

Inspector General

United States
Department of Defense



Defense Hotline Review

September 28, 2007

Reimbursement of Settlement
Costs at Defense Contract
Management Agency Melbourne

Report No. D-2007-6-010

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Acronyms

DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
FAR	Federal Acquisition Regulation
IG	Inspector General



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

September 28, 2007

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
COMMANDER, DEFENSE CONTRACT MANAGEMENT
AGENCY MELBOURNE, FLORIDA

SUBJECT: Report on Hotline Allegation Regarding the Reimbursement of Settlement Costs at
Defense Contract Management Agency Melbourne (Report No. D-2007-6-010)

We are providing this final report for review and comment. We performed this review based on a Defense Hotline complaint.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Although we received initial management comments on a draft of this report from Defense Contract Management Agency on July 5, 2007, Defense Contract Management Agency stated that it was revising the management comments. As of September 28, 2007, we have not received the revised management comments. We request that management provide comments to the final report that conform to the requirements of DoD Directive 7650.3. We should receive the management comments by November 28, 2007.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to the e-mail addresses 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. Matters considered by management to be exempt from public release should be clearly marked for Inspector General consideration.

Management comments should indicate concurrence or nonconcurrence with each finding and recommendation. Comments should describe actions taken or planned in response to agreed-upon recommendations and provide anticipated dates for completing the actions. State specific reasons for any nonconcurrence and propose alternative actions, if appropriate.

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Meredith Long-Morin at (703) 604-8739 (DSN 664-8739), meredith.morin@dodig.mil. See Appendix B for the report distribution.

A handwritten signature in black ink, appearing to read "Wayne C. Berry".

Wayne C. Berry
Acting Assistant Inspector General
for Audit Policy and Oversight

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Hotline Allegation Regarding the Reimbursement of Settlement Costs at Defense Contract Management Agency Melbourne

Results In Brief

What We Did

We reviewed a DoD Hotline complaint alleging that a contracting officer reimbursed a Government contractor \$880,000 in unallowable settlement costs associated with an alleged false claim.

We also reviewed the contracting officer's actions taken on a May 23, 2002, Defense Contract Audit Agency (DCAA) audit report for compliance with DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports."

What We Found

We substantiated the allegation that the contracting officer reimbursed the contractor \$880,000 in unallowable legal settlement costs. The contracting officer also reimbursed \$70,000 in other unallowable costs associated with the settlement and executive compensation costs of \$179,000 that are expressly unallowable based on the Federal Acquisition Regulation. Defense Contract Management Agency (DCMA) Melbourne inaccurately reported questioned costs addressed in the May 23, 2002, DCAA audit report in the DCMA Melbourne portion of the DoD IG Semiannual Report to Congress.

What We Recommended

DCMA Melbourne needs to recoup the unallowable settlement and executive compensation costs, including applicable penalties and interest. DCMA should implement procedures for preparing advance agreements and resolving differences of opinion between a contracting officer and a DCMA attorney. The Commander, DCMA Melbourne should emphasize accurate reporting of contract audit report data.

Management Comments

Although we received initial management comments from DCMA on July 5, 2007 based on an April 10, 2007 draft of this report, DCMA stated that it was revising the management comments. As of September 28, 2007, we have not received the revised management comments. Therefore, we issued this final report without management comments and request that DCMA provide management comments to the final report by November 28, 2007.

United States Department of Defense
Office of Inspector General
Project No. D2007-DIP0AI-0037.000
Report No. D-2007-6-010
September 28, 2007

