



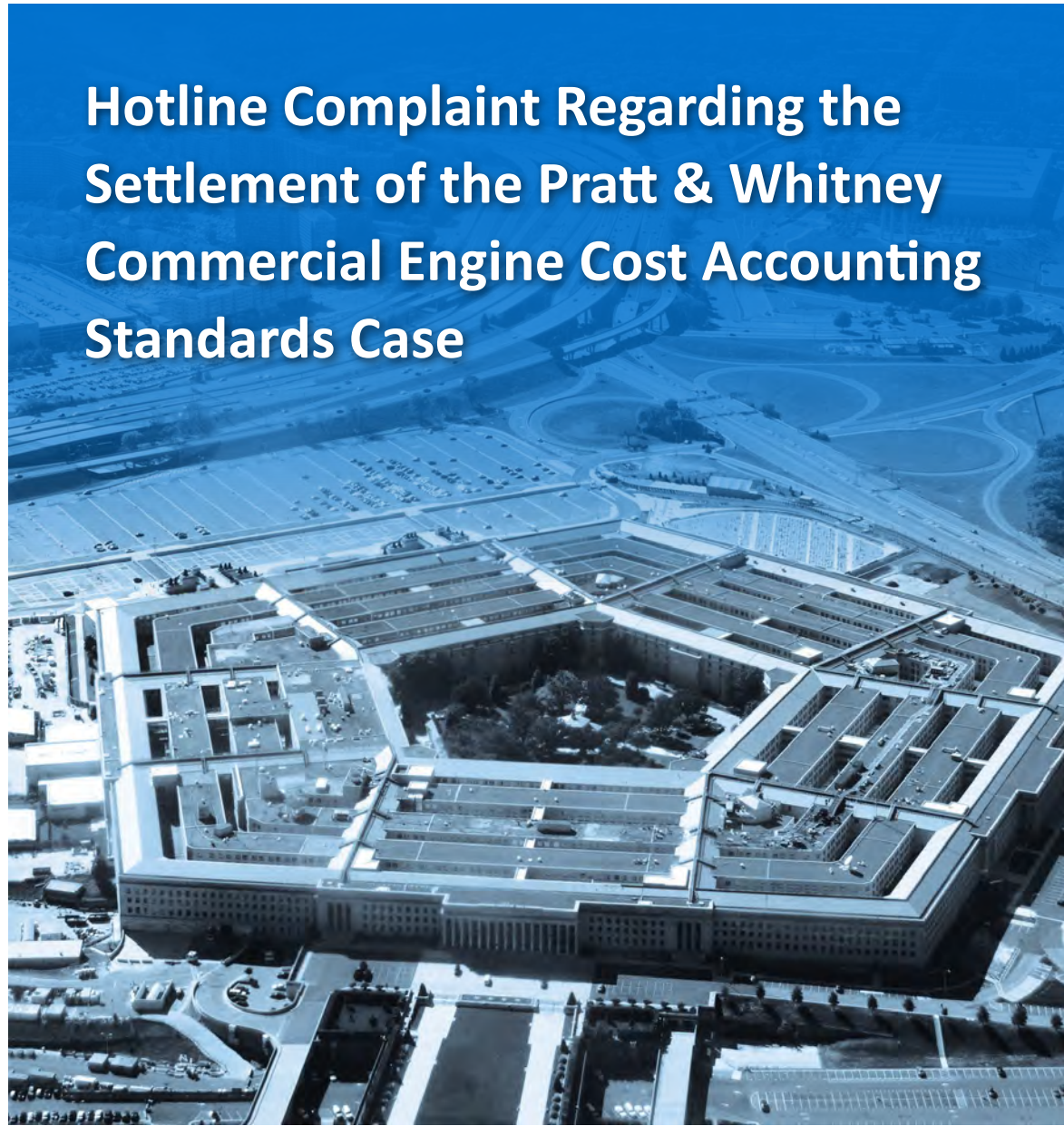
INSPECTOR GENERAL

U.S. Department of Defense

MAY 30, 2014



Hotline Complaint Regarding the Settlement of the Pratt & Whitney Commercial Engine Cost Accounting Standards Case



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Results in Brief

Hotline Complaint Regarding the Settlement of the Pratt & Whitney Commercial Engine Cost Accounting Standards Case

May 30, 2014

Objective

We conducted an oversight review to determine the validity of a DoD Hotline complaint alleging that (i) management exerted pressure to settle a case in litigation for an amount agreeable to the contractor rather than fair to the taxpayer and (ii) the settlement amount was about \$500 million less than an amount consistent with Government procurement regulations.

Findings

We found no evidence to substantiate the allegation that there was pressure from the highest levels of the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA) to settle the litigation for an amount that was agreeable to UTC Pratt & Whitney rather than an amount that was fair to the taxpayer. We substantiated that DCMA did not establish a settlement position that was consistent with the Federal Acquisition Regulation (FAR). Therefore, we are not able to provide a reliable estimate for a settlement amount. We also found that DCAA assistance negatively impacted the settlement amount; DCMA legal counsel was unable to influence the decision to settle; and DCMA did not vet one negotiator with a potential conflict of interest. Additionally, we determined that current problems with the DCMA administration of Pratt's continuing Cost Accounting Standards (CAS) 418 noncompliance may be resulting in increased costs on DoD contracts; therefore, we issued a Notice of Concern to the Director, DCMA, on April 17, 2013.

Recommendations

We recommend that the Director, DCMA:

- Implement a policy requiring that management determine that the attorney's litigative position includes sufficient information and data to justify a settlement negotiated in accordance with the FAR;
- Evaluate the feasibility of requiring that 'material disagreements' between a contracting officer and a trial attorney regarding the decision to seek a negotiated settlement with the contractor be elevated to a board of review;
- Implement best practices wherein general counsel conflict of interest and impartiality reviews are documented in writing real-time; and
- Take actions to ensure Pratt complies with the CAS when accounting for the actual cost of aircraft engine parts and ensure the U.S. Government recovers any resulting increased costs paid to Pratt since 2005.

We recommend that the Director, DCAA, perform an internal review to assess auditor adherence with the requirements of DCAA Contract Audit Manual 15-506.2, "Support Government Trial Attorney" and take necessary corrective action, where warranted.

Management Comments and Our Response

The Director, DCMA, comments were responsive to the recommendations and identified actions that met the intent of our recommendations.

The Director, DCAA, did not agree that DCAA negatively impacted negotiations and as a result will not implement our recommendation. The Director did not provide new evidence for us to consider or factual support for certain key assertions from their response. Therefore, we request that the Director reconsider the DCAA position or provide additional evidence and/or comments to substantiate the DCAA position. Please see the recommendations table on the following page.

Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Director, Defense Contract Management Agency		B, D, E, F ¹
Director, Defense Contract Audit Agency	C	

Please provide comments by June 30, 2014.

¹ On May 24, 2013, DCMA concurred with each of our recommendations from our April 17, 2013, Notice of Concern. DCMA will provide the DoD Office of Inspector General with semiannual updates until each recommendation has been successfully implemented (Appendix E).



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

May 30, 2014

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Hotline Complaint Regarding the Settlement of the Pratt & Whitney
Commercial Engine Cost Accounting Standards Case
(Report No. DODIG-2014-077)

We are providing this draft report for review and comment. We partially substantiated one of two allegations made by the complainant and have made recommendations that we believe, if implemented, will protect the Department from similar short-comings in the future.

We considered comments from the Defense Contract Management Agency and Defense Contract Audit Agency when preparing the final report. DoD Directive 7650.3 requires that recommendations be resolved promptly. The comments from the Director, Defense Contract Audit Agency, were not responsive. Therefore, we request additional comments on Recommendation C by June 30, 2014.

If possible, send a Microsoft Word (.doc) file and portable document format (.pdf) file containing your comments to apo@dodig.mil. Copies of your comments must have the actual signature of the authorizing official for your organization. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

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

A handwritten signature in black ink, appearing to be "J. A. ...", is located below the text of the memorandum.

Policy and Oversight

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Introduction

Objective

Our objective was to assess a complaint submitted to the Defense Hotline (Case No. 109704) regarding a June 5, 2006, settlement agreement between the U.S. Government and the United Technologies Corporation, Pratt & Whitney (Pratt). The complainant alleged:

- There was pressure from the highest levels of the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) to settle this litigation for an amount that was agreeable to the contractor rather than an amount that was fair to the taxpayer.
- The litigation of Pratt's cost accounting for engine parts on commercial engine collaboration programs from 1984 through 2004 was settled for an amount about \$500 million less than an amount consistent with Government procurement regulations, including the Cost Accounting Standards (CAS).

