517.

**Management Comments.** By Memorandum dated August 20, 2010, the Director, Budget Policy and Procedures Division, Office of Budget, Assistant Secretary of the
Navy, (Financial Management and Comptroller) responded to this recommendation. The Director commented that

- Though there was a Purpose Statute, the violation will be "cured" when Groton de-obligates the amounts that were improperly charged to the Ship Construction Navy appropriation and charges these amounts to the Operations & Maintenance, Navy appropriation.

- A violation of the Antideficiency Act, including a violation of 31 USC § 1341 (a)(l)(A) or § 1517, did not occur in this matter. Whether or not Groton violated the Antideficiency Act depends on whether there is an adequate unobligated balance in the appropriation to which the submarine overhaul obligations should have been charged to, in this case, Operations & Maintenance, Navy. As there are sufficient appropriations available for obligation, the Department of Navy is not legally required to report a deficiency in accordance with the Antideficiency Act since there is no such deficiency.

**Our Response.** The actions taken by the Director, Budget Policy and Procedures Division, Office of Budget, Assistant Secretary of the Navy, (Financial Management and Comptroller) did not in all respects comply with the requirements of the DoD Financial Management Regulation, Volume 14, Chapter 3. However, we accept their finding that a violation of 31 USC § 1341 (a)(l)(A) or § 1517 did not occur in this matter if the Navy has sufficient, proper funds to adjust the obligation. We will monitor the Department of Navy actions to correct the Purpose Statute violation until completion.
The former Deputy Officer, Groton Business Operations Department, liquidated contract debt to offset an unpaid amount of $1,919,000 said to exist for pension costs\(^\text{17}\) on Contract No. N00024-06-C-2108, a contract awarded by the Naval Sea Systems Command in 1996 for a SEAWOLF Class Submarine. The debt liquidation was provided for in the September 30, 2004, Memorandum of Agreement (see Finding B). However, at the time of contract award the estimate of future pension costs\(^\text{18}\) for the contract period of performance was zero ($0). Therefore, the former Deputy Officer, Groton Business Operations Department in essence provided the contractor with $1,919,000 in debt liquidation for nonexistent pension costs. When questioned about this action, a June 7, 1996, Memorandum of Agreement was provided as support for the debt liquidation; however, the June 7, 1996, Memorandum of Agreement had no significance in the contract negotiation. As reported in Finding B, the former Deputy Officer, Groton Business Operations Department did not prepare business clearance memoranda justifying the actions he took in executing either 2004 Memoranda of Agreement. Additionally, contract case file records were subsequently misplaced or discarded. The $1.9 million debt liquidation unjustifiably improved the contractor's profit standing to the detriment of the United States Government in its contractual relationship with the contractor.

**Naval Sea Systems Command Negotiation Objective for Contractor Pension Costs.**

The former Naval Sea Systems Command contract specialist that assisted in the negotiation of Contract No. N00024-96-C-2108 in 1996\(^\text{19}\) provided the following information regarding the impact that the Groton June 7, 1996, Memorandum of Agreement had on the contract negotiation objectives established by the Naval Sea Systems Command negotiation team:

\(^{17}\) Federal Acquisition Regulation 31.205-6 – Compensation for Personal Services, subparagraph (j) *Pension Costs* provides that a contractor shall measure, assign, and allocate the costs of all defined-benefit pension plans in compliance with Cost Accounting Standard 412—Cost Accounting Standard for Composition and Measurement of Pension Cost, and Cost Accounting Standard 413—Adjustment and Allocation of Pension Cost. The Regulation also provides that pension costs are allowable subject to the referenced standards and specified cost limitations.

\(^{18}\) Cost Accounting Standard 412—Cost Accounting Standard for Composition and Measurement of Pension Cost provides that the components of pension cost under a defined benefit plan are (i) the normal cost for the period, (ii) a part of any unfunded liability, (iii) an interest equivalent on the unamortized portion of any unfunded actuarial liability, and (iv) an adjustment for any actuarial gains and losses.

\(^{19}\) The former contract specialist, now a Branch Chief, Contracts, Naval Sea Systems Command, provided to the Office of Inspector General the pre- and post-Business Clearance Memoranda prepared by the Naval Sea Systems Command negotiation team in accordance with Federal Acquisition Regulation 1.602-1(a), as well as copies of the original contract and the restructured contract.
The basis for the agreement to remove all pension costs for 1996 through 2002 was the overfunded status\(^{20}\) of the contractor’s pension plan that arose prior to 1996.

No cause and effect existed between the Groton June 7, 1996, Memorandum of Agreement and the removal of all pension costs for 1996 through 2002.

Had the Naval Sea Systems Command negotiation team believed that the Groton June 7, 1996 Memorandum of Agreement was significant to contract negotiations; the negotiation team would have referenced it in their Business Clearance Memoranda. The Business Clearance Memoranda, and the resulting contract, are silent with regard to the Groton June 7, 1996, Memorandum of Agreement with the contractor.

**Review of Terms, Contract No. N00024-96-C-2108.** Contract No. N00024-96-C-2108 included the Incentive Price Revision – Firm Target contract clause found at Federal Acquisition Regulation 52.216-16. The terms included therein by the Naval Sea Systems Command and the contractor provided the contract final price would be established by adjusting the total final negotiated cost by an amount for profit or loss, determined as follows:

When the total final negotiated cost is greater than the total target cost, the amount for profit or loss is the total target profit less FIFTY (50%) percent of the amount by which the total final negotiated cost exceeds the total target costs.

During contract negotiations, the Naval Sea Systems Command and contractor had agreed to remove all pension costs from the contract target costs. Under the Incentive Price Revision – Firm Target clause included in the contract, any actual pension costs incurred by the contractor would have reduced the contractor’s potential profit on the contract by 50 percent of any actual pension costs.

**Review of Terms, Groton June 7, 1996 Memorandum of Agreement.** The terms included and agreed upon by a former Groton Assistant Contracts Officer and the contractor in the June 7, 1996, Memorandum of Agreement state that:

The Navy recognizes that in the event the contractor incurs pension costs from 1996 forward that were not estimated or proposed by [the contractor] as a result of this agreement, the [contractor’s] effective profit rate would consequently be reduced based on the method of calculating fee as established in the contract clause entitled "Incentive Price Revision - Firm Target”. The Navy has determined that in the event of this occurrence, [the contractor] in consideration for this agreement, should be "made whole” on the [Contract No. N00024-96-C-2108] only, by excluding

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\(^{20}\) Overfunding of a pension plan can occur when the value of pension plan assets exceeds the sum of the actuarial liability plus the normal cost for the period. Under this situation, pension cost is $-0-.$
pension costs from allowable incurred costs for purposes of calculating profit in accordance with the said incentive price revision clause.

The June 7, 1996, Memorandum of Agreement revised the profit arrangement negotiated by the Naval Sea Systems Command, reversing the incentive placed on the contractor to avoid any future employee pension costs during the period 1996 through 2002. No evidence was provided by the Groton Business Operations Officer to demonstrate that the Government had received any contractual consideration for entering into the June 7, 1996, Memorandum of Agreement, other than the assertion that the removal of all pension costs from the rates during contract negotiation was the result of the June 7, 1996, Memorandum of Agreement.

**Lack of Rescission/Modification for Change to Contract Structure.** No action was taken by the Groton Business Operations Department to revise the June 7, 1996, Memorandum of Agreement to reflect the contract restructure that occurred in 1999. The original contract underwent a significant change from fixed-price incentive fee to firm-fixed price and cost-plus incentive fee. There is no provision in the June 7, 1996 Agreement that specified the rights of either party in the event of a change to a firm-fixed price or cost-plus incentive fee type contract.

The Groton Business Operations Officer asserted that “As stated in the June 7, 1996 [Memorandum of Agreement], the intent of the document was to make the contractor ‘whole’ should events and costs change in the future.”

**Lack of Contractor Claim or Invoice.** Groton Business Operations Department personnel were not able to provide a contractor proposal, claim, or invoice asserting a right for payment in any amount arising from the June 7, 1996, Memorandum of Agreement. A written contractor demand for payment is a sound business practice underlying all government contracting. It ensures that payments made by government officials to third party contractors are based upon a valid claim for payment.

The Groton Business Operations Officer asserted that “For clarification purposes: The terms of the [June 7, 1996 Memorandum of Agreement] do not contain a requirement to submit a claim, proposal, or other submission.”

**Groton Demonstration of Amount.** The Groton Business Operations Officer provided calculations made in June of 2009 for the Office of Inspector General that showed the $1,919,000 offset was attributable to the contractor incurring pension expense during its 2003 fiscal year. These calculations show a total pension expense of $1,834,520, with $1,614,387 in pension expense attributed to the firm-fixed price line items in the restructured contract and $220,134 attributed to the cost plus incentive fee line items. The firm-fixed price component of $1,614,387 was comprised of cost ($1,403,814) and profit ($210,572), while the cost plus incentive fee was comprised of fee. The calculations resulted in an unexplained difference of $84,480 from the offsetting amount of $1,919,000 included in the September 30, 2004, Memorandum of Agreement for pension expense.
The Groton Business Operations Officer asserted “Pension costs did not change until 2003 and were included in the 2004 settlement because the parties always intended to make the contractor whole on this issue.”