Introduction

Objectives

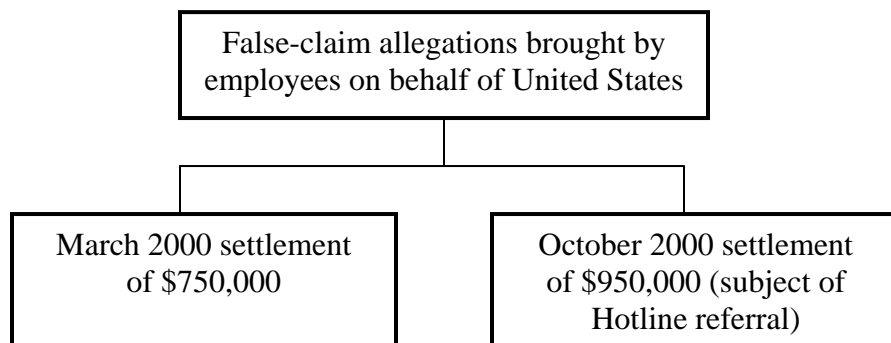
We conducted this review to determine the validity of the allegations received by the DoD Hotline. We also reviewed the contracting officer's actions taken on DCAA Audit Report No. 1301-2000Q10100002, May 23, 2002, to determine whether they complied with DoD Directive 7640.2. See Appendix A for a discussion of our scope and methodology and for prior coverage.

Background

Defense Contract Management Agency. DCMA is the DoD Component that works directly with Defense suppliers to help ensure that DoD, Federal, and allied government supplies and services are delivered on time at projected cost and meet performance requirements. DCMA, acting through its 50 field offices, resolves and completes the disposition of most contract audit reports for the Army, Navy, Air Force, and Defense Logistics Agency.

False Claims Act. The False Claims Act, section 3729, title 31, United States Code (31 U.S.C. 3729 et seq.) permits U.S. citizens to file actions against Government contractors who knowingly present a false claim to the Government for payment. The False Claims Act allows the citizen to receive a portion of amounts due to the Government resulting from such actions or settlements.

Settlements Related to Alleged False Claims. Two employees of a Government contractor filed an action on behalf of the United States in accordance with the False Claims Act. As depicted below, the contractor entered into two settlements related to the false-claim allegations.



In March 2000, the contractor paid the United States \$750,000 to settle the false claim allegations. The employees received a portion of the settlement in accordance with the False Claims Act. In October 2000, the contractor paid the employees \$950,000

to settle their personal injury claims in reporting the false claim allegation. The \$950,000 settlement costs included \$880,000 to settle the personal injury claims and \$70,000 in associated costs.

Defense Contract Audit Agency Audit Report. DCAA provides audit and financial advisory services to all DoD Components, including DCMA. In Audit Report No. 1301-2000Q10100002, May 23, 2002, DCAA questioned the \$950,000 settlement costs as unallowable on Government contracts based on Federal Acquisition Regulation (FAR) 31.205-47(b)(3). DCAA also questioned executive compensation costs of \$179,370 because they exceeded the compensation limits specified by FAR 31.205-6(p)(1).

Findings

A. Hotline Allegation: Reimbursement of Settlement Costs

We substantiated the DoD Hotline allegation that a contracting officer reimbursed a Government contractor \$880,000 in unallowable costs associated with settlement of a false claim allegation. In total, the contracting officer reimbursed \$950,000 in unallowable costs, including \$880,000 in settlement costs and \$70,000 in associated expenses. According to FAR 31.205-47(c)(1), settlement costs are unallowable unless the settlement agreement specifically indicates that they are allowable. Both a DCMA fraud attorney and DCAA concluded that the settlement costs were unallowable. In light of that conclusion, the contract file did not contain sufficient rationale for the contracting officer to reimburse the costs. The advance agreement, which provisionally accepted the settlement costs, does not comply with portions of FAR Subparts 31.1 and 42.7. The contracting officer should require the contractor to pay back the settlement costs plus penalties and interest.