The complaint did not make allegations against specific parties, nor did it accuse specific parties of violating criminal or administrative offenses. Consequently, these allegations did not warrant an investigation of a suspect or subject, in accordance with the Council of the Inspectors General on Integrity and Efficiency (CIGIE), Quality Standards for Investigations.

However, given the significance of the government allegedly foregoing \$500 million in an out of court settlement, we determined it appropriate to assess the processes, procedures and policies used to formulate the settlement between DCMA and Pratt.

Our assessment was conducted in accordance with CIGIE, Quality Standards for Inspection and Evaluation (QSIE). Throughout our assessment we remained alert for indicators of fraud, other illegal acts, or abuse as required by the QSIE. We found no indicators requiring referral to an appropriate investigative body.

See Appendix A for details on our scope and methodology.

Background

In 1991, DCAA issued Audit Report Nos. 2641-91L44200001 and 2641-91D44200804 finding that Pratt had not complied with the following CAS when accounting for the cost of material obtained through the use of collaboration agreements:

- CAS 410 Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives,
- CAS 418 Allocation of Direct and Indirect Costs, and
- CAS 420 Accounting for Independent Research and Development Costs and Bid and Proposal Costs

DCAA found the noncompliances in a DCAA audit of a FY 1984 incurred cost submission for Pratt. DCAA found that Pratt had not included any costs associated with its collaboration agreements with foreign parts suppliers in the allocation bases it used to allocate indirect costs, general and administrative expenses, and the cost of independent research and development costs and bid and proposal costs to its U.S. Government contracts. The collaboration agreements provided that, in exchange for the parts the suppliers supply, Pratt would pay them a percentage of revenue received by Pratt from the sale of the respective jet engine (referred to as “revenue share”). The revenue share reflected the percentage of parts supplied to the program. Pratt had argued that title for the parts never passed from the supplier to Pratt under the collaboration agreements and therefore Pratt did not have any costs to include in the same allocation bases.

On December 2, 1996, DCMA determined that Pratt had not complied with the cited CAS and issued a demand for payment to Pratt in the amount of \$260 million. The demand was to recover the estimated increased costs paid by the U.S. Government to Pratt from 1984 through 1995. Pratt appealed the decision to the Armed Services Board of Contract Appeals (ASBCA), which decided in favor of Pratt on July 30, 2001. The U.S. Government appealed the decision to the U.S. Court of Appeals for the Federal Circuit (Court) and on January 15, 2003, the Court vacated the ASBCA decision.² The Court ruled that the terms cost and material cost as used in the CAS include the revenue share payments made by Pratt for the parts under the collaboration agreements. As such, Pratt was required to include a cost for collaboration parts in its

² Donald H. Rumsfeld, Secretary of Defense v. United Technologies Corporation, Pratt & Whitney, 315 F.3d 1361, 1377; 2003 U.S. App. LEXIS 569; 49 U.C.C. Rep. Serv. 2d (Callaghan) 492; 60 Fed. R. Evid. Serv. (Callaghan) 827 (U.S.C.A. Fed. Cir., January 15, 2003)

allocation bases. The Court remanded the case to the ASBCA to include a determination of damages. Of particular significance, the Court provided in Footnote 19 of the decision that:

To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts.

After the Court decision, the DCMA trial attorney prepared for renewed litigation in front of the ASBCA while attempting to reach an out-of-court settlement. On November 24, 2003, DCMA issued an updated demand to Pratt in the amount of \$754.7 million to recover the estimated increased costs paid by the U.S. Government to Pratt from 1984 through 2002.

On June 5, 2006, the DCMA contract management office settled the damages associated with Pratt's failure to comply with Cost Accounting Standards 410, 418, and 420 from 1984 through 2004 for \$283 million. Also on June 5, 2006, the DCMA contract management office (CMO) approved for use by Pratt, a noncompliant cost accounting practice, to account for the cost of parts acquired through its collaboration agreements.

See Appendix B for a chronology of events that transpired from 1991 through 2006.

See Appendix C for a chronology of significant amounts that were demanded, proposed, and/or offered from 1996 through 2006.

Finding A

Alleged Pressure to Settle in Favor of Pratt at the Expense of the Taxpayer

We found no evidence to support the allegation.

Allegation

The complainant alleged that there was pressure from the highest levels of the DCAA and DCMA to settle this litigation for an amount that was agreeable to the contractor rather than an amount that was fair to the taxpayer.

Our Review

We did not substantiate the allegation. To determine the validity of the allegation we performed procedures including:

- obtained and analyzed DCAA and DCMA legal, negotiation, and settlement files and documentation;
- obtained and analyzed relevant e-mail communications relating to negotiation and settlement;
- reviewed applicable laws, regulations, DoD Instructions, DCMA instructions, and DCAA policies; and
- conducted interviews with DCMA and DCAA personnel including members of management who had influence or participated in the negotiation and settlement, including former Directors of both agencies (see the following table).

Agency	Title of Person Interviewed and Positions Held Between Nov. 24, 2003 and June 5, 2006	Status*
Defense Contract Management Agency	Director	Former
	Acting Director Deputy Director Director East	Former
	Acting General Counsel Deputy General Counsel	Former
	Director East (Aeronautical Systems Division) Executive Director Contract Operations	Former
	Counsel East	Former
	Counsel Hartford	Former
	Chief Trial Attorney (Director), Contract Disputes Resolution Center	Current
	Chief Trial Attorney, Contract Disputes Resolution Center	Former
	Senior Trial Attorney, Contract Disputes Resolution Center	Current
	Commander, Aircraft Propulsion Operations	Former
	Commander, Aircraft Propulsion Operations Pratt & Whitney Group Chief, Business Operations, Aircraft Propulsion Operations Pratt & Whitney	Former
	Commander, Aircraft Propulsion Operations Pratt & Whitney	Former
	Divisional Administrative Contracting Officer, Pratt & Whitney	Former
	Corporate Administrative Contracting Officer, United Technologies Corporation	Former
Defense Contract Audit Agency	Director	Former
	Regional Director, Northeastern Region	Former
	Special Programs Manager, Northeastern Region	Former
	Resident Auditor, United Technologies Corporation Resident Office	Former
	Supervisory Auditor, United Technologies Corporation Resident Office	Former
	Auditor, United Technologies Corporation Resident Office	Former
	Government Expert Witness on Cost Accounting Standards before the ASBCA	Former

* There has been personnel turnover in the job positions identified in this chart and report. For positions identified with a status of "Current" the individual interviewed held the same job position at the time of the interview as during the relevant time period of, November 24, 2003 through June 5, 2006. Where the individual interviewed no longer held the position due to turnover, retirement, etc., the status is identified as "Former."

Based on the performance of these procedures we concluded that:

- actions³ taken by the former Director, DCMA to explore the feasibility of an administrative settlement with Pratt in lieu of continued litigation did not constitute pressure to settle for an amount that was agreeable to Pratt rather than an amount that was fair to the taxpayer;
- actions taken by the former Regional Director, Northeastern Region, DCAA to advocate for a particular settlement amount did not equate to pressure to settle for an amount that was agreeable to Pratt rather than an amount that was fair to the taxpayer;
- actions taken by the former Director East, DCMA⁴, to reach a negotiated settlement based in part upon advice from DCAA was not improper pressure to settle for an amount that was agreeable to Pratt rather than an amount that was fair to the taxpayer; and
- action by the Commander, Aircraft Propulsion Operations Pratt & Whitney, DCMA to approve a DCMA pre-negotiation settlement position that was not supported with sufficient documentation did not equate to pressure to settle for an amount that was agreeable to Pratt rather than an amount that was fair to the taxpayer.

These actions did not equate to pressure from the highest levels to settle for an amount that was agreeable to the contractor rather than an amount that was fair to the taxpayer, as alleged by the Hotline complainant.

³ See Appendix B, Chronology of Events.

⁴ The Director, DCMA East, was promoted to Deputy Director, DCMA, on September 26, 2005, and was promoted to Acting Director, DCMA, on January 12, 2006. He held this position until his retirement from Government service on April 30, 2008.

Finding B

DCMA Settlement Not Consistent with Government Procurement Regulations, including the Cost Accounting Standards

The DCMA contract management office (CMO) failed to protect the Government's interest when determining a reasonable basis for the \$283 million settlement amount. DCMA's settlement position was derived without obtaining sufficient documentation from Pratt to substantiate the negotiation objective under the principles articulated in the Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS) or the intent of Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit.