**Failure to Safeguard the Interests of the United States in its Contractual Relationships.** Based on a review of existing records and files, the actions taken by the former Deputy Officer, Groton Business Operations Department, to grant the contractor entitlement to an offset of $1,919,000 for Pension Costs as a part of the September 30, 2004, Memorandum of Agreement were not justified.

Based on the records and information made available to the Office of Inspector General, the June 7, 1996, Memorandum of Agreement:

- Did not provide any contractual consideration to the United States Government for entering the Agreement,
- Eliminated the incentive the contractor had to avoid any actual pension costs as provided for in the Incentive Price Revision – Firm Target clause included in the contract,
- Unjustifiably improved the contractor’s potential profit position on Contract No. N00024-96-C-2108.

The available records indicate that the actions taken by senior Groton contracting officers since 1996 with regard to pension costs on Contract No. N00024-96-C-2108 breached the responsibilities granted a contracting officer by Federal Acquisition Regulation 1.602-2 – Responsibilities, which states:

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 United States in its contractual relationships. In order to perform these responsibilities, contracting officers should be allowed wide latitude to exercise business judgment.

**Management Comments on the Finding and Our Response.**

The Assistant Secretary of the Navy, (Research Development and Acquisition), provided the Department of Navy Response dated May 21, 2010. A summary of the comments is provided below. The full text of the response is provided in the Management Comments section of the report.

**Management Comments:** Naval Sea Systems Command Negotiation Objective for Contractor Pension Costs. The Department of Navy did not concur with this finding. The Assistant Secretary of the Navy, (Research Development and Acquisition) stated that
while the Post Negotiation Business Clearance Memorandum does not reference the 1996 Memorandum of Agreement as the cause of the removal of $145 million of pension costs from the forward pricing rates, the 1996 Memorandum of Agreement was known necessary to obtain the contractor’s concurrence to remove pension costs from the contract target cost settlement. He stated that, in retrospect, the Memorandum of Agreement should have been referenced in the Post Negotiation Business Clearance Memorandum, as it was relevant to the final settlement of Contract No. N00024-96-C-2108.

**Our Response.** We appreciate that the Assistant Secretary of the Navy, (Research Development and Acquisition) concurred in principle; however, we consider the comments nonresponsive. Subsequent to receipt of the Department of Navy response, we held meetings with Naval Sea Systems Command contracting officials (Director for Contracts, Deputy Director of Contract Policy, and Director, Shipbuilding Contracts) to discuss the potential impact that additional information obtained by the DoD OIG from third parties might have on the Department of Navy position. In a July 1, 2010 meeting, the DoD OIG auditors were told that:

- When negotiating Contract No. N00024-96-C-2108 in 1996, prior Naval Sea Systems Command contracting officials purposely disregarded the existing *Advance Agreement Pension Costs* that had been executed by the U.S Government and the contractor in December 1986.\(^{21}\) This decision was made despite the fact that the U.S. Government and the contractor had agreed to use the accounting practices identified in the 1986 *Advance Agreement Pension Costs* with respect to the equitable determination of the amount of pension costs allocable to and allowable on Government contracts.

- When negotiating the incentive fee structure under a fixed-price incentive contract, Naval Sea Systems Command contracting officials stated that the 1986 *Advance Agreement Pension Plan* did not provide for an adjustment to the negotiated target cost. The Agreement only provided for an adjustment to negotiated allowable cost. The Naval Sea Systems Command contracting officials advised the DoD OIG auditors that, under their interpretation, had Contract No. N00024-96-C-2108 been negotiated using the accounting practices

\(^{21}\) Under the 1986 Advance Agreement Pension Plan, the contractor was required to price pension expense for future contracts on the assumption that its pension plans were not overfunded. Thus, negotiated contract prices would include the pension plan normal cost, amortization of actuarial gains (except any arising out of an actuarial surplus) and losses, a part of any unfunded actuarial liability, and an interest equivalent on any unamortized portion of any unfunded actuarial liability. The Advance Agreement required that, for any year during which the pension plan may be in an actuarial surplus position, the contractor and the Government agreed to equitably adjust, as promptly as possible after the end of such year, firm fixed price, fixed price incentive and cost type contracts performed during said year. The adjustment was to give the Government credit for its portion of the actuarial surplus in the form of a direct reduction in pension costs allocable to such contracts. The amount of the direct reduction would be an amount equal to the allocable excess of pension cost priced into the contract over the amount of allocable pension costs actually funded for the plan(s) for that year.
provided in the 1986 *Advance Agreement Pension Plan*, the contractor would have received a $48 million windfall profit on the contract.

- To avoid paying such a windfall profit, prior Naval Sea Systems Command contracting officials established the incentive fee structure under Contract No. N00024-96-C-2108 with $0 for pension cost. However, Naval Sea Systems Command contracting officials told the DoD OIG auditors that the contractor would agree with this approach only if the Groton Business Operation Department executed the 1996 Memorandum of Agreement. That Agreement gave the contractor an out if their employee pension plan came out of full funding and they experienced pension cost during the contract period of performance.

- The Naval Sea Systems Command contracting officials asserted to the DoD OIG auditors that the pension deal negotiated with the contractor under Contract No. N00024-96-C-2108 protected the U.S. Government from paying a windfall profit of $48 million at a cost of $1,919,000 - the amount included as an offset by the former Deputy Officer in the Groton 2004 Memorandum of Agreement.

We requested the Naval Sea Systems Command Director for Contracts provide to the DoD OIG a management letter identifying and attesting to the assertions made to the auditors on July 1, 2010. We requested the letter include sufficient detail and reference to supporting records to allow the auditors to judge its relevance, validity and reliability in accordance with the auditing Standards promulgated by the Comptroller General of the United States.

The DoD OIG was not provided with the requested management letter from the Naval Sea Systems Command Director for Contracts. Instead, a Naval Sea Systems Command contracting official not in attendance at the July 1, 2010 meeting advised the DoD OIG by email that the Navy now concurs in principle to this finding, and that:

- The Naval Sea Systems Command contracting officials were unaware of the existence of the 1986 Advance Agreement Pension Costs until the July 1, 2010 meeting when a copy was provided by the DoD OIG auditors.

- Upon review of that agreement and subsequent discussions with SUPSHIP Groton, the Navy agrees that the 1986 Advance Agreement was technically still in effect at the time Contract N00024-96-C-2108 was negotiated in 1996.

- The Navy believes its treatment of pension costs in the negotiation of Contract N00024-96-C-2108 resulted in the lowest cost solution for the Government.

We note that had the Naval Sea Systems Command priced Contract No. N00024-96-C-2108 in accordance with the 1986 *Advance Agreement Pension Costs*, the contract price would have increased by the same unsubstantiated $48 million that the Naval Sea Systems Command contracting officials argued on July 1, 2010 amounted to a windfall
profit. Under the December 1986 *Advance Agreement Pension Costs*, the contractor was required to price pension expense for future contracts on the assumption that its pension plans were not overfunded. Likewise, had they complied with the 1986 *Advance Agreement Pension Costs*, the contract price, estimates at completion, and contract funding and budget requirements would have increased by the same unsubstantiated $48 million.

We researched prior DoD IG Report No. 98-087, *Cost of SSN-21 Class Submarines*,

dated March 6, 1998 and found we had reported that the $7.393 billion cost limitation placed by Congress on the Seawolf Program appeared to be adequate. The March 1997 estimate-at-completion provided by the Navy Seawolf Program Management Office was $7.393 billion, which was at the Congressionally mandated cost limitation. The September 1997 estimate-at-completion from the Navy Seawolf Independent Cost Review Team was $7.3257 billion, or $67.3 million under the cost limitation. Adding contractor pension cost computed in accordance with the 1986 *Advance Agreement Pension Costs* could have put the Seawolf Program over the Congressionally mandated cost limitation.

**Updated Management Comments:** Naval Sea Systems Command Negotiation Objective for Contractor Pension Costs.  By memorandum dated August 27, 2010, the Director, Program Analysis and Business Transformation, Deputy Assistant Secretary of the Navy (Acquisition and Logistics Management) commented that the Navy agrees that the December 1986 *Advance Agreement Pension Cost* was technically still in effect at the time Contract N00024-96-C-2108 was negotiated in spring 1996 but was subsequently cancelled in 1997. The Navy believes its treatment of pension costs in the negotiation of Contract N00024-96-C-21 08 resulted in the lowest cost solution for the Government.

**Our Response.** We appreciate that the Department of Navy has accepted the legal standing of the December 1986 *Advance Agreement Pension Cost*. However, the Department of Navy has not taken responsibility for the actions taken by the former Naval Sea Systems Command contracting officials to disregard and override the requirements of the 1986 *Advance Agreement Pension Cost* when negotiating the terms of Contract No. N00024-96-C-2108. The actions taken by former Naval Sea Systems Command contracting officials to reach a “lowest cost solution” were inappropriate and

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22 The National Defense Authorization Act for Fiscal Year 1998 directed the Inspector General, DoD, to determine whether the cost limitation imposed on the Seawolf class submarines was adequate. In making that determination, the Inspector General was requested to determine the current cost estimate of the Navy for completion of the SSN-21, SSN-22 and SSN-23. Congress had imposed cost limitations on the Seawolf Program, starting in 1994. The National Defense Authorization Act for Fiscal Year 1996 authorized SSN-23 and imposed a cost limitation of $7.224 billion for the procurement of three Seawolf class submarines, SSN-21, SSN-22 and SSN-23. The cost limitation could be automatically increased for economic inflation, compliance with changes in Federal and state laws and post delivery and outfitting costs. The $7.224 billion cost limitation was based on cost estimates and projections that the Navy provided to Congress. By Fiscal Year 1998, the cost limitation had grown to $7.393 billion due to the impact of economic inflation and outfitting and post delivery costs.
did not fulfill public policy goals and objectives as envisioned under the Federal Acquisition Regulation.