Criteria on Allowability of Costs Related to Legal Settlements. FAR 31.205-47 provides criteria for determining the allowability of costs associated with legal proceedings. Regarding disputes filed under the False Claims Act, FAR 31.205-47(b) states:

The costs incurred with any proceeding....brought by a third party in the name of the United States under the False Claims Act, 31 U.S.C. 3730, are unallowable if the result is-

- (b)(1) *In a criminal proceeding, a conviction;*
- (b)(2) *In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary*

-
- penalty where the proceeding does not involve an allegation of fraud or similar misconduct;*
- (b)(3) *A final decision by an appropriate official of an agency to-*
(i) Debar or suspend the contractor;
(ii) Rescind or void a contract; or
(iii) Terminate a contract for default by reason of a violation or failure to comply with a law or regulation.
- (b)(4) *Disposition of the matter by consent or compromise if the proceeding could have led to any of the outcomes listed in paragraphs (b)(1) through (3) of this section (but see paragraphs (c)...of this subsection) (emphasis added)*
- (b)(5) *Not covered by paragraphs (b)(1) through (4) of this subsection, but where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable by reasons of paragraphs (b)(1) through (4) of this subsection.*

As reflected in paragraph (b)(4), the costs associated with the disposition by consent or compromise (settlement) are unallowable if the proceeding could have led to any of the outcomes in paragraphs (b)(1) through (b)(3), subject to the two exceptions provided in FAR 31.205-47(c). FAR 31.205-47(c) states:

- (c)(1) *To the extent they are not otherwise unallowable, costs incurred in the connection with any proceeding under paragraph (b) of this subsection commenced by the United States (emphasis added) that is resolved by consent or compromise pursuant to an agreement entered into between the contractor and the United States, and which are unallowable solely because the paragraph (b) of this subsection, may be allowable to the extent specifically provided in such agreement.*
- (c)(2) *In the event of a settlement of any proceeding brought by a third party under the False Claims Act in which the United States did not intervene, reasonable costs incurred by the contractor in connection with such a proceeding, that are not otherwise unallowable by regulation or by separate agreement with the United States, may be allowed if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.*

Since the United States intervened in the alleged false claims, only paragraph (c)(1) above applies to the \$880,000 in settlement costs. Accordingly, the settlement costs are unallowable because the underlying settlement agreement does not specifically provide that any of the settlement costs are allowable on Government contracts.

Legal and Audit Opinions. The contracting officer received written opinions on the allowability of the settlement costs from both a DCMA fraud attorney and DCAA. In a written communication March 5, 2002, the DCMA fraud attorney concluded that

the \$880,000 settlement costs were unallowable based on an analysis of the applicable provisions in FAR 31.205-47. The attorney recommended the application of penalties in accordance with FAR 42.709, but did not recommend that the alleged false claim be referred for civil fraud. In Audit Report No. 1301-2000Q10100002, May 23, 2002, DCAA also concluded that the \$880,000 settlement costs were unallowable and subject to penalties. DCAA questioned an additional \$70,000 in costs that were incurred in connection with the settlement.

Contracting Officer's Determination. The DCMA contracting officer, in a March 5, 2004 Memorandum for Record, disagreed with the DCMA fraud attorney and DCAA and concluded that the settlement costs were allowable on Government contracts. Where disagreement with an audit report involves an interpretation of law or regulation, Office of Management and Budget (OMB) Circular A-50 requires the contracting officer to document the legal basis for decisions not agreeing with audit recommendations.

In the Memorandum for Record, the contracting officer cited two primary reasons for allowing the settlement costs. First, the contracting officer determined that the October 2000 settlement was separate and distinct from the March 2000 settlement in which the United States intervened. Therefore, the contracting officer concluded that the criteria for allowability of the settlement costs should be based on FAR 31.205-47(c)(2), which allows settlement costs of a legal proceeding when the United States does not intervene and the proceeding lacks merit. However, the Memorandum for Record provides no legal rationale to support the contracting officer's determination. In contrast, the DCMA fraud attorney provided relevant court case precedence in support of his opinion that the October 2000 settlement directly relates to the March 2000 settlement in which the United States intervened. We also contacted the Department of Justice attorney who represented the United States in the March 2000 settlement who agreed that the two settlements are directly related because they involve damages resulting from the same alleged false claims.

Second, the contracting officer determined there was little likelihood that the legal proceeding would have been successful on the merits. The contracting officer believed that the decision of the United States not to intervene in the proceeding resulting in the October 2000 settlement was evidence that the allegations lacked merit. However, the United States did not intervene in the October 2000 settlement because it involved personal injury claims in which the Government had no interest, not because the proceeding lacked merit. We agree with the DCMA fraud attorney and the Department of Justice attorney that both settlements resulted from the same false claim allegations.