Allegation

The complainant alleged that the litigation of Pratt's cost accounting for engine parts on commercial engine collaboration programs from 1984 through 2004 was settled for an amount about \$500 million less than an amount consistent with Government procurement regulations, including the CAS.

Our Review

We partially substantiated the allegation. DCMA's settlement position was derived without obtaining sufficient documentation from Pratt to substantiate the Divisional Administrative Contracting Officer's (DACO) prenegotiation settlement position consistent with FAR Part 31 "Contract Cost Principles and Procedures," the rules and regulations established by the Cost Accounting Standards Board, and the intent of the Court as stated in Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit. Because DCMA did not substantiate their position, we are not able to provide a reliable estimate of what the settlement amount would have been had DCMA complied with the regulations.

The DACO, with the approval of DCMA management, settled the case on June 5, 2006, for \$283 million. This amount was \$133.9 million less than the litigative recovery of \$416.9 million anticipated by the DCMA Senior Trial Attorney in his litigative risk assessment and almost \$471.7 million less than the \$754.7 million demand for payment that DCMA had made to Pratt on November 24, 2003.

DCMA justified the reasonableness of its \$283 million settlement amount by citing the following factors:

- settlement expectations from management,
- future litigative costs,
- the litigative risk of returning the case to the Armed Services Board of Contract Appeals where they had previously lost the case, and
- conclusion of audit and legal effort on a case that had already spanned 20 years.

The DACO's undated prenegotiation memorandum was approved by the DCMA Group Chief, Operations Division (Finding E) and the Commander, DCMA Aircraft Propulsion Operations, Pratt. The negotiation approval authority granted to the DACO included a negotiation target of \$324.5 million and a maximum⁵ negotiation position of \$269.5 million. The approved DCMA prenegotiation position was flawed for the following reasons.

- Pratt had more than \$12.2 billion in total revenue share payments for collaboration parts that was never audited (Finding C).
- The DACO actions were not consistent with the intent of Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit. The DACO did not require that Pratt demonstrate with evidence its assertion that \$7.1 billion in revenue share payments included payments beyond that for the cost of the collaboration parts. Footnote 19 of the decision states: "To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts."⁶ (Finding C).
- The DACO did not demonstrate the regulatory authority in the FAR and the CAS to justify her acceptance of \$4.1 billion in revenue share payments as payments for items other than parts.

⁵ The former DACO used the term "maximum" on the prenegotiation memorandum to describe the lowest amount acceptable as settlement with Pratt.

⁶ Donald H. Rumsfeld, Secretary of Defense v. United Technologies Corporation, Pratt & Whitney, 315 F.3d 1361, 1377; 2003 U.S. App. LEXIS 569; 49 U.C.C. Rep. Serv. 2d (Callaghan) 492; 60 Fed. R. Evid. Serv. (Callaghan) 827 (U.S.C.A. Fed. Cir., January 15, 2003)

- The DACO did not use compound interest in accordance with the rules and regulations established by the Cost Accounting Standards Board and found at 48 CFR 9903.201-4.

DCMA's settlement position was derived without obtaining sufficient documentation from Pratt to substantiate the DACO's prenegotiation settlement position consistent with FAR Part 31 "Contract Cost Principles and Procedures," the rules and regulations established by the Cost Accounting Standards Board, and the intent of the Court as stated in Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit. It was the trial attorney's litigation position that all the revenue share payments should be deemed the cost of collaboration parts unless shown to be otherwise by Pratt. The decision by DCMA management to reach a negotiated settlement instead of pursuing a court decision on the amount of damages owed by Pratt to the U.S. Government left the DACO and her team with data insufficient to support a negotiated settlement position that was consistent with FAR and CAS.

Subsequent to the events described above, DCMA Instruction 134, "Boards of Review," was established. The instruction provides policies and assigns responsibility for ensuring that in specified circumstances, the decision processes of the contracting officer are reviewed by a Board of Review chaired by the Executive Director, Contracts; Directorate Contracts Director; Center Director; or a designee. The review process can identify potential discrepancies with FAR and CAS; however, as established it provides a control check that takes place at the end of the prenegotiation determination process. It does not include a control procedure to ensure that the contracting officer has evaluated the information and data available from the trial attorney to determine that it is sufficient to support a settlement position that is consistent with FAR and CAS. Performing this type of analysis prior to making a decision to pursue a negotiated settlement with the contractor has the potential to save DoD resources and ensure any future settlement amounts are consistent with the procurement regulations.

We believe that had the instruction been in place at the time the Board would have disagreed with the basis of the DACO's prenegotiation settlement position. However, the instruction would not have ensured that the DACO and her team had data sufficient to support a negotiated settlement position that was consistent with FAR and CAS. A new policy should be implemented that requires that a management official oversee an evaluation determining the extent to which data obtained from the trial attorney supporting litigation is sufficient to support and justify a settlement negotiated consistent with the Federal Acquisition Regulation.

Recommendation, Management Comments, and Our Response

Recommendation

We recommend that the Director, Defense Contract Management Agency, implement a 2-step policy with guidelines that require that a management official oversee an evaluation determining the extent to which data obtained from the trial attorney supporting litigation is sufficient to support and justify a settlement negotiated consistent with the Federal Acquisition Regulation.

1. Obtain a written evaluation considering at a minimum:
 - a. The objections of the trial attorney, if any, to pursuing a settlement.
 - b. A determination that the data and information obtained by the trial attorney to support litigation is sufficient to justify a contracting officer's determination in accordance with the Federal Acquisition Regulation.
 - c. Where it is determined that the data and information obtained by the trial attorney to support litigation is not sufficient to support and justify a contracting officer's determination in accordance with the Federal Acquisition Regulation, an assessment of the actions needed and time required to obtain sufficient information and data.
2. When the trial attorney disagrees with the written results of the evaluation, a board of review must assess the trial attorney's objections.

DCMA Comments

The Director partially agreed with this recommendation.

The Director advised that this is the only instance at DCMA where there was a continuing disagreement between the trial attorney and contracting officer over the terms of a negotiated settlement. The Director further explained that subsequent to the settlement identified in this report, the Agency established the CACO/DACO group at the Cost and Pricing Center. This group created a common reporting chain staffed with experienced personnel at the GS 15 level and an efficient set of internal controls over for the review and approval of business processes. The Director stated that current controls provide adequate oversight of a contracting officer settlement in lieu of litigation. In addition, it is not necessary

or practicable to require a Board of Review to assess trial attorney's settlement objections for cases that are in active litigation. There are very short time constraints over settlement discussions and the Government representative needs to be able to respond quickly to settlement offers.

The Director agreed that in the future, the Agency will amend its Defense Contract Management Agency Instruction 134, "Boards of Review," by July 2014 to ensure (1) documentation of deliberations and proper resolution of issues regarding settlement are addressed in either the pre-negotiation memorandum or post negotiation memoranda and (2) that a GS-1102-15 Supervisory Team Leader review is required for the settlement actions for all contracting officers.

Subsequent to the Director providing comments to the draft of this report the OIG met with the Defense Contract Management Agency Director of Cost and Pricing Policy and Associate General Counsel about the partial concurrence. At the meeting, they provided a recently found policy, DCMA-GC Operating Instruction 2, "Resolution of Intra-General Counsel Differences" dated December 22, 2008. The Instruction provides a process for an attorney to air disagreements outside the Agency, including disagreements of the type reported on in our report. At our request, the General Counsel updated the out-of-date content the Instruction, reissued it on April 4, 2014 and then distributed it as a policy memorandum to all attorneys on April 7, 2014.

Our Response

The comments from DCMA and DCMA actions are fully responsive. We believe that the actions taken and the actions planned can provide a control mechanism to help prevent any reoccurrence of the events described in this report. No further comments are required.

Finding C

DCAA Assistance Negatively Impacted the Settlement Amount

The DCAA settlement position of \$234 million offered to DCMA senior management was not consistent with the principles articulated in the Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS) or the intent of Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit. DCAA did not perform sufficient work to validate the \$12.2 billion in revenue share payments asserted by Pratt. In making its recommendation, DCAA inappropriately provided advice on litigative risk. Additionally, the DCAA position did not consider the DCMA Senior Trial Attorney's litigative strategy to have Pratt bear the burden in court regarding the legitimacy of the revenue share payments. The DCAA settlement recommendation of \$234 million resulted in a substantial reduction in the settlement expectation anticipated by DCMA.