Management Comments: For the following findings, the Assistant Secretary of the Navy (Research Development and Acquisition) did not provide a response.

- Review of Terms, Groton June 7, 1996 Memorandum of Agreement.
- Lack of Rescission/Modification for Change to Contract Structure.
- Lack of Contractor Claim or Invoice.
- Groton Demonstration of Amount.

Our Response. The Department of Navy did not refute our findings as presented, nor did they provide any additional factual evidence for our consideration that may have persuaded us that the former Deputy Officer, Groton Business Operations Department had complied with the Federal Acquisitions Regulation.

Management Comments: Failure to Safeguard the Interests of the United States in its Contractual Relationships. The Department of Navy did not concur with the finding on safeguarding U.S. interests. In his response, the Assistant Secretary of the Navy (Research Development and Acquisition) stated that in consideration for the pension Memorandum of Agreement of 1996, the Government received a lower price on the award of the SSN23 contract. He also provided that a subsequent modification to that contract (P00017) clearly stated that all written agreements would remain in effect. The Assistant Secretary of the Navy (Research Development and Acquisition) provided that, based on the above, the contractor was entitled to the $1,919,000 adjustment.

Our Response. We disagree. In addition to our original finding, we find that the actions taken by prior Naval Sea Systems Command contracting officials to circumvent the existing 1986 Advance Agreement Pension Cost when negotiating Contract No. N00024-96-C-2108 also violated Federal Acquisition Regulation 1.602-2 – Responsibilities.

We find that the ‘unpaid bill’ for pension costs that was used by the former Deputy Officer to offset $1,919,000 of contractor debt was in effect consideration given to the contractor for agreeing to circumvent the requirements of the existing 1986 Advance Agreement Pension Cost when entering into Contract No. N00024-96-C-2108. We find no provision in the Federal Acquisition Regulation that would allow for the use of such an arrangement as the basis for offsetting a legitimate contractor debt.
These actions by Navy acquisition officials neither maintain the public’s trust nor fulfill the public policy objectives of the Department of Defense. Federal Acquisition Regulation 1.102 (a) states in part “The vision for the Federal Acquisition System is to deliver on a timely basis the best value product or service to the customer, while maintaining the public’s trust and fulfilling public policy objectives.”

Recommendations, Management Comments, and Our Response.

Recommendation C.

We recommend that the Director for Contracts, Naval Sea Systems Command:

1. Reassess the action taken by the former Deputy Officer, Groton Business Operations Department, to liquidate $3,882,926 in contract debt owed to the United States Government and take action to recover the $3,615,860 in contract debt offset against unpaid bills on Contract Nos. N00024-96-C-2108 and N00024-00-C-8501.

Management Comments. In his May 21, 2010 response, Assistant Secretary of the Navy, (Research Development and Acquisition) responded that this recommendation is duplicative of recommendation B.4.a.

Updated Management Comments. Subsequent to the May 21, 2010 Department of Navy response, the Director, Program Analysis and Business Transformation, Deputy Assistant Secretary of the Navy, (Acquisition and Logistics Management) commented that the Department of Navy concurs in principle with Recommendation C.1 but that the Navy believes its treatment of pension costs in the negotiation of Contract N00024-96-C-2108 resulted in the lowest cost solution for the Government.

Our Response. We appreciate that the Department of Navy concurred in principle; however, we consider the comments nonresponsive. The Department of Navy fails to acknowledge that actions taken by former Naval Sea Systems Command contracting officials to reach a “lowest cost solution” were inappropriate and did not fulfill public policy goals and objectives as envisioned under the Federal Acquisition Regulation. Within 30 days of the issuance date of this report, the Assistant Secretary of the Navy (Research Development and Acquisition) needs to take vigorous action to ensure that legitimate contract debts totaling $1,919,000 are recovered from the contractor. In our opinion, these debts owed to the U.S. Government were wrongly offset against a 'unpaid bill' for pension costs as a part of the Groton 2004 Memorandum of Agreement. We find that the $1,919,000 offset of debt awarded to the contractor was consideration for agreeing to circumvent the legally binding requirements of the 1986 Advance Agreement Pension Cost when entering into Contract No. N00024-96-C-2108. We find no provision
in the Federal Acquisition Regulation allowing for such an arrangement and payment. (Also see Finding B, Recommendation B.4, Our Response.)

2. Re-evaluate the existing management controls at the Groton Business Operations Department and make improvements that ensure that all contract actions executed by senior level contracting officers represent effective contracting, ensure compliance with the terms of the contract, and safeguard the interests of the United States in its contractual relationships with the contractor.

   Management Comments. The Department of Navy concurred with the recommendation.

   Our Response. The Navy comments were responsive.

3. Issue a directive memorandum to all Supervisor of Shipbuilding, Conversion and Repair contracting officers establishing that the following dictates of Federal Acquisition Regulation 1.602-2 – Responsibilities shall take precedence over the ‘wide latitude to exercise business judgment’ afforded contracting officers when making contracting decisions on behalf of U.S. Government.

   Contracting officers are responsible for … ensuring compliance with the terms of the contract, and safeguarding the interests of the United States in its contractual relationships.

   Management Comments. The Department of Navy did not concur with the recommendation. In his response, the Assistant Secretary of the Navy (Research Development and Acquisition) observed that the DODIG recommendation is that NAVSEA should disregard the plain language of Federal Acquisition Regulation 1.602-2 by having one sentence in that Federal Acquisition Regulation cite take precedence over the next sentence to which it specifically refers.

   Our Response. We have rescinded the recommendation.

4. Evaluate the need to rotate senior civilian contracting officers on a periodic basis between the several Supervisor of Shipbuilding, Conversion and Repair locations.

   Management Comments. The Department of Navy concurred with the recommendation.

   Our Response. The Navy comments were responsive.

5. Within 3 months of the issuance of this final report, provide the Assistant Inspector General for Audit Policy and Oversight a report detailing the results from
Recommendations C.1, C.2, and C.4 above, as well as a copy of the written guidance established in accordance with Recommendation C.3.

**Management Comments.** The Department of Navy concurred with Recommendations C.1, C.2 and C.4.

**Our Response.** The Navy comments were responsive.
Appendix A. Scope and Methodology

The project was established after risk factors were observed during follow-up work on Department of Defense Inspector General Report No. D-2008-6-005. The process used by the Supervisor of Shipbuilding, Conversion and Repair, Groton, to establish final indirect rates appeared to conflict with Federal Acquisition Regulation Part 42.7 – Indirect Rates, Federal Acquisition Regulation 52.216-7 Allowable Cost and Payment, and Cost Accounting Standard 406. This conclusion was reached after review of the information included in the Navy’s response to the Report, dated July 9, 2008, Enclosure (1), Finding A: Premature Establishment of Indirect Cost Rates. The Navy had nonconcurred with our recommendation to discontinue the practice of establishing final indirect cost rates without taking final action on Defense Contract Audit Agency unresolved and questioned cost.

The project scope was designed to demonstrate that final indirect costs rates established by contracting officers at the Supervisor of Shipbuilding, Conversion and Repair, Groton, complied with Federal Acquisition Regulation Part 42.7 – Indirect Rates, Federal Acquisition Regulation 52.216-7 Allowable Cost and Payment, and Cost Accounting Standard 406. We used auditor findings and recommendations included by the following Defense Contract Audit Agency in the following reports:

- Report Number 02361-1999R10150001, dated 30 September 1999
- Report Number 02361-1999R10100001, dated 31 August 2001
- Report Number 02361-2003B17900017, dated 14 September 2004

We performed this project from February 2009 through February 2010.

Prior Coverage. In the last 6 years, we issued two other reports related to the Navy’s actions on Defense Contract Audit Agency audit reports. We reported several inadequacies with the contract audit follow-up process, including inaccuracies with the Supervisor of Shipbuilding, Conversion and Repair, Groton semiannual reporting of contract audit follow-up data.

### Summary of Assistant Secretary of the Navy, (Research Development and Acquisition) Comments

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>May 21, 2010 ASN(RD&amp;A) Comments</th>
<th>August 27, 2010 ASN(A&amp;LM) Comments</th>
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<tr>
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<td>C.5</td>
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MEMORANDUM FOR THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Department of the Navy Response – Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut (D2009-DIP0A1-0022.005)

The Department of the Navy (DoN) response to the DODIG Draft Report is attached. The response includes detailed comments to the findings contained in the DODIG report as well as the responses pertaining to the potential violations of 31 USC 1341. The Navy’s response is to be incorporated into the final DODIG report on the Supervisor of Shipbuilding Conversion and Repair Groton, Connecticut.

Thank you for the opportunity to comment on the subject final report. My point of contact is [redacted].