DCMA lacks a written policy for resolving or elevating disagreements between a contracting officer and a DCMA attorney. Paragraph 4.2 of DoD Directive 7050.5, "Coordination of Remedies for Fraud and Corruption Related to Procurement Activities," requires DoD Components to review and implement the appropriate actions that are necessary to recover funds lost through fraud or corruption. Because

the settlement costs stemmed from the alleged false claims, the contracting officer should have been required to follow specific instructions for resolving the disagreement with the DCMA fraud attorney before rendering a determination that was contrary to his expert advice.

Advance Agreement. In March 2004, the DCMA contracting officer entered into an agreement with the contractor to provisionally authorize reimbursement of the \$880,000 settlement costs. The agreement provides that the contractor shall pay back the settlement costs if the Government later determines that the costs are unallowable. The agreement does not comply with portions of FAR Subparts 31.1 and 42.7. FAR 31.109(b) states, “Advance agreements may be negotiated either before or during a contract but should be negotiated before the incurrence of the costs involved.” The advance agreement was executed approximately 4 years after the settlement costs were incurred.

Further, the agreement does not comply with FAR 31.109(c), which states “The contracting officer is not authorized . . . to agree to a treatment of costs inconsistent with this part.” Because the settlement costs are unallowable under FAR 31.205-47, the contracting officer’s use of an advance agreement to render the settlement costs allowable was not appropriate.

The agreement also violates FAR 42.709, which requires that contracting officers assess penalties when a contractor includes expressly unallowable costs in an incurred cost proposal submitted to the Government. The advance agreement waives penalties on the settlement costs even if the Government later determines the costs to be unallowable. According to FAR 42.709-5, a contracting officer shall waive penalties if any one of the following situations exists:

- The contractor withdraws the incurred cost proposal* before the Government formally initiates an audit and submits a new proposal.
- The amount of the unallowable costs subject to penalty is \$10,000 or less.
- The contractor demonstrates that appropriate policies and controls are in place to preclude unallowable costs subject to penalties from being included in indirect cost proposals, and the unallowable costs subject to penalties were inadvertently incorporated in the proposal.

None of these situations apply in the case of the settlement costs. DCMA should have guidelines for preparing advance agreements which help to ensure that the agreement complies with the FAR.

* An incurred cost proposal is a contractor’s claim for direct and indirect costs charged to Government contracts. DCAA audits the contractor’s incurred cost proposal to determine that the costs are reasonable, allocable, and allowable as prescribed by the Federal Acquisition Regulation, Defense Federal Acquisition Regulation Supplement, and contract provisions.

Recommendation A

A.1. We recommend that the Director, Defense Contract Management Agency:

a. Implement procedures for resolving differences of opinion between a contracting officer and a Defense Contract Management Agency attorney before the contracting officer makes a final determination.

b. Issue guidelines for preparing advance agreements which help to ensure compliance with applicable Federal Acquisition Regulation requirements.

A.2. We recommend that the Commander, Defense Contract Management Agency Melbourne direct the contracting officer to:

a. Recoup the unallowable settlement costs of \$950,000, including applicable penalties and interest.

b. Provide documentation confirming that Recommendation A.2.a has been implemented.

Management Comments Required

On July 5, 2007, the Defense Contract Management Agency provided initial comments on a draft of this report. However, the Defense Contract Management Agency stated that it was revising the management comments. As of September 28, 2007, we have not received the revised management comments. Therefore, we request that the Commander, Defense Contract Management Agency provide comments on the final report.