DCAA provided advisory services⁷ to the DCMA Senior Trial Attorney and to the DCMA DACO throughout the settlement process. From January 2005 through March 2005, DCAA participated in a 'data exchange' with Pratt as a part of the effort by DCMA senior management to facilitate a negotiated settlement. As part of the data exchange, Pratt provided DCAA and the DCMA team with data and information regarding the revenue share payments Pratt asserted it made to its parts suppliers from 1984 through 2004. The data provided by Pratt showed it made more than \$12.2 billion in revenue share payments to suppliers for engine parts during this period. Of the \$12.2 billion Pratt asserted that more than \$7.1 billion represented payments for items other than parts. However, Pratt failed to provide evidence to substantiate the assertion.

The U.S. Court of Appeals for the Federal Circuit had ruled on January 15, 2003, that the terms "cost" and "material cost," as used in the CAS, include the revenue share payments made by Pratt for the parts under the collaboration agreements. The U.S. Court of Appeals for the Federal Circuit provided in Footnote 19 of the decision that:

⁷ DoD Directive 5105.36, "Defense Contract Audit Agency," February 28, 2002 provided that DCAA shall provide accounting and financial advisory services regarding contracts to all DoD Components responsible for procurement and contract administration services. DCAA provides audit policy to its auditors in the form of the DCAA Contract Audit Manual (DCAM). DCAM Chapter 15-500 Section 5, "Procedures for Actual or Potential Contract Disputes Cases," identifies the auditor's responsibilities when supporting the Government trial attorney.

To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts.

In the data exchange, Pratt did not provide evidence to show that \$7.1 billion represented payments for items other than collaboration parts.

The DCMA Senior Trial Attorney stated that he planned to establish in court the legitimacy of the \$7.1 billion in revenue share payments for items other than parts. He chose not to seek additional data from Pratt through discovery. Additionally, he stated that it was his belief that Pratt would never settle administratively for an amount that was reasonable. He believed the only way to attain equity was through litigation.

DCAA did not perform sufficient work to validate the information provided by Pratt through the data exchange and support its recommended settlement position of \$234 million. Without the benefit of evidence from Pratt to show that the \$12.2 billion in revenue share payments included \$7.1 billion in payments beyond that for the collaboration parts, DCAA took steps internally to determine which portions of the \$7.1 billion qualified as payments.

On March 31, 2005, DCAA provided the results of its work to the Director, DCMA East and the DCMA Senior Trial Attorney.⁸ DCAA concluded in part that:

- the direction provided by the U.S. Court of Appeals for the Federal Circuit in Footnote 19 was not feasible,
- the total revenue share payments less payments for items other than parts as provided by Pratt in the data exchange could be used retroactively, and
- the use of a Pratt estimate of the cost to make the parts in-house in lieu of the actual cost to obtain the parts from a supplier may be a viable solution prospectively.

On April 28, 2005, the Regional Director, DCAA, provided the Director, DCMA East, the DCAA recommended settlement amount of \$234 million. At that time, the DCMA settlement offer to Pratt was \$605 million.

⁸ See Appendix B, Chronology of Events.

DCAA based its recommended settlement position on an estimate obtained from Pratt. DCAA used an estimate of the cost to Pratt to manufacture the parts in-house in lieu of obtaining the parts from the suppliers. DCAA asserted this amount was \$334 million. DCAA then stated that:

recognizing there are certain litigative risks associated with this issue, we believe it is reasonable to agree to 70% of the \$334 million total impact, or \$234 million.

On June 2, 2005, the Commander, DCMA Aircraft Propulsion Operations, based on the DCAA work product, recommended to the Director, DCMA East, that DCMA settle the case for \$315 million. The DCMA Counsel, Hartford, recommended that DCMA settle for \$307 million.

On June 6, 2005, the Director, DCMA East, advised the Director, DCMA, that the Government team had splintered and had differing opinions about the settlement amount, the lowest of which was the DCAA amount of \$234 million.

On June 20, 2005, the Director, DCMA East, directed the DACO to form a second team to try to reach a negotiated settlement with Pratt. This action led the DCMA contracting personnel and the DACO team at Pratt to conclude that further litigation was not an option and to direct their attention to achieving a negotiated settlement. Also on June 20, 2005, the DCMA Senior Trial Attorney reduced his settlement offer to Pratt to \$514 million. Pratt's counter offer remained at \$175 million.

The DCMA Senior Trial Attorney advised the Office of Inspector General (OIG) that he had not requested that DCAA provide the Director, DCMA East, with a recommendation on a reasonable settlement amount. He also had not assisted DCAA with identifying any specific 'litigative risks' associated with its recommendation.

By using an estimate instead of the actual cost of the parts, the DCAA settlement position of \$234 million was not compliant with CAS 418 and was not consistent with the intent of the Court as stated in Footnote 19 from the decision of U.S. Court of Appeals requiring Pratt to substantiate the cost of the parts.

DCAA did not perform sufficient work to validate the assertions made by Pratt through the data exchange and to support its recommended settlement position. Without having performed sufficient work, DCAA did not have evidence to opine on the assertions made by Pratt. DCAA audit policy provided in the DCAA Contract Audit Manual (DCAM) Paragraph 2-302.3, "Evidence (GAGAS 6.04b)," states that:

The auditor's work shall include the examination or development of sufficient evidence to afford a reasonable basis for the auditor's conclusions and recommendations regarding cost representations, management decisions influencing costs, financial statements, or any other matters requiring the auditor's opinion.

Regarding the DCAA position on litigative risks, DCAM 15-506.2, "Support Government Trial Attorney," states that:

Field auditors should provide only basic accounting information and specific issue (factual) support. They should exercise special care to avoid expressing opinions on subjects outside the accounting field. They should not express legal or engineering opinions... For example, auditors should avoid assessing the litigative risk of a case. This responsibility for board or court cases rests with the Government trial attorney.

The former Director, DCAA advised the OIG that he was not aware of the data exchange at the time. When shown the specifics of Footnote 19 and the opinion of the Court, and asked whether he would have anticipated that the auditors' in doing their data exchange, would have wanted to see that the contractor had followed Footnote 19, he replied:

Oh, absolutely, yeah. I guess I would go so far to say that if the contractor did provide sufficient evidence, that the portion of the revenue shares was for something other than the parts cost, and we agreed it was, probably should have issued a supplemental audit report.

Regarding the DCAA assessment of litigative risk, the former Director, DCAA, stated that DCAA is not qualified to assess litigative risk.

Regarding the level of reliance that he placed on the DCAA recommended settlement amount, the former Director, DCMA East, advised the OIG that:

If they said that they felt that was reasonable, and I got it from basically and essentially a counterpart of mine, I would think that it was in the ballpark. I mean I -- who was I to go back and question something like that just from a knowledge of accounting and a knowledge of auditing and professional standards, I couldn't do it.

The OIG asked the former Director, DCMA, how the information provided to him in June of 2005 by the Director, DCMA East, had influenced his understanding of the settlement negotiations. He advised the OIG that he could not recall the specifics.

When the OIG advised him that at that time the Government team had three positions on settlement, including the Commander's position of \$315 million, the local counsel's position of \$307 million, and the DCAA position of \$234 million, the former Director, DCMA stated in part that:

We are talking on making offers in the \$600 million range, and then you come up and say, 'Well, we think we can justify \$315, \$307, and \$235 million,' that would get my attention.

I would have given [the DCAA position of \$234 million] a lot of weight.

Most contracts guys would look at the DCAA numbers and say, 'If I got a number for DCAA, I got to have a really good reason to deviate from it significantly.'

Recommendation, Management Comments, and Our Response

Recommendation

We recommend that the Director, Defense Contract Audit Agency, perform an internal review to assess auditor adherence to the requirements of DCAA Contract Audit Manual 15-506.2, "Support Government Trial Attorney," and take necessary corrective action, as warranted.

DCAA Comments

The Director did not agree with this recommendation and does not consider it necessary to perform an internal review. The Director disclosed that many of the individuals involved with the subject case are no longer with DCAA. As a result, the Director contends that the basis of the DCAA assertions in the settlement correspondence quoted in the report can not be determined. Specifically, the basis can not be identified for the 70 percent reduction DCAA applied in recommending the settlement. However, the Director explained further that DCAA reviewed pertinent documents and correspondence in its files and considers the advisory services provided by the DCAA to have complied with Agency guidance. The Director concluded that any litigative strategy relating to this issue was within the sole discretion and direction of the DCMA contracting officer and trial attorneys.