Sean J. Stackley

Attachments:
As stated

cc:
COMNAVSEASYSCOM
NAVIG
NAVSEA RESPONSE TO DODIG DRAFT REPORT ON ACTIONS TO 
ESTABLISH FINAL INDIRECT COST RATES ON REPORTABLE CONTRACT 
AUDIT REPORTS BY THE SUPERVISOR OF SHIPBUILDING, CONVERSION 
AND REPAIR, GROTON, CONNECTICUT (D2009-DIPOAI-0022.005)

Introduction

The Department of Defense Inspector General (DODIG) 
performed a review of the actions taken by the Supervisor 
of Shipbuilding, Groton CT (SUSG) to establish final 
indirect cost rates on cost reimbursable-type contracts 
under Project No. D2009-DIPOAI-0022.005. The following 
comments are provided in accordance with DoD Directive 
7650.3.

DODIG Finding A. Noncompliant Method for Administering 
Indirect Cost Rates on Cost Reimbursable Type Contracts

SUPSHIP Groton does not comply with Federal Acquisition 
Regulation (FAR) and the Cost Accounting Standards (CAS) 
when establishing final indirect rates for use in settling 
Government cost reimbursable type contracts and uses Post 
Audit Disallowance Factor in lieu of final indirect cost 
rates to remove unallowable costs from cost reimbursable 
type contracts.


The Groton Business Operations Officer has initiated a 
corrective action plan that partially addressed the 
noncompliant practices. The plan includes discontinuing the 
use of the Post Audit Disallowance Factor. However, it is 
lacking in the areas of final cost settlement and Cost 
Accounting Standards administration.

CONCUR: SUPSHIP Groton will review and revise its 
corrective action plan to further address the final cost 
settlement and CAS administration.

2. Noncompliance with FAR 52.216-7 Allowable Cost and 
Payment.

The use by the Groton Business Operations Department of a 
Post Audit Disallowance Factor in lieu of final indirect 
cost rates to segregate unallowable costs does not comply 
with Federal Acquisition Regulation 52.216-7 - Allowable 
Cost and Payment. The contract clause requires that each

ENCLOSURE (1)
final indirect cost rate exclude unallowable costs, as shown in the records maintained by the contractor. However, under the Groton practice, contractor indirect cost rates include all identified unallowable costs. In lieu of complying with FAR 52.216-7 and excluding unallowable costs from each indirect cost rate, Groton uses the Post Audit Disallowance Factor. As a result of this Contract Audit Follow-Up project, and as discussed further in the section below for Groton Proposed Corrective Action, the Groton Business Operations Officer has proposed discontinuing the use of the Post Audit Disallowance Factor.

CONCUR IN PRINCIPLE: SUPSHIP Groton did comply with FAR 52.216-7 - Allowable Cost and Payment. The disagreement between DODIG and SUPSHIP Groton was the technique used to comply with applicable FAR. As noted in the DODIG draft audit report, it has been a long standing practice by the contractor to use Post Audit Disallowance Factors to exclude unallowable costs as a percentage of the total cost, as compared to the common industry practice of excluding unallowable costs by cost element. Both techniques achieve the same result of excluding unallowable costs from indirect cost rates.

In light of the DODIG concern, the contractor has revised their billing system to exclude unallowable costs, by cost element, effective 1 January 2009.


Public statute 41 U.S.C. 422(f)(2)(A) provides in part that "Cost accounting standards promulgated under this section shall be mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with pricing and administration." Use of the Post Audit Disallowance Factor by the Groton Business Operations Department violates the provisions of Cost Accounting Standard 406 - Cost Accounting Period. For example, Groton contracting officials included $15.4 million in unallowable corporate office costs recorded by the contractor in fiscal years 1997 through 1999 in the Post Audit Disallowance Factor used to adjust contract costs in the contractor's cost accounting period for 2006. Cost Accounting Standard 406 was effective as of April 17, 1992. The Groton practice for
use of the Post Audit Disallowance Factor dates from the
1970s.

CONCUR: SUPSHIP Groton's corrective action plan provides
that it will no longer move negotiated and settled costs
forward into the next open accounting period after an
incurred cost year has been settled and closed.

4. Measure of Materiality of Cost Impact, Violation of
CAS 406.

Personnel in the Groton Business Operations Department
could not demonstrate that the on-going violation of Cost
Accounting Standard 406 caused by use of the Post Audit
Disallowance Factor has had a material or immaterial cost
impact on Government contract prices and costs. Although
they asserted an immaterial cost impact on individual
indirect cost rates for a particular cost accounting
period, they did not demonstrate their assertion using the
criteria provided at Federal Acquisition Regulation 30.605
Criteria for determining whether amounts of costs are
material or immaterial are provided at 48 Code of Federal
Regulations 9903.305 - Materiality, and include: the
absolute dollar amount involved, the impact on Government
funding, and the cumulative impact of individually
immaterial items.

NONCONCUR: SUPSHIP Groton firmly believes that the
Government was not harmed by the practice of using the
disallowance factor. During the DoD IG review, SUPSHIP
Groton provided a cost impact demonstrating the
immateriality. However, the contractor's change in
accounting and billing systems, effective 1 January 2009,
has modified this practice going forward to be consistent
with the DOD IG recommendation.

5. Failure to Make a Determination after Receipt of
Report of Alleged Noncompliance from Auditor.

The administrative contracting officer in the Groton
Business Operations Department failed to comply with
Federal Acquisition Regulation 30.605 - Processing
Noncompliances and take action upon the receipt from the
auditor of a report of alleged Cost Accounting Standard
noncompliance. On September 14, 2004, the Defense Contract
on Application of Agreed-Upon Procedures, Prior Year Overhead Adjustments. DCAA reported that:

- The contractor's practice of recording prior period indirect cost adjustments as a current year cost separation shop order is noncompliant with Cost Accounting Standards 401 and 402 and produces an inaccurate final rate presentation.
- The contractor should be required to bill costs for all contracts in the same accounting/billing period that the costs were recognized.
- The contractor should be required to record the prior period costs in the specific account, in the appropriate cost pool, and allocate the expense to final cost objectives through the applicable overhead, fringe benefit, or General and Administrative rate applicable to the cost accounting period in which the expense was recorded.

NONCONCUR: The referenced DCAA Report on Agreed-Upon Procedures No. 02361-2003B17900017 dated September 14, 2004, was not issued as a CAS noncompliance audit report (i.e., Reportable Audit), and therefore was not treated as such. DCAA issued their Agreed-Upon Procedures (AUP) review at the request of SUPSHIP Groton ACO to evaluate the contractor's financial system for potential improvement.

Subsequent to the issuance of DCAA's AUP review, a complete CAS Disclosure Statement audit was performed by DCAA in 2006 (AAR 2361-2007B19100001), and the results of that audit state: "The practices, as described, comply with applicable Cost Accounting Standards and FAR Part 31 and are consistent with the contractor's actual practices." The audit further states that: "The control environment and overall accounting system and related internal controls are considered adequate." Finally, DCAA Groton has not issued a non-compliance audit relative to the original Agreed-Upon Procedure report.


The Department of Defense Inspector General, Office of the Assistant Inspector General for Audit Policy and Oversight,
believes the proposed corrective action plan, if implemented, will not go far enough to bring the business practices used by the Groton Business Operations Department into compliance with the Federal Acquisition Regulation and Cost Accounting Standards. The corrective action plan does not (i) address Cost Accounting Standards administration, and (ii) provides for the continued use of the ‘Reservation of Rights’ practice.

- Cost Accounting Standards Administration. The plan does not address actions necessary to achieve compliance with 41 USC 422 and Federal Acquisition Regulation Part 30, Cost Accounting Standards Administration. The allegations of noncompliance with Cost Accounting Standards 401 and 402 included in Defense Contract Audit Agency Report No. 02361-2003817900017 need to be addressed by the Groton Business Operations Department as required by Federal Acquisition Regulation 30.605 - Processing Noncompliances. Additionally, the violation of Cost Accounting Standard 406 caused by the past use of the Post Audit Disallowance Factor as identified in this report needs to be examined to ensure the Government has not paid increased prices and costs on contracts subject to the Cost Accounting Standards.

- Reservation of Rights. The use of the ‘Reservation of Rights’ procedure must be ended. “Reservation of Rights’ simply delays the negotiation of cost issues and pushes costs into future cost accounting periods in violation of Cost Accounting Standard 406. These delays jeopardize the Government’s position by risking the loss of government records and personnel familiar with the cost issue (see Findings B and C). All cost allowability and allocability issues except those specifically addressed by the Cost Principle at Federal Acquisition Regulation 31.205-47 - Costs Related to Legal and Other Proceedings, must be addressed, negotiated and settled as a part of the settlement of the contractor’s fiscal year final indirect cost rates. The Federal Acquisition Regulation does not provide for the deferral of any other type of cost issue. The duty given the administrative contracting officer in Federal Acquisition Regulation Part 42.7 - Indirect Cost Rates, is to settle all indirect cost issues when
establishing final indirect cost rates for a contractor’s fiscal year.

PARTIALLY CONCUR: SUPSHIP Groton will review and revise the corrective action plan to ensure that the plan addresses CAS administration. As stated in SUPSHIP Groton corrective action plan, the use of Reservation of Rights will be limited. SUPSHIP Groton believes the use of Reservation of Rights is in compliances with the FAR, but acknowledges that this technique should only be used in the most compelling circumstances to settle issues that would unreasonably delay settlement of final rates. There is no prohibition in the FAR against paying the cost conditionally and later retrieving any excess amount paid, with interest, if the cost is determined to be unallowable or unallocable.

DoDIG Recommendations For Finding A.

1. Recommend the Business Operations Officer at SOSG takes the following actions:

   a. Implement the proposed SUPSHIP Groton corrective action plan dated 16 July 2009 submitted to DODIG.