B. Recouping Unallowable Executive Compensation Costs

The contracting officer reimbursed the contractor \$179,370 of expressly unallowable executive compensation costs, although the costs exceeded the compensation limits specified in Federal Acquisition Regulation 31.205-6(p)(1), "Compensation for Personal Services." The contracting officer also did not assess the penalties and interest that Federal Acquisition Regulation 42.709 requires when a contractor includes expressly unallowable costs in its incurred cost proposal. DCAA questioned these excess compensation costs and recommended the assessment of penalties in

Audit Report No. 1301-2000Q10100002. The contracting officer reimbursed these costs even though the contractor had agreed with the DCAA audit position.

Recommendation B

We recommend that the Commander, Defense Contract Management Agency Melbourne direct the contracting officer to:

B.1. Recoup the unallowable executive compensation costs of \$179,370, including applicable penalties and interest.

B.2. Provide documentation confirming that Recommendation B.1 has been implemented.

Management Comments Required

On July 5, 2007, the Defense Contract Management Agency provided initial comments on a draft of this report. However, the Defense Contract Management Agency stated that it was revising the management comments. As of September 28, 2007, we have not received the revised management comments. Therefore, we request that the Commander, Defense Contract Management Agency provide comments on the final report.

C. Accurately Reporting Questioned Costs

The contracting officer did not accurately report the questioned costs in the DCMA portion of the Semiannual Report to Congress for Audit Report No. 1301-2000Q10100002. Although the DCMA Melbourne portion of the DoD Inspector General's Semiannual Report to Congress for the period ending March 31, 2004, reported questioned costs of \$880,000, the actual questioned costs were \$1,129,370. DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports," dated February 12, 1988, prescribes DoD policy and procedures for the disposition of reportable contract audit reports. Paragraph 5.2.5 of DoD Directive 7640.2 requires DoD Components to maintain up-to-date records on all reportable contract audit reports. Without accurate information on questioned costs, DCMA management lacks a reliable mechanism for ensuring that all questioned costs are timely and effectively resolved and dispositioned in accordance with DoD Directive 7640.2.

Recommendation C

We recommend that the Commander, Defense Contract Management Agency Melbourne emphasize to contracting officers the importance of accurately reporting contract audit report data in the Defense Contract Management Agency Melbourne portion of the DoD IG Semiannual Report to Congress.

Management Comments Required

On July 5, 2007, the Defense Contract Management Agency provided initial comments on a draft of this report. However, the Defense Contract Management Agency stated that it was revising the management comments. As of September 28, 2007, we have not received the revised management comments. Therefore, we request that the Commander, Defense Contract Management Agency provide comments on the final report.

Appendix A. Scope and Methodology

We evaluated the records maintained by DCMA Melbourne to determine the validity of the allegation. Specifically, we:

- reviewed the applicable regulations, directives, and instructions;
- reviewed the outcome of relevant legal cases;
- interviewed the contracting officer and others involved in reviewing the settlement costs for allowability;
- reviewed the DCMA contract files addressing negotiation of the settlement costs, such as the advance agreement, settlement agreement, and court pleadings and dismissal statements from the legal proceedings; and
- interviewed employees of the DCAA Melbourne office involved with Audit Report No. 1301-2000Q10100002, May 23, 2002, and reviewed the associated working papers.

We also evaluated contracting officer actions taken in response to DCAA Audit Report No. 1301-2000Q10100002 for compliance with DoD Directive 7640.2, “Policy for Follow-up on Contract Audit Reports.”

We performed this review from October 2006 through March 2007.

Use of Computer-Processed Data. DCMA maintains a Web-based eTools system to provide the status of contract audit reports. However, we did not rely on the accuracy of the computer-processed data generated by eTools as a basis for our findings and recommendations. Instead, we traced the information in the eTools system to source documents.

Prior Coverage. During the last 5 years, the Department of Defense Inspector General (IG) has issued two reports related to contract audit followup actions on incurred costs, such as the settlement costs addressed in the DoD Hotline.

- IG DoD Report No. D-2005-6-003, “Oversight Review of the DCMA Santa Ana’s Actions on Incurred Cost Audits,” March 17, 2005
- IG DoD Report No. D-2004-6-006, “Oversight Review of the Naval Sea Systems Command Contract Audit Follow-up Process,” July 8, 2004

Appendix B. Report Distribution

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