Our Response

The comments from DCAA are not responsive. The Director did not adequately consider the evidence we outlined in the finding or provided during discussions. For instance while stating that the basis of the 70 percent reduction was unclear, the Director apparently neglects the statements of the DCMA interviewees, who unequivocally deny being the source of this proposal, as well as statements of the DCAA interviewees who pointedly decline to refute that they, in fact, were the source. The Director also apparently neglects to consider e-mail correspondence from DCAA to the DCMA Division Director in which DCMA attorneys were not included, wherein DCAA refutes the DCMA trial attorneys' litigation strategy and advocates a different settlement strategy. When DCAA recommended, in writing, a reasonable settlement position that factored in litigative risk (not provided by or agreed to by the DCMA attorneys), DCAA went beyond its guidance to provide basic accounting information and factual support to the contracting officer and DCMA Counsel.

In the subsequent meetings after receiving the response, DCAA did not provide new evidence for us to consider or factual support for the assertions in its response.

We request that the Director of DCAA reconsider the DCAA position or provide additional evidence and/or comments to substantiate the DCAA position in response to the final report.

Finding D

DCMA Legal Counsel Unable to Influence Decision to Settle

The DCMA CMO at Pratt was able to conclude negotiations with Pratt and settle the case for \$283 million despite the advice of the DCMA Chief Trial Attorney that the settlement position did not “adequately represent the Government’s best interest.” The DACO team and DCMA management were willing to reach a negotiated settlement for an amount that was significantly less than the recovery anticipated by the DCMA Senior Trial Attorney.

By approving the DACO’s prenegotiation memorandum, the DCMA contract management office gave the DACO approval to negotiate a settlement that fell within a range of \$269 million to \$324.5 million. In contrast, the DCMA Senior Trial Attorney concluded in his May 26, 2005, Litigative Risk Assessment that the U.S. Government’s worst case recovery if litigation proceeded to conclusion was \$416.9 million, but that the U.S. Government should expect to recover more.

On April 4, 2006, the DACO’s prenegotiation memorandum was provided to the Chief Trial Attorney, Contract Disputes Resolution Center, DCMA, for comment. On April 10, 2006, the Chief Trial Attorney advised the Acting General Counsel, DCMA that:

We do not feel that the Command’s position adequately represents the Government’s best interests and, accordingly, do not concur in the position.

The burden to demonstrate that the revenue share payments included payment beyond that for the collaboration parts themselves is upon Pratt. The burden is not upon the Government to make Pratt’s case for them. Under Pratt’s own collaboration agreements, the only items for which Pratt pays are the parts. All other payments other than the [revenue share payments] payments made under Pratt’s collaboration agreements ... are payments by the collaborators to Pratt. Pratt has not shown that its [revenue share payments] to the collaborators are for anything but parts.

We have seen nothing stated in the [pre-negotiation memorandum] which leads us to change our litigation risk assessment of May 26, 2005. Pratt has presented no arguments, or evidence, to make us reconsider our earlier assessment. The only thing that has changed is the Command’s willingness to accept, in advance of negotiation, Pratt’s arguments...

We do not understand, or agree with, the Command's negotiating position.

Despite the objections of the DCMA Chief Trial Attorney, the DCMA CMO at Pratt proceeded with settlement negotiations.

On April 29, 2006, the DACO and the DCMA Group Chief, Operations Division⁹ (Finding E) reached a tentative settlement agreement with Pratt for \$283 million. The tentative settlement amount was approved by the Director, DCMA East, on May 1, 2006. The Acting General Counsel, DCMA, did not intercede to ensure the settlement was consistent with the intent of the Court as stated in Footnote 19 of the U.S. Court of Appeals. On June 5, 2006, the DACO signed an agreement with Pratt that settled the monetary damages resulting from the CAS noncompliances from 1984 through 2004 for \$283 million. This amount was \$133.9 million less than the litigative recovery of \$416.9 million anticipated by the DCMA Senior Trial Attorney in his litigative risk assessment and almost \$471.7 million less than the \$754.7 million demand for payment that DCMA had made to Pratt on November 24, 2003. It was also only \$23 million more than the \$260 million that the U.S. Government sought from Pratt in its final decision in 1996.¹⁰

In discussions with the OIG, the Acting General Counsel, DCMA, stated he could agree with a procedure wherein a contracting officer is not allowed to settle a case that is in litigation unless the contracting officer gets the agreement of the trial attorney.

Current policy, DCMA Instruction 905, "Contract Claims and Disputes," states:

3.4.3. Once litigation at the ASBCA has commenced, the Contracting Officer shall consult with the assigned CDRC trial attorney and other appropriate advisors (e.g., audit, technical) before attempting any settlement. In the event of any material disagreement between the Contracting Officer and the CDRC trial attorney concerning the best course of action for the agency, the Contracting Officer shall elevate the matter for resolution at least one level above each individual.

As identified above the 'material disagreement' was elevated at least one level above each individual. However, the additional oversight brought to bear in each respective chain of command did not resolve the significant issues raised by Chief Trial Attorney.

⁹ DCMA agreed with Pratt that both sides of the negotiation would be represented by two people from the "business side of the house" and that attorneys would not be present.

¹⁰ In 1996 the U.S. Government demanded that Pratt pay \$260 million to settle the same case for the period 1984 through 1995. See Appendix C, Chronology of Significant Amounts.

Additionally, DCMA Instruction 134, “Boards of Review” does not require that a ‘material disagreement’ that remains unresolved be subjected to a Board of Review prior to management approval of any settlement negotiations with a contractor.

Recommendation, Management Comments, and Our Response

Recommendation

We recommend that the Director, Defense Contract Management Agency, evaluate the Defense Contract Management Agency Instruction 134, “Boards of Review,” and determine the feasibility of requiring that ‘material disagreements’ between a contracting officer and a Trial Attorney regarding the decision to seek a negotiated settlement with the contractor be elevated to a board of review.

DCMA Comments

The Director partially agreed with this recommendation and addressed the details in the management comments provided in response to Recommendation B.

Our Response

Due to the reissuance of the policy, “Resolution of Intra-General Counsel Differences” described in Finding B, we consider the comments from DCMA and DCMA actions fully responsive. No further comments are required.

Finding E

DCMA Did Not Vet One of Two Settlement Negotiators

At settlement negotiations held in late April and early May, 2006, one of the two DCMA employees representing the U.S. Government at the negotiation table was a former employee of Sikorsky Aircraft Corporation. Sikorsky is another business unit of the United Technology Corporation. In March of 2006, Counsel, DCMA East, had been notified by the Chief Trial Attorney, DCMA, of a potential conflict of interest problem that could arise by having a former employee of another UTC business unit participating directly in negotiations between the U.S. Government and Pratt. The Group Chief had never worked for Pratt. Nonetheless, Counsel, DCMA East, acting in the role of East Region Ethics Advisor, did not act on the conflict of interest allegation at the time.

The employee in question, the Group Chief, Business Operations, DCMA Aircraft Propulsion Operations Pratt, also supervised the other DCMA employee at the negotiation table—the DACO. The Group Chief had been hired by DCMA in November 2005 from his quality management position with Sikorsky. Prior to his employment with Sikorsky, the Group Chief was a Lieutenant Colonel in the U.S. Air Force where he served as the Commander, DCMA Pratt. He retired from Military Service in 2004.

As a result of our inquiry, on February 3, 2012, Counsel for the DCMA Eastern Regional Command drafted a legal opinion¹¹ for the record based on the facts at the time. DCMA policy did not and does not require general counsel conflict of interest and impartiality reviews be documented in writing at the time concerns are identified. Counsel concluded and the OIG agrees that “[t]he Agency should have evaluated [Group Chief’s] participation in conjunction with the standards of 5 CFR §2635.502, ‘Personal and business relationships’”. However, in evaluating all the facts, Counsel for the DCMA Eastern Regional Command concluded that the Group Chief did not have a statutory conflict when he participated in settlement discussions in 2006 and that a reasonable person with knowledge of all the facts would not question the impartiality of the Group Chief in the matter. Finally, Counsel concluded that she would have authorized the Group Chief to participate in the negotiations.

¹¹ The “legal opinion” was a memorandum for record that documented the conflict of interest review. The review considered the Standards of Ethical Conduct for Employees of the Executive Branch in 5 CFR Part 2635.

Though in this circumstance, the potential conflict did not result in a problem in relation to the negotiation, we believe that the Director, DCMA, should consider implementing a best practice wherein general counsel conflict of interest and impartiality reviews are documented in writing at the time concerns are identified.