   CONCUR: SUPSHIP Groton Corrective Action Plan has already been implemented. Completed.

   b. Within 3 months of this issuance of this report, comply with the requirements of FAR Part 30.6 (CAS Administration) and address the allegations of noncompliance included in DCAA Report No. 02361-2003B17900017 (Report on Application of Agreed-Upon Procedures, Prior Year Overhead Adjustment), including each Statement of Conditions and Recommendations identified by DCAA in that report.

   NONCONCUR: The referenced DCAA Report on Agreed Upon Procedures No. 02361-2003B17900017 was not issued as a noncompliance audit report (i.e., Reportable Audit), and therefore was not treated as such. DCAA issued their Agreed Upon Procedures (AUP) review at the request of SUPSHIP Groton ACO to evaluate the contractor’s financial system for improvement. Subsequent to the issuance of DCAA’s AUP review, a complete Disclosure Statement audit was performed by DCAA and the results of that audit did not disclose any issues or alleged CAS non-compliances from the AUP review.
c. Within 3 months of this issuance of this report, demonstrate using the criteria provided at FAR Part 9903.305 - Materiality, that use of Post Audit Disallowance Factor for the period April 17, 1992, to the contractor's fiscal year ending in 2008 did or did not result in a material cost impact on contracts covered by the CAS clause.

NONCONCUR: DCAA never issued a CAS non-compliance audit, therefore the contractor had no requirement to provide a cost impact on a contract basis. SUPSHIP Groton does not have the data available to determine the cost impact on a contract basis.

d. For open years, negotiate and settle contractor final indirect cost rates in accordance with FAR 52.216-7 and CAS 406.

CONCUR.

e. Eliminate the "Reservation of Rights" procedure from use in negotiating and settling final indirect cost rates.

NONCONCUR: NAVSEA firmly believes that in limited circumstances, reservation of rights is in the best interest of the Government and permissible under the FAR. FAR 1.102(d) provides: "The role of each member of the Acquisition Team is to exercise personal initiative and sound business judgment in providing the best value product or service to meet the customer’s needs. In exercising initiative, Government members of the Acquisition Team may assume if a specific strategy, practice, policy or procedure is in the best interests of the Government and is not addressed in the FAR, nor prohibited by law (statute or case law), Executive order or other regulation, that the strategy, practice, policy or procedure is a permissible exercise of authority."

2. The Director, Shipbuilding Contracts Division, NAVSEA:


CONCUR.
b. Perform a review of each SUPSHIP to determine whether the cognizant Business Operations Department:

(i) Establish contractor final indirect cost rates in accordance with FAR 52.216-7.

(ii) Administers CAS compliances IAW FAR 30.6.

(iii) Prohibits the use of the Reservation of Rights practice as a tool in settling contractor final indirect rates for a contractor cost accounting period.

CONCUR with A.2.b.(i) and (ii). NONCONCUR with A.2.b.(iii): The Director, Shipbuilding Contracts Division supports the limited use of Reservation of Rights. Approval for its use will require advance approval by the Director for Contracts, Naval Sea Systems Command.

c. Take corrective action to gain compliance with FAR 52.216-7 and FAR 30.6 for noncompliances identified as a result of the review performed in response to Recommendation A.2.b.

CONCUR.

d. By November 30, 2010, provide the Assistant IG for Audit Policy and Oversight a copy of the review results from recommendation A.2.b. and any associated reports and corrective action plans related thereto.

CONCUR.


The September 30, 2004, Memorandum of Agreement and supporting records demonstrate that the former Deputy Officer liquidated the following contract debts against two unpaid amounts due the contractor on existing contracts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Item</th>
<th>Contractor Debt</th>
<th>Unpaid Amounts</th>
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<tbody>
<tr>
<td>Indirect cost settlement, 1997</td>
<td></td>
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through 2001 $965,257
Interest assessment, indirect cost settlement, 1997 through 2001 $307,775
Interest and penalties, indirect cost settlements, 1989 through 1992 $193,154
Contract overpayment, Contract No. N00024-95-C-2101 $709,540
Price adjustment, change in contractor Cost Accounting Standards practice $1,707,200
Pension costs on Contract No. N00024-96-C-2108, a SEAWOLF Class submarine $1,919,000
Funding short-fall, Contract No. N00024-00-C-8501, a fixed price contract for submarine overhaul $1,696,860
Total $3,882,926 $3,615,860
Difference, Contract Debt Allowed to Remain with Contractor $267,066

2. Retrieval of Monies Remaining with the Contractor.

Federal Acquisition Regulation 32.602(a) prohibits the contracting officer from allowing a contractor to retain contract debts to cover amounts that may become payable in future periods. At the culmination of the debt liquidation described above, the former Deputy Officer allowed $267,066 in contract debt to remain with the contractor to be “used to offset future negotiated amounts.” On July 16, 2009, the Groton Business Operations Officer advised the Department of Defense Inspector General, Office of the Assistant Inspector General for Audit Policy and Oversight, by letter that the contractor had issued a check payable to the U.S. Treasury for $267,066. The check was dated June 24, 2009, and represented the contract debt remaining with the contractor at the culmination of the September 30, 2004, Memorandum of Agreement.

3. Violation of Contracting Officer Responsibilities, Contract Debt.

The former Deputy Officer violated paragraph (a) of Federal Acquisition Regulation 32.602 by liquidating contract debts totaling $3,882,926 and offsetting this amount against $3,615,860 in unpaid bills, in this case unpaid amounts on two contracts, as follows:
Contract No. N00024-96-C-2108. In Finding C of this report, we describe the substance of the $1,919,000 in unpaid contractor pension costs said to exist on a submarine contract.

Contract No. N00024-00-C-8501. A $1,696,860 funding short-fall on Contract No. N00024-00-C-8501, a fixed price contract for submarine overhaul. As detailed below, the former Deputy Officer settled eight unabjudicated change order proposals for an amount that exceeded the available funding on the contract by $1,696,860.

<table>
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<th>Fixed Price, Contract No. N00024-00-C-8501, as of June 27, 2002</th>
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<tr>
<td>Contractor Proposed Price, Eight Change Order Proposals</td>
<td>$2,684,579</td>
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<tr>
<td>Settlement Price, Eight Change Order Proposals</td>
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<tr>
<td>New Price, Contract No. 00024-00-C-8501</td>
<td>$23,534,114</td>
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<td>Funding Available on Contract</td>
<td>$21,837,254</td>
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<tr>
<td><strong>Funding short-fall</strong></td>
<td><strong>$1,696,860</strong></td>
</tr>
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Rather than obtain additional funding through the upward obligation process, the former Deputy Officer circumvented internal controls and offset the unpaid amount by liquidating existing contract debt. By liquidating these contracts debts himself, the former Deputy Officer violated paragraph (b) of Federal Acquisition Regulation 32.602 by authorizing the liquidation of contract debts, a responsibility specifically assigned to the government payment office.

NONCONCUR: The DODIG cited FAR provisions at 32.602 regarding offsets were not in the FAR in 2004 when these actions occurred, but rather were added to the FAR by Federal Acquisition Circular (FAC) 2005-27 dated 9/17/2008 with an effective date of 10/17/2008. SUPSHIP Groton has and will continue to comply with the revised FAR provisions.

The former Deputy, Field Procurement Office Chief of the Contracting Office (FFO CCO) exercised his authority in good faith under FAR 1.102, the provisions of FAR Part 32.
that were in effect at the time of the agreement, and DoD Directive 7640.2.

Specifically, FAR 32.606(d) in effect in 2004 when these actions occurred stated: "Except in cases in which an agreement has been entered into for deferment of collections (32.613) or bankruptcy proceedings against the contractor have been initiated, the contractor shall be required to liquidate the debt by - (1) cash payment in a lump sum on demand; or (2) credit against existing unpaid bills due the contractor."

Additionally, DoD Directive 7640.2 provides: "The responsibility for reaching agreement with the contractor is the contracting officer's, and he has wide latitude and discretion in that regard."


Public statute 31 U.S.C. 1341(a)(1) states, "An officer or employee of the United States Government or of the District of Columbia government may not - (A) make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation." On inquiry regarding the reason for the delay in negotiating the eight unbudgeted change orders, the former Deputy Officer advised the Department of Defense Inspector General auditors that lack of available funding had caused the delays, and that all funding had expired. To get new funding would have required going through the "upward obligation process." When asked to confirm the accuracy of the statements made by the former Deputy Officer, the current Groton Business Operations Officer acknowledged that using offsetting funds was not appropriate and in hindsight, the proper approach would have been to use the upward obligation process. By authorizing and approving the settlement of the eight change order proposals for a price of $2,317,171, the former Deputy Officer may have obligated the U.S. Government for an expenditure that exceeded the amount of funding available on the contract by $1,696,860, potentially violating 31 U.S.C. 1341(a)(1)(A).

Additionally, the potential exists that the actions taken by the former Deputy Officer violated other provisions of the Antideficiency Act, including those identified in
5. Failure to Execute Business Clearance Memoranda.

The decision by the former Deputy Officer to forego preparing and obtaining approved business clearance memoranda prior to executing either 2004 Agreement violated Federal Acquisition Regulation 1.602-1 - Authority and Federal Acquisition Regulation 1.602-2 - Responsibilities. Personnel in the Groton Business Operations Department had insufficient records and evidence to demonstrate that either 2004 Agreement (i) complied with all requirements of law, executive orders, regulations, and all other applicable procedures, and (ii) ensured compliance with the terms of the contract and safeguarded the interests of the United States.

CONCUR IN PRINCIPLE: A consolidated business clearance memorandum should have been prepared to demonstrate that the MOA complied with the applicable PAR provisions. However, SUPSHIP Groton did obtain legal advice on many of the underlying issues as appropriate and prepared business case documentation for the individual items covered by the 2004 MOA.

6. Failure to Maintain Contract Files.

The Groton Business Operations Department did not have case file documentation available for either 2004 Agreement that met the criteria at Federal Acquisition Regulation 4.801. The Groton Business Operations Officer stated that case files had existed for all contract actions involved in both settlement agreements, but that some contract files were subsequently misplaced or discarded. He also stated that Groton Business Operations Department does not have a separate policy or procedure that implements Federal Acquisition Regulation 4.801. Without business clearance memoranda and complete case file documentation to support the actions taken by the former Deputy Officer, Groton Business Operations Department personnel were not able to demonstrate that the 2004 Agreements represented effective contracting, ensured compliance with the terms of the contract, and safeguarded the interests of the United States in its contractual relationships.
CONCUR: As stated to DODIG during their site visit in 2009, some of the case files were subsequently misplaced or discarded as a result of several record cleanups in the Business Operations Department.

DODIG Recommendations for Finding B.

1. Recommend that SUPSHIP Groton Business Operations Officer:

   a. Within 3 months of the issuance of this report, establish and implement policies and procedures that ensure that all Groton contracting officers have met the requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, prior to executing all future MOA with the contractor.

   CONCUR.

   b. Within 3 months of the issuance of this report, perform a review of all existing MOA to ensure that each one meets the requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, prior to its execution with the contractor.

   CONCUR.

   c. Immediately issue a directive memorandum to all Groton Business Operations Department contracting officers and contracting personnel advising them of their duty to comply with FAR 32.602 - Responsibilities, FAR 1.602-1 - Authority and FAR 1.602-2 - Responsibilities, when contracting for the U.S.

   CONCUR.

2. The Business Operations Officer, Supervisor of Shipbuilding, Conversion and Repair, Groton:

   a. Within 3 months of this issuance of this report, establish and implement policies and procedures that ensure that the Groton Business Operations Department establishes and maintains contract case files containing the records of
all contractual actions sufficient to constitute a complete history of the transaction for the purpose of:

(1) Providing a complete background as a basis for informed decisions at each step in the acquisition process;
(2) Supporting actions taken;
(3) Providing information for reviews and investigations; and
(4) Furnishing essential facts in the event of litigation or Congressional inquiries.

b. Within 6 months of the issuance of this final report, perform a review of all existing case file records to determine that each contains a record of all contractual actions sufficient to ensure a complete history of the transaction.

c. Immediately issue a directive memorandum to all Groton Business Operations Department contracting officers and contracting personnel advising them of their duty to comply with Federal Acquisition Regulation Subpart 4.8 - Government Contract Files, when performing contracting duties for the United States.

CONCUR.

3. The Director, Shipbuilding Contracts Division, Naval Sea Systems Command:

a. Oversee and document oversight of the actions taken by the Groton Business Operations Officer described in above in items B.1 and B.2 to ensure:

(1) The actions are effectively and efficiently performed, and
(2) The Groton Business Operations Department has sufficient resources available to accomplish the tasks within the time frames specified.

CONCUR.

4. The Director of Contracts, Naval Sea Systems Command:

   a. Reassess the action taken by the former Deputy Officer, Groton Business Operations Department to liquidate $3,882,926 in contract debt owed to the United States Government and take action to recover the $3,615,860 in contract debt offset against unpaid bills on Contract Nos. N00024-96-C-2108 and N00024-00-C-8501.

   b. Re-evaluate the existing management controls at the Groton Business Operations Department for collecting contract debts and make improvements that ensure all contract debts are collected in accordance with the regulatory procedures provided in Federal Acquisition Regulation, Subpart 32.6.

   c. Within 3 months of the issuance of this final report, provide the Assistant Inspector General for Audit Policy and Oversight a report detailing the results from Recommendations B.4.a and B.4.b, above.

CONCUR IN PRINCIPLE: The NAVSEA Director for Contracts has reviewed the action taken by the former Deputy, Field Procurement Office Chief of the Contracting Office (FPO CCO) to liquidate $3,882,926 in contract debt against unpaid bills on the two contracts cited, and believes those actions were undertaken in good faith. The FAR provisions at 32.602(a) addressing offsets were added in 2008, four years after the offset arrangement was agreed to by the former Deputy FPO CCO. Action has been taken to properly match appropriation type and fiscal years on the two contracts affected by the offset. The NAVSEA Director for Contracts will provide a report within 3 months of the issuance of the final DoDIG report detailing the results of that assessment.

5. As prescribed in DoD Financial Management Regulation, Volume 14, Chapter 3, the Assistant Secretary of the Navy, Financial Management and Comptroller direct the Navy Comptroller Office to initiate preliminary reviews and possible corrective actions for the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut that potentially violated the Antideficiency Act as defined
by the DoD Financial Management Regulation. We specifically refer to action taken by the former Deputy Officer, Groton Business Operations Department, to authorize a contract debt liquidation to offset expired funding and a funding short-fall of $1,696,860 on Contract No. N00024-00-C-8501. This action authorized an expenditure in excess of the funds available under the contract and potentially violated the Statute at 31 U.S.C. 1341 and 31 U.S.C. 1517.

TO BE ADDRESSED BY ASN(FM&C).

DODIG Finding C. Groton Unable to establish Contractor Entitlement to Pension Cost Offset.

Naval Sea Systems Command Negotiation Objective for Contractor Pension Costs. The former Naval Sea Systems Command contract specialist that assisted in the negotiation of Contract No. N00024-96-C-2108 in 1996 provided the following information regarding the impact that the Groton June 7, 1996, Memorandum of Agreement had on the contract negotiation objectives established by the Naval Sea Systems Command negotiation team. The former contract specialist, now a Branch Chief, Contracts, Naval Sea Systems Command, provided to the Office of Inspector General the pre- and post- Business Clearance Memoranda prepared by the Naval Sea Systems Command negotiation team in accordance with Federal Acquisition Regulation 1.602-1(a), as well as copies of the original contract and the restructured contract.

- The basis for the agreement to remove all pension costs for 1996 through 2002 was the overfunded status of the contractor's pension plan that arose prior to 1996.
- Had the Naval Sea Systems Command negotiation team believed that the Groton June 7, 1996 Memorandum of Agreement was significant to contract negotiations; the negotiation team would have referenced it in their Business Clearance Memoranda. The Business Clearance Memoranda, and the resulting contract, are silent with regard to the Groton June 7, 1996, Memorandum of Agreement with the contractor.
NONCONCUR:

While the Post BCM does not reference the MOA as the cause of the removal of $145 million of pension costs from proposed indirect FR 196 Forward Pricing Rates, documentation was found in the contract file by the former contract specialist (now Branch Head) as follows:

1. A negotiation note found in the contract file (verified to be in the contract specialist’s hand) states that the pension costs would be “[o]ut as long as [the former Deputy Officer, Groton Business Operations Department] can use an MOA to pass through.”

2. An memorandum to SUPSHIP Groton dated May 28, 1996 provided an update to the Forward Pricing Rates to reflect the exclusion of pension costs from 1996-2002, in accordance with the draft of the subject MOA that was attached to the correspondence. This memorandum was transmitted via FAX from SUPSHIP Groton to the contract specialist on May 30, 1996.

3. Written in the contract specialist’s hand on the faxed draft MOA is “As of 5/30/96, SUPSHIP and have agreed to this language and are ready to sign the agreement. I asked [DACO] to hold for the day.”

The above clearly demonstrates that the ACO and NAVSEA (via the contract specialist) were in close coordination during the negotiation of the MOA. The MOA was known necessary to obtain concurrence to remove 1996-2002 pension costs from the contract target cost settlement. In retrospect, the MOA should have been referenced in the Post Negotiation Business Clearance Memorandum as it was relevant to the SSN 23 final settlement.

**Failure to Safeguard the Interests of the United States in its Contractual Relationships.** Based on a review of existing records and files, the actions taken by the former Deputy Officer, Groton Business Operations Department, to grant the contractor entitlement to an offset of $1,919,000 for Pension Costs as a part of the September 30, 2004, Memorandum of Agreement were not justified.

Based on the records and information made available to the Office of Inspector General, the June 7, 1996, Memorandum of Agreement:

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August 27, 2010, the Director, Program Analysis and Business Transformation, provided that the Navy concurs in principle with Recommendation C.1.

- Did not provide any contractual consideration to the United States Government for entering the Agreement, 
- Eliminated the incentive the contractor had to avoid any actual pension costs as provided for in the Incentive Price Revision - Firm Target clause included in the contract, 
- Unjustifiably improved the contractor's potential profit position on Contract No. N00024-96-C-2108.

NONCONCUR: In consideration for the pension MOA of 1996, the government received a lower price on the award of the SSN23 contract. A subsequent modification to that contract (P00017), clearly stated that all written agreements would remain in effect. Based on the above, the contractor was entitled to this adjustment.

DODIG Recommendations for Finding C.