Recommendation, Management Comments, and Our Response

Recommendation

We recommend that the Director, Defense Contract Management Agency, implement a best practice wherein general counsel conflict of interest and impartiality reviews are documented in writing at the time concerns are identified.

DCMA Comments

The Director agreed and stated that the Office of the General Counsel will implement a best practice wherein general counsel conflict of interest and impartiality reviews are documented in writing at the time concerns are identified.

Our Response

The comments from DCMA are fully responsive, and no additional comments are required.

Finding F

DCMA Taking Action to Correct Continuing Cost Accounting Standards Noncompliance

On April 17, 2013, the OIG issued a Notice of Concern¹² advising the Director, DCMA, that its CAS administration practices at United Technologies Corporation, Pratt, did not provide positive assurance that the U.S. Government avoided paying windfall profits on its CAS-covered contracts with Pratt (Appendix D). Since 1984, DCMA has not administered a CAS-compliant accounting practice at Pratt for collaboration parts and the current noncompliant practice may yet again be resulting in increased cost paid by the U.S. Government. On May 24, 2013, DCMA concurred with each of our recommendations and will provide the OIG with semiannual updates until each recommendation has been successfully implemented (Appendix E).

FAR 30.605, "Processing Noncompliances," provides procedures that DCMA shall follow to have a contractor correct a noncompliant cost accounting practice and obtain a cost impact proposal. On June 5, 2006, the DACO approved Pratt's use, starting in 2005, of an estimate to account for the cost of the parts, in lieu of the actual cost of the parts.¹³ The DACO found that the practice was noncompliant with CAS 418 but was resulting in an immaterial cost impact on CAS-covered contracts. However, neither DCMA nor DCAA were monitoring the noncompliance to ensure it remained immaterial.

As a result of our oversight review into the settlement, DCAA reported on September 22, 2011, that the Pratt noncompliant cost accounting practice may be resulting in an estimated cost impact of as much as \$15.2 million for the year examined by DCAA – FY 2009. Additionally, neither DCMA nor DCAA had acted to compel Pratt to abide by Footnote 19 of the ruling of the U.S. Court of Appeals for the Federal Circuit. Pratt still has collaboration agreements that use revenue share payments and has yet to show the U.S. Government that the revenue share payments made to its collaboration partners since 2005 included payments beyond that for the collaboration parts. Finally, DCMA had not taken action to have Pratt implement a CAS-compliant cost accounting practice for the cost of parts acquired through collaboration agreements.

¹² A Notice of Concern is issued to alert DoD management of significant findings that require immediate attention. By issuing a Notice of Concern, DoD management officials can take proactive steps to mitigate the reported issue.

¹³ CAS 418 requires the use of actual cost.

Recommendations, Management Comments, and Our Response

Recommendations

Our Notice of Concern (Appendix D) included eight recommendations. DCMA agreed with each recommendation (Appendix E) and agreed to provide the OIG with semiannual updates until each recommendation is successfully implemented. We consider the DCMA response to our Notice of Concern recommendations to be responsive.

DCMA Comments

The Director reaffirmed concurrence with the eight recommendations and agreed to provide status updates on request.

On March 24, 2014, Executive Director of Contracts, DCMA notified the OIG of the current status of actions taken in response to the recommendations in the Notice of Concern. In accordance with FAR 52.233-1, DCMA notified Pratt of the final decision that it was noncompliant with CAS 418 from January 1, 2005, to December 31, 2012 and demanded that Pratt repay \$210,968,414 to the U.S. Government. Pratt appealed the final decision to the Armed Service Board of Contract Appeals and the case was established as 59222.

Our Response

The comments from DCMA are fully responsive, and no additional comments are required.

Appendix A

Scope and Methodology

We performed this project from October 2009 through May 2013 in accordance with the Council of the Inspectors General on Integrity and Efficiency, “Quality Standards for Inspection and Evaluation.” Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our review objectives. To determine the validity of the Defense Hotline complaint, we:

- obtained and reviewed DCAA and DCMA legal, negotiation, and settlement files and documentation;
- obtained and reviewed relevant e-mail communications relating to negotiation and settlement;
- reviewed applicable laws, regulations, DoD Instructions, DCMA instructions, and DCAA policies;
- conducted interviews with DCMA and DCAA personnel including members of management who had influence or participated in the negotiation and settlement, including former Directors of both agencies;
- coordinated with Defense Criminal Investigate Service; and
- coordinated with OIG legal throughout the process for advice and for assistance with obtaining records and testimony.

Use of Computer-Processed Data

We did not rely on computer-processed data as part of our review.

Prior Coverage

In the last 5 years, we have issued three other reports on DCMA contracting officer actions in response to DCAA audit reports.

Report No. D-2010-6-002, “Report on Allegation of Unsatisfactory Conditions Regarding Actions by the Defense Contract Management Agency, Earned Value Management Center,” July 28, 2010.

Report No. D-2009-6-008, "Report on Hotline Complaint Regarding the Actions by a Contracting Officer at the Defense Contract Management Agency, East Hartford Office," August 31, 2009.

Report No. D-2009-6-004, "Defense Contract Management Agency Actions on Audits of Cost Accounting Standards and Internal Control Systems at DOD Contractors Involved in Iraq Reconstruction Activities," April 8, 2009.

Appendix B

Chronology of Events

Date	Description
1991 (multiple dates)	DCAA reported that Pratt had not complied with CAS 410, 418, and 420 when accounting for the cost of material obtained through the use of collaboration agreements.
December 2, 1996	DCMA determined that Pratt had not complied with the cited CAS and issued a demand for payment to Pratt in the amount of \$260 million.
July 30, 2001	Pratt appealed the DCMA decision to the Armed Services Board of Contract Appeals who decided in favor of Pratt.
January 15, 2003	The U.S. Government appealed the decision to the U.S. Court of Appeals for the Federal Circuit who vacated the ASBCA decision and remanded the case to the ASBCA to include a determination of damages.
November 24, 2003	DCMA issued an updated demand to Pratt in the amount of \$754.7 million to recover the estimated increased costs paid by the U.S. Government to Pratt from 1984 through 2002. Amount is a "Rough Order of Magnitude" produced by DCAA as a nonaudit service.
August 24, 2004	Director, DCMA, discussed ongoing litigation with Pratt at the Air Force Material Command Strategic Suppliers Summit.
September 2004 (multiple dates)	DCMA Director received factsheet from Director, DCMA East; both Directors were briefed on the case in detail. DCMA Director East on behalf of DCMA Director communicated to Pratt their willingness to meet and discuss the cost accounting issue.
October 12, 2004	DCMA Director sent a letter to Pratt communicating that a negotiated resolution of this matter was a desirable goal and invited them to present their settlement position.
December 2004	DACO delegated negotiation authority for the settlement to the Senior Trial Attorney. Pratt offered \$125 million to settle; DCMA (with Director East approval) countered with \$605 million and Pratt responded that counter offer was too high.
January - March 2005	Pratt data exchange with DCAA and DCMA.
March 30 2005	DCAA Northeastern Regional Director e-mailed the DCAA Director a briefing sheet that identified a range of settlement positions calculated by DCAA as a nonaudit service.
March 31 2005	<p>DCAA Northeastern Regional Director with staff briefed Director, DCMA East, and the Senior Trial Attorney on the summary of impacts for settlement discussions using the Pratt assertions included within the data exchange. DCAA presented:</p> <ul style="list-style-type: none"> • Pratt's next offer would be between \$136 and \$233 million. • Direction provided by the U.S. Court of Appeals for the Federal Circuit in Footnote 19 was not feasible. • Total revenue share payments less payments for items other than parts as provided by Pratt in the data exchange could be used retroactively. • Pratt estimate of the cost to make the parts in-house in lieu of the actual cost to obtain the parts from a supplier may be a viable solution prospectively. • \$200 million was a reasonable recovery considering Pratt's explanation that some portion of the revenue shares represented payments for items other than parts.