Recommend that the Director of Contracts, NAVSEA:

1. Reassess the action taken by the former Deputy Officer, Groton Business Operations Department, to liquidate $3,882,926 in contract debt owed to the U.S. Govt and take action to recover the $3,615,860 in contract debt offset against unpaid bills on Contract #s N00024-96-C-2108 and N00024-00-C-8501.

   THIS RECOMMENDATION IS DUPLICATIVE OF RECOMMENDATION AT B.4.a.

2. Re-evaluate the existing management controls at the Groton Business Operations Department and make improvements that ensure that all contract actions executed by senior level contracting officers represent effective contracting, ensure compliance with the terms of the contract, and safeguard the interests of the U.S. in its contractual relationships with the contractor.

   CONCUR: NAVSEA will review to ensure that effective internal management controls are in place at SUPSHIP Groton Business Operations Department and that all contract actions are in compliance with the FAR, DFARS, NMCARS and NAVSEA Contracting Handbook. NAVSEA does not believe there is a systemic problem with SUPSHIP Groton contracting officers not safeguarding the interests of the U.S. in its contractual relationships with the contractor.
3. Issue a directive memorandum to all SUPSHIP contracting officers establishing that the following dictates of FAR 1.602-2 - Responsibilities shall take precedence over the 'wide latitude to exercise business judgment' afforded contracting officers when making contracting decisions on behalf of the U.S. Govt.

Contracting officers are responsible for...
ensuring compliance with the terms of the contract, and safeguarding the interests of the United States in its contractual relationships.

NONCONCUR: FAR 1.602-2 provides as follows: "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 United States in its contractual relationships. In order to perform these responsibilities, contracting officers should be allowed wide latitude to exercise business judgment." The DODIG recommendation is that NAVSEA should disregard the plain language of FAR 1.602-2 by having one sentence in that FAR cite take precedence over the next sentence to which it specifically refers.

4. Evaluate the need to rotate senior civilian contracting officers on a periodic basis between the several SUPSHIP locations.

CONCUR.

5. Within 3 months of the issuance of this final report, provide the Assistant IG for Audit Policy and Oversight a report detailing the results from Recommendations C.1, C.2, and C.4 above, as well as a copy of the written guidance established IAW Recommendation C.3.

PARTIALLY CONCUR: The NAVSEA Director for Contracts will provide the DODIG a report detailing the results of Recommendations C.1, C.2, and C.4, but does not concur with the recommendation at C.3.
FINDING: "POTENTIAL VIOLATION OF 31 U.S.C. § 1341 LIMITATIONS ON EXPENDING AND OBLIGATING AMOUNTS"

Department of the Navy
Comments on Draft DoDIG Report D2009-DP00AI-0022.005
Actions to Establish Final Indirect Cost Rates
on Reportable Contract Audit Reports
by the Supervisor of Shipbuilding, Conversion and Repair,
Groton, Connecticut


Public statute 31 U.S.C. 1341(a)(1) states, “An officer or employee of the United States Government or of the District of Columbia government may not – (A) make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation…” On inquiry regarding the reason for the delay in negotiating the eight unadjudicated change orders, the former Deputy Officer advised the Department of Defense Inspector General auditors that lack of available funding had caused the delays, and that all funding had expired. To get new funding would have required going through the “upward obligation process.” When asked to confirm the accuracy of the statements made by the former Deputy Officer, the current Groton Business Operations Officer acknowledged that using offsetting funds was not appropriate and in hindsight, the proper approach would have been to use the upward obligation process. By authorizing and approving the settlement of the eight change order proposals for a price of $2,317,171, the former Deputy Officer may have obligated the U.S. Government for an expenditure that exceeded the amount of funding available on the contract by $1,696,860, potentially violating 31 U.S.C. § 1341(a)(1)(A). Additionally, the potential exists that the actions taken by the former Deputy Officer violated other provisions of the Antideficiency Act, including those identified in Financial Management Regulation, Volume 14, Chapter 2, paragraph 020103.

PARTIALLY CONCUR: Authorizing an expenditure in excess of the funds available on a contract would not result in a violation of 31 USC § 1341(a)(1)(A) since the Department had and continues to have funds available in the appropriation in question (Operation and Maintenance, Navy) to accommodate the item in question.

The action could conceivably have resulted in a violation of 31 USC § 1517(a) (making an obligation or expenditure exceeding an apportionment or other administrative subdivision of funds) if the command holding 1517 responsibility, in this case Fleet Forces Command (FFC), did not have the funds available to cover the $1.7M increase to the contract. This is unlikely since FFC holds nearly one quarter of the Navy’s O&M funds and would have been able to approve and fund the necessary upward obligation.

The other statutes referenced in the finding via the FMR are either not applicable to this instance (31 USC § 1342) or are not part of the ADA statute (1301, 1502(a) and 3302(b)). See FMR Volume 14, Chapter 2, paragraph 020101.

Enclosure (2)
RECOMMENDATION B.5.
INITIATE PRELIMINARY REVIEWS AND POSSIBLE CORRECTIVE ACTIONS

Department of the Navy
Comments on Draft DoDIG Report D2009-DIP0A1-0022.005
Actions to Establish Final Indirect Cost Rates
on Reportable Contract Audit Reports
by the Supervisor of Shipbuilding, Conversion and Repair,
Groton, Connecticut

The draft DoDIG Report D2009-DIP0A1-0022.005 includes a recommendation to initiate a preliminary Antideficiency Act violation investigation. Specifically, recommendation B.5. says:

“As prescribed in DoD Financial Management Regulation, Volume 14, Chapter 3, the Assistant Secretary of the Navy, Financial Management and Comptroller direct the Navy Comptroller Office to initiate preliminary reviews and possible corrective actions for the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut that potentially violated the Antideficiency Act as defined by the DoD Financial Management Regulation. We specifically refer to action taken by the former Deputy Officer, Groton Business Operations Department, to authorize a contract debt liquidation to offset expired funding and a funding short-fall of $1,696,860 on Contract No. N00024-00-C-8501. This action authorized an expenditure in excess of the funds available under the contract and potentially violated the Statute at 31 U.S.C. 1341(a)(1)(A).”

ASN(FM&C) concurs with comment on this recommendation.

- First, authorizing an expenditure in excess of the funds available under a contract is not, in and of itself, a violation of the ADA. Should it ultimately be determined that an ADA did occur, it is more likely to be a violation of 31 USC 1517(a) (making an obligation or expenditure exceeding an appropriation or other administrative subdivision of funds) rather than a violation of 31 USC 1341(a)(1)(A) (making an obligation or expenditure exceeding an appropriation or fund.)
- Second, the ASN(FM&C) and the Navy Comptroller Office are the same organization.
- Third, preliminary investigations are normally conducted by the budget submitting office or their subordinate command where the potential violation occurred, rather than by the Navy Comptroller Office. If necessary, ASN(FM&C) will take appropriate action to direct a preliminary investigation with the appropriate command in accordance with the timelines prescribed in the PMR Volume 14, Chapter 3.
MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL (DODIG)

SUBJ: FOLLOW-UP ON DODIG AUDIT REPORT NUMBER D2009-DIPOAI-0022.005, ACTIONS TO ESTABLISH FINAL INDIRECT COST RATES ON REPORTABLE CONTRACT AUDIT REPORTS BY THE SUPERVISOR OF SHIPBUILDING, CONVERSION AND REPAIR (SUPSHIP), GROTON, CONNECTICUT

Ref: (a) DoDIG E-mail to FMB-52 of 16 August 2010

Encl: (1) DON Follow-up Response

The subject follow-up requested in reference (a) is provided as enclosure (1). One recommendation was assigned to the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) on the subject audit.

Questions may be directed to [Blank].

Gayle L. Evans
Director
Budget Policy and Procedures Division
Office of Budget

Copy to:
OU5DC
DON FOLLOW-UP ON DODIG AUDIT REPORT NO. D2009-D00022.005

Recommendation B.5: The Inspector General recommended that the ASN(FM&C) direct the Navy Comptroller Office to initiate preliminary reviews and possible corrective actions for the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut that potentially violated the ADA as defined by the DoD Financial Management Regulation. In authorizing and approving the settlement of the eight change order proposals for a price of $2,317,171, the former Deputy Officer at the Groton Business Operations may have obligated the U.S. Government for an expenditure that exceeded the amount of funding available on the contract by $1,696,860 and potentially violated 31 U.S.C. § 1341(a)(1)(A).

Previous DON Response: The ASN(FM&C) concurred with the following comments on this recommendation:

- Authorizing an expenditure in excess of the funds available under a contract is not, in and of itself, a violation of the ADA. Should it ultimately be determined that an ADA did occur, it is more likely to be a violation of 31 USC § 1517(a).
- The ASN(FM&C) and the Navy Comptroller Office are the same organization.
- Third, preliminary investigations are normally conducted by the budget submitting office or their subordinate command where the potential violation occurred, rather than by the Navy Comptroller Office. If necessary, ASN(FM&C) will take appropriate action to direct a preliminary investigation with the appropriate command in accordance with the timelines prescribed in the FMR Volume 14, Chapter 3.

DODIG Requested Follow-up Information: As required by DoD FMR Volume 14, Section 030402, provide a copy of the request for preliminary review of the potential ADA violation. As described at DoD FMR Volume 14, Section 030303, where the results of the preliminary review indicate that “no violation occurred, provide evidence to support that this result was coordinated with OUSD(C).