Chronology of Events (cont'd)

Date	Description
April 2005	Pratt offered \$175 million settlement based on data exchange. DCAA Northeastern Regional Director responded to Director, DCMA East request and stated that DCAA believed: <ul style="list-style-type: none"> \$334 million is a reasonable estimate of the cost impact (based on estimate of the cost to Pratt to manufacture); \$234 million is a reasonable settlement, recognizing certain litigative risks associated with this issue.
May 26, 2005	Senior Trial Attorney issues litigative risk assessment to DCMA Counsel and Director, DCMA East. Outlined recovery range from \$814-\$417 million if litigation proceeds to conclusion. Outlined an expectation of settlement around \$420 million with a minimum of \$375 million.
June 2, 2005	"Government-Only Meeting" wherein the litigation strategy and negotiation strategy were discussed. Based on the DCAA work product, the following expressed their expectation of recovery: <ul style="list-style-type: none"> \$315 million - Commander, DCMA Aircraft Propulsion Operations \$307 million - DCMA Counsel, Hartford \$234 million - DCAA
June 6, 2005	Director, DCMA East, conducted a video teleconference with the Director, DCMA advising that the Government team had splintered and had differing opinions about the settlement amount, the lowest of which was the DCAA position of \$234 million.
June 20, 2005	Senior Trial Attorney offered to Pratt to settle for \$514 million but Pratt's counter offer remained at \$175 million. Subsequently Director, DCMA East, directed the DACO to form a second team to try to reach an administrative settlement with Pratt.
September 17, 2005	Senior Trial Attorney explained to Commander, DCMA Aircraft Propulsion Operations, that nothing new had occurred with respect to settlement since the June 20 meeting, and litigation was proceeding.
September 26, 2005	Director, DCMA East, was promoted to Deputy Director, DCMA.
October 31, 2005	DACO via Commander, DCMA Aircraft Propulsion Operations, provided Counsel, DCMA East, a proposed agreement with Pratt wherein the DACO would agree to allow Pratt prospective use of an estimate of the cost to Pratt to manufacture the parts in-house in lieu of obtaining the parts from the suppliers.
November 10, 2005	Senior Trial Attorney responding on behalf of Contract Disputes Resolution Center responded to Counsel, DCMA East, that they could not support the agreement proposed by the DACO.
November 14, 2005	United Technology Corporation, Sikorsky Aircraft Corporation, employee became Group Chief, Business Operations, DCMA Aircraft Propulsion Operations Pratt.
January 12, 2006	Director, DCMA East, who was promoted to Deputy Director, DCMA, is promoted to Acting Director, DCMA.
January 25-31, 2006	Group Chief, Business Operations, DCMA Aircraft Propulsion Operations Pratt, conducted a going forward strategy meeting for the CMO. DACO issued delegation amendment to Senior Trial Attorney for negotiation authority and started to develop a prenegotiation settlement objective with DCAA and local counsel.
March 3, 2006	Senior Trial Attorney delegation for negotiation authority expired and he requested a 90-day extension.

Chronology of Events (cont'd)

Date	Description
March 21, 2006	Commander, DCMA Aircraft Propulsion Operations, Pratt, notified Commander, DCMA Aircraft Propulsion Operations, that the DACO was prepared to proceed with settlement negotiations pending approval to proceed.
March 22, 2006	Chief Trial Attorney, Contract Disputes Resolution Center notified Counsel, DCMA East, that there were concerns with the former Sikorsky employee (now Group Chief, Business Operations, DCMA Aircraft Propulsion Operations Pratt), the least of which were a former employee of another UTC business unit participating directly in negotiations between the U.S. Government and Pratt and how that would appear.
April 4, 2006	Counsel, DCMA Hartford, provided the prenegotiation settlement objective to Acting General Counsel, DCMA; Counsel, DCMA East; and Contract Disputes Resolution Center on behalf of the Commander, DCMA Aircraft Propulsion Operations, and the DACO.
April 10, 2006	Chief Trial Attorney, Contract Disputes Resolution Center informed the Acting General Counsel, DCMA; DCMA East; and Counsel, DCMA Hartford that the litigation team did not concur to the CMO's pre-negotiation settlement objective.
April 11-12, 2006	Commander, DCMA Aircraft Propulsion Operations decided to proceed with settlement without Senior Trial Attorney. Senior Trial Attorney informed Pratt: <ul style="list-style-type: none"> • Senior Trial Attorney authority to negotiate the dispute in litigation expired, and • DACO and the CMO would like to undertake the negotiation by themselves.
April 26-27, 2006	Group Chief, Business Operations, DCMA Aircraft Propulsion Operations Pratt and DACO conducted settlement negotiations with Pratt. Pratt's last offer was \$270 million, and the Government's last offer was \$291 million.
April 29, 2006	Pratt offered settlement for \$283 million.
May 1, 2006	DACO accepted Pratt's offer after approval from the Director, DCMA East.
June 5, 2006	DACO and Pratt sign: <ul style="list-style-type: none"> • "Settlement Agreement," which settled the historical issues in the amount of \$283 million for the period 1984-2004. • "Collaboration Agreement," settled the prospective issues approving for use by Pratt a noncompliant cost accounting practice to account for the cost of parts acquired through its collaboration agreements.

Appendix C

Chronology of Significant Amounts

Date Proposed	Amount	Description
December 2, 1996	\$260,000,000	DCMA Demand for Payment for 1984-1995.
November 24, 2003	\$754,700,000	DCMA Demand for Payment for 1984-2002. Amount is a "Rough Order of Magnitude" produced by DCAA as a nonaudit service.
December 9, 2004	\$125,000,000	Pratt Offer
December 22, 2004	\$605,000,000	DCMA Counter Offer
December 22, 2004	\$375,000,000	DACO delegated negotiation authority for the settlement to Senior Trial Attorney with this as a minimum.
March 31, 2005	\$200,000,000	DCAA verbally advised this was a reasonable recovery considering Pratt's explanation that some portion of the revenue shares represented payments for items other than parts.
April 12, 2005	\$175,000,000	Pratt Offer
April 28, 2005	\$234,000,000	DCAA Litigative Risk Assessment identified what DCAA considered to be an acceptable cost recovery for 1984-2004.
May 26, 2005	\$814,000,000	An internal estimate compiled for the Senior Trial Attorney, DCMA but never served to Pratt. The estimate updated the Nov. 23, 2003 demand for (1) an additional 2 years of data, 2003 - 2004; (2) inclusion of the impact of Pratt Military Engines general and administrative expenses; and (3) a change in method and the use of agreed-upon data.
May 26, 2005	\$416,900,000	DCMA Litigative Risk Assessment worst case scenario on recovery but expect to recover more.
May 26, 2005	\$375,300,000	DCMA Litigative Risk Assessment absolute minimum on recovery through negotiations.
June 2, 2005	\$315,000,000	"Government-Only Meeting" wherein the litigation strategy and negotiation strategy were discussed. Using the DCAA work product, the Commander, DCMA Aircraft Propulsion Operations, expressed expectation of lowest recovery.
June 2, 2005	\$307,000,000	"Government-Only Meeting" wherein the litigation strategy and negotiation strategy were discussed. Using the DCAA work product DCMA Counsel, Hartford, expressed expectation of lowest recovery.
June 2, 2005	\$234,000,000	"Government-Only Meeting" wherein the litigation strategy and negotiation strategy were discussed. Using the DCAA work product, DCAA expressed expectation of lowest recovery.
June 20, 2005	\$514,000,000	DCMA Offer

Chronology of Significant Amounts (cont'd)

Date Proposed	Amount	Description
January 31, 2006	\$300,000,000	DACO issued delegation amendment to Senior Trial Attorney for negotiation authority with this amount as a minimum.
April 4, 2006	\$324,500,000	DCMA prenegotiation settlement objective ceiling.
April 4, 2006	\$269,500,000	DCMA prenegotiation settlement objective minimum.
April 28, 2006	\$270,000,000	Pratt Offer
April 28, 2006	\$291,000,000	DCMA Counter Offer
June 5, 2006	\$283,000,000	Settlement

Appendix D

Notice of Concern



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

APR 17 2013

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY

SUBJECT: Notice of Concern – DCMA Inappropriate Management of a Cost Accounting Standards (CAS) Noncompliance at United Technologies Corporation, Pratt & Whitney (Project No. D2010-DIP0AI-0023.000)

The Defense Contract Management Agency (DCMA) Cost Accounting Standards (CAS) administration practices do not provide positive assurance that the U.S. Government has avoided paying windfall profits on its CAS-covered contracts with the United Technologies Corporation, Pratt & Whitney (Pratt). Under DCMA administration, Pratt has not used a cost accounting standards compliant practice to estimate, accumulate and report the cost of collaboration parts obtained from foreign suppliers on U.S. Government contracts since 1984. On September 22, 2011 the Defense Contract Audit Agency (DCAA) reported that the current noncompliant cost accounting practice used by Pratt since its fiscal year 2005 may be resulting in an estimated cost impact of as much as \$15.2 million for the one year examined by DCAA – fiscal year 2009. Pratt has been using the current noncompliant practice to estimate, accumulate and report costs on its U.S. Government contracts subject to the Cost Accounting Standards for eight years.