DON Response: A violation of the ADA did not occur in this matter and a preliminary ADA review will, therefore, not be initiated. To offset expired funding and a funding short-fall of $1,696,860 on a FY01 O&M funded submarine overhaul contract, N00024-00-C-8501, SUPSHIP contracting officials improperly authorized contract debt liquidation on various Ship Construction Navy (SCN) contracts in the amount of $3,882,926. These liquidated SCN contract debts owed to the DON were used to offset a total of $3,615,860 in unpaid claims owed the contractor for settlement of two issues; (1) pension costs related to a SCN funded submarine nuclear refueling overhauls contract (N00024-96-C-2108) and (2) the aforementioned funding shortfall for the O&M funded submarine overhaul contract (N00024-00-C-8501). The use of liquidated SCN funds to offset debts owed to the contractor for the O&M funded contract resulted in a violation of the Purpose Statute, 31 U.S.C. § 1301(a). However, the obligation of funds

Enclosure (1)
Page 1 of 3
FOLLOW-UP ON DODIG AUDIT REPORT NUMBER D2009-DIPOAI-0022.005

from the SCN appropriation to offset O&M,N funds owed the contractor did not result in an ADA violation. This is because there are sufficient balances legally available from the current appropriation (FY 2010 O&M,N) available for the same purpose. In 63 Comp.Gen. 422, B-213137, June 22, 1984, the GAO stated,

Not every violation of 31 U.S.C. § 1301(a) also constitutes a violation of the ADA. Even though an expenditure may have been charged to an improper source, the ADA’s prohibition against incurring obligations in excess or in advance of available appropriations is not also violated unless no other funds were available for that expenditure.

Concerning the use of current year funds to pay for an obligation properly chargeable to a cancelled appropriation, pursuant to 31 U.S.C. § 1553(b), current funds may legally be used to correct the accounts at issue in this matter. In Decision B-318831, April 28, 2010, the GAO stated,

Cancelled balances are unavailable to pay any obligation even though properly incurred to the expiration of the appropriation. Instead, an obligation that would have been properly chargeable to the cancelled appropriation must be paid from a current appropriation available for the same purpose, see GAO Decision B-318831, April 28, 2010.

The funding cited on the submarine overhaul contract, 171 1804.60BA (FY 2001 O&M,N), was issued to the SUPSHIP on a Technical Operating Budget (TOB) by FFC. The TOB did not pass 31 USC § 1341 or § 1517 responsibility to SUPSHIP and FFC has provided an additional $1,696,860 in current year O&M,N to pay the contractor for this within-scope cost adjustment. The Purpose Statute violation will be “cured” when SUPSHIP de-obligates the amounts that were improperly charged to the SCN appropriation and charges these amounts to the O&M,N appropriation.

A violation of 31 USC § 1341(1)(A) or § 1517 did not occur in this matter. Whether or not SUPSHIP violated the ADA depends on whether there is an adequate unobligated balance in the appropriation to which the submarine overhaul obligations should have been charged to, in this case, O&M,N. As there are sufficient appropriations available for obligation, the DON is not legally required to report a deficiency in accordance with the ADA since there is no such deficiency. See GAO Decisions B-318831, B-289209, and B-308969.

A preliminary review of the DoDIG issue was conducted and found not to warrant an ADA investigation due to previous rulings by the GAO as noted above.

Finding B: By authorizing and approving the settlement of the eight change order proposals for a price of $2,317,171, the former Deputy Officer may have obligated the

Enclosure (1)
FOLLOW-UP ON DODIG AUDIT REPORT NUMBER D2009-DIPOAI-0022.005


Previous DON Response: The DON partially concurred with the Inspector General’s finding. Authorizing an expenditure in excess of the funds available on a contract is not, in and of itself, a violation of the ADA. The probability that this would result in a violation of 31 USC § 1341(a)(1)(A) (making an obligation or expenditure exceeding an appropriation or fund) is not great as the Department should have sufficient funds available in the appropriation in question, Operation and Maintenance, Navy (O&M,N) to accommodate this and other relatively modest obligation adjustments. The contract debt liquidation authorized to offset expired funding and a funding short-fall of $1,696,860 on Contract No. N00024-00-C-8501 could conceivably have resulted in a violation of 31 USC § 1517(a) (making an obligation or expenditure exceeding an apportionment or other administrative subdivision of funds) if the command holding 1517 responsibility (Fleet Forces Command (FFC), in this case) did not have the funds available to cover the $1.7M increase to the contract.

DODIG Requested Follow-up Information: As described at DoD FMR Volume 14, Section 030303, where the results of the preliminary review indicate that “no violation” occurred, provide evidence to support that this result was coordinated with OUSD(C).

DON Response: As discussed in the DON Response to Recommendation B. 5, a preliminary review of the DoDIG issue was conducted and found not to warrant an ADA investigation. In accordance with an OASN(FM&C) Office of General Counsel determination, pursuant to 31 USC 1553, current funds may legally be used to correct the accounts at issue in this matter. This “cures” the Purpose Statute violation (not an ADA as previously discussed).
MEMORANDUM FOR THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Department of the Navy Response – Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut (D2009-DIP0AI-0022.005)

Ref: (a) DoN Response to DODIG Report dated 21 May 2010

The Department of the Navy (DoN) response to the DODIG Draft Report was provided via reference (a) and included detailed comments to the findings contained in the DODIG report as well as the responses pertaining to the potential violations of 31 USC 1341. Subsequent discussions were held between your auditors and NAVSEA and ASN(FM&C) personnel in an effort to reconcile areas of disagreement reflected in reference (a).

Through email correspondence dated 19 July and 23 July, the DODIG forwarded further information and analysis regarding DoN Nonconcurrence with Recommendations A.1.b, A.1.c and C.1 and requested that DoN reconsider its position. The comments and information reflected in these emails provide additional data and recommendation, which appear to modify the DODIG Draft Report. The following is provided in response to DODIG emails of 19 July and 23 July 2010 regarding Recommendations A.1.b, A.1.c and C.1.

A.1.b: Concur in principle. SUPSHIP Groton located the attached document (Ser 442 dtd 31 Jan 05) requesting the contractor to respond to the September 14, 2004 DCAA audit.

A.1.c: Concur in principle. The Navy’s response to the DoDIG draft report accurately stated that DCAA had not issued a CAS 406 non-compliance audit report related to the Post Audit Disallowance Factor, and thus to date the Navy has not issued a notice of potential noncompliance to the contractor. Upon receipt of a signed final report from DoDIG asserting a CAS 406 noncompliance, the Navy will process the alleged noncompliance in accordance with the procedures at FAR 30.605.
SUBJECT: Department of the Navy Response – Actions to Establish Final Indirect Cost Rates on Reportable Contract Audit Reports by the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut (D2009-DIP0AI-0022.005)

C.1: Concur in principle. NAVSEA was unaware of the existence of the 1986 Advance Agreement on Pension Costs until the 1 July 2010 meeting when a copy was provided by the DoD. Upon review of that agreement and subsequent discussions with SUPSHIP Groton, the Navy agrees that the 1986 Advance Agreement was technically still in effect at the time Contract N00024-96-C-2108 was negotiated in spring 1996. [Note: your email incorrectly identifies the contract as N00024-06-C-2108.] The agreement was subsequently cancelled in 1997. During the 1996 negotiations, the status of the Advance Agreement was in a state of flux, with proposing a revised methodology to the CACO on 1 April 1996. Negotiations with on Contract N00024-96-C-2108 concluded prior to the CACO's formal response to on 24 June 1996. The Navy believes its treatment of pension costs in the negotiation of Contract N00024-96-C-2108 resulted in the lowest cost solution for the Government.

ASN(FM&C) personnel have responded separately to similar email requests regarding comments under their cognizance. Thank you for the opportunity to comment on the subject draft report and continuing to discuss the findings and recommendations. My point of contact is

Bruce A. Sharp
Director, Program Analysis and Business Transformation
Deputy Assistant Secretary of the Navy
(Acquisition and Logistics Management)

Attachments:
As stated

cc: COMNAVSEASYSCOM NAVIG
From: Supervisor of Shipbuilding, Conversion and Repair, USN, Groton

To: [Redacted]

Subj: REPORT ON AUDIT OF APPLICATION OF AGREED UPON PROCEDURES RELATING TO PRIOR YEAR OVERHEAD ADJUSTMENTS

Ref: (a) Audit Report 2361-2003B17900017, dated 14 Sep 04

Encl: (1) Audit Report 2361-2003B17900017, dated 14 Sep 04

1. Reference (a) reports the results of an audit requested by our office relating to the application of agreed upon procedures for prior year overhead adjustments. The scope of the audit addressed the evaluation of the financial and cost aspects of said adjustments as well as compliance with applicable laws and regulations.

2. The DCAA analysis disclosed several significant deficiencies in the method of accounting for prior year overhead adjustments. The specifics of the audit finding are found in the "Statement of Conditions and Recommendation" section of the audit report.

3. At this time we request that you review the audit findings and either submit a corrective plan of action to our office on or before 15 February 2005 or provide our office with a rebuttal response to the audit findings.
Subj: REPORT ON AUDIT OF AGREED UPON PROCEDURES RELATING TO PRIOR YEAR OVERHEAD ADJUSTMENTS

If you have any questions regarding this issue, or would like to discuss the issue in greater detail, please contact either the undersigned at extension [redacted] or [redacted] at extension [redacted].

[Redacted]
Contracting Officer