Background. DCMA administration of the Pratt cost accounting practices for jet engine parts acquired through collaboration agreements can be broken into two periods. The first period is from 1984 until June 5, 2006 when DCMA reached an administrative settlement with Pratt and Pratt agreed to pay the U.S. Government \$283 million in damages resulting from their failure to comply with CAS for the period 1984 through 2004.

The Attachment to this Notice of Concern provides a summary of significant events surrounding the period 1984 through June 5, 2006 that impact the actions identified in the Notice of Concern, including:

- On January 29, 1991 DCAA first reported the CAS noncompliances in a review of the contractor's annual incurred cost submission for calendar year 1984.
- On December 2, 1996 DCMA issued a demand to Pratt that Pratt pay the U.S. Government \$260 million in increased costs resulting from the CAS noncompliances for the period 1984 through 1995.
- On January 15, 2003 the United States Court of Appeals for the Federal Circuit vacated an earlier Armed Services Board of Contract Appeals (ASBCA) decision in favor of Pratt and found:
 - The revenue share payments were a cost under the Cost Accounting Standards, and

Notice of Concern (cont'd)

- If Pratt wanted to argue that some portion of the revenue share payments represented payments for items other than parts, then the burden is on Pratt to show that the revenue share payments included payments beyond that for the collaboration parts.
- On November 24, 2003 DCMA demanded that Pratt pay the U.S. Government \$755 million in increased costs resulting from the CAS noncompliances for the period 1984 through 2002.
- On June 5, 2006 DCMA agreed to settle the impact resulting from the Pratt noncompliances for the period 1984 through 2004 for \$283 million
- When settling the case for \$283 million, DCMA did not abide by the decision of the United States Court of Appeals for the Federal Circuit and require that Pratt bear its burden and show that approximately \$5 billion of revenue share payments that DCMA accepted as revenue share payments for items other than parts were in fact payments for items other than parts.

The Notice of Concern addresses the actions taken by DCMA in the second period which covers 2005 to the present.

Notice of Concern: On June 5, 2006 the DCMA contract management office approved for use by Pratt a revised cost accounting practice for collaboration parts. In granting approval, DCMA determined the practice was noncompliant with CAS 418 but was not causing a material cost impact to U.S. Government contracts. DCMA approved the practice for use starting in 2005. The noncompliant practice approved by DCMA, allowed Pratt to use an estimate of the cost of collaboration parts included in the allocation base used to allocate material overhead costs to U.S. Government contracts instead of the actual cost of the parts. CAS 418 requires a contractor use actual cost in the direct material base used to allocate material overhead costs to U.S. Government contracts. Under DCMA CAS administration, Pratt is using an estimate for the cost of collaboration parts instead of the revenue share payments. In its January 15, 2003 decision, the United States Court of Appeals for the Federal Circuit held that: "... Pratt purchased parts from its foreign parts suppliers, and the revenue share payments comprise costs for these parts."

On April 27, 2010 DCMA advised the OIG that it could not demonstrate that it had monitored the cost impact of the ongoing CAS 418 noncompliance to ensure that the cost impact had not become material. Neither could DCMA demonstrate that it had taken action to have the contractor implement a compliant cost accounting practice in accordance with FAR 30.605(b)(4)(i)(A).

Similarly DCAA could not demonstrate to the OIG that it had monitored the materiality of the CAS 418 noncompliance since June 5, 2006. DCAA is required by DoD Directive 5105.36 to perform all necessary contract audits for DoD and provide accounting and financial advisory services regarding contracts to DoD components responsible for contract administration.

Subsequent to the OIG inquiring about the status of the existing noncompliance, DCAA reported on July 27, 2010 that the cost accounting practice used by Pratt to estimate the material overhead rates in their forward pricing rate proposal for fiscal years 2010 through 2012 was noncompliant with CAS 418. DCAA identified the noncompliant practice as the same practice found

Notice of Concern (cont'd)

noncompliant by DCMA on June 5, 2006; i.e. the use of an estimated cost in lieu of the actual cost of collaboration parts in the allocation base used to estimate, accumulate and report material overhead rates. In a second report issued on September 22, 2011 DCAA reported that the existing CAS 418 noncompliance was resulting in a cost impact that DCAA estimated may be as high as \$15.2 million for the one year examined by DCAA – fiscal year 2009. DCAA found that Pratt was recording the revenue share payments resulting from its collaboration agreements with its suppliers in its financial accounting records as required by generally accepted accounting principles. However, DCAA did not attempt to adjust its estimated \$15.2 million cost impact for any revenue share payments that may or may not have been made for items other than parts. The Court of Appeals for the Federal Circuit put that burden on Pratt.

On September 28, 2011, DCMA, after consultation with legal counsel, issued a notice of potential noncompliance with CAS 418 to Pratt. In accordance with FAR 30.605(b)(2)(ii), DCMA allowed Pratt 60 days to either (A) agree or submit reasons why they consider the existing practice to be compliant and (B) submit rationale to support any written statement that the cost impact of the noncompliance is immaterial.

Pratt responded to the DCMA notice of potential noncompliance on December 7, 2011 and on August 14, 2012 Pratt advised DCMA that it had been notified on June 5, 2006 of the noncompliance and that the noncompliance remained immaterial.

Since receiving the second Pratt response on August 14, 2012, DCMA has neither made a determination of compliance or noncompliance as required by FAR 30.605(b)(3)(ii) and notified the contractor and the auditor in writing of the determination and the basis for the determination as required by FAR 30.605(b)(2)(iii).

On January 8, 2013, the OIG briefed the Director, DCMA through the use of an Early Alert on the status of the DCMA effort to process the existing noncompliance with CAS 418 at Pratt. The Director, DCMA provided the OIG with a timeline outlining an accelerated determination and decision making process. On February 27, 2013 the DCMA administrative contracting officer and his team briefed the OIG on the same process. However DCMA has not demonstrated it has taken actions to have Pratt correct the accounting practice that it found noncompliant on June 5, 2006. It also has not demonstrated that it has taken any actions to recover any increased costs that may have been paid by the U.S. Government since 2005. On March 7, 2013 the OIG advised the Director, DCMA that the accelerated determination and decision making process did not comply with FAR 30.605 or protect the interests of the U.S. Government.

DCMA has not complied with the requirements of FAR 30.605 Processing Noncompliances when administering a CAS 418 noncompliance at the United Technologies Corporation, Pratt & Whitney. The contractor uses an estimate of the cost of parts acquired through the use of collaboration agreements in lieu of the actual cost of the parts in the allocation base used to estimate, accumulate and report material overhead rates on its U.S. Government contracts. DCMA first notified Pratt that this practice was noncompliant with CAS 418 on June 5, 2006. Pratt has been using this noncompliant practice since 2005. DCAA has reported that in 2009, the only year it has examined and one of eight years where Pratt has used the noncompliant practice, the estimated cost impact may be as high as \$15.2 million. The DCMA CAS administration

Notice of Concern (cont'd)

practices do not provide positive assurance that the U.S. Government has avoided paying windfall profits on its CAS-covered contracts with the United Technologies Corporation, Pratt & Whitney.

Recommendation: We recommend that the Director, DCMA take the following actions in a timely manner to ensure that (i) the cost accounting practice used by Pratt include the actual cost of collaboration parts in the allocation base used to allocate material overhead costs to U.S. Government contracts in accordance with the rules and regulations established by the Cost Accounting Standards Board, and (ii) the U.S. Government recovers any increased costs paid to Pratt since 2005 and resulting from the contractor's use of a cost accounting practice determined by DCMA to be noncompliant with CAS 418 on June 5, 2006:


1. If legally required, make a second determination of compliance or noncompliance in accordance with FAR 30.605(b)(3)(ii).
2. If legally required, notify the contractor of this determination in accordance with FAR 30.605(b)(3)(iii).
3. Make a determination of materiality in accordance with the requirements of FAR 30.605(b)(4).
4. In making the decision on materiality as required by FAR 30.605(b)(4) abide by the decision of the United States Court of Appeals for the Federal Circuit and, where Pratt argues that some portion of the revenue share payments represent payments for items other than parts, require that Pratt provide evidence that the revenue share payments included payments beyond that for the collaboration parts.
5. Follow the procedures in paragraphs (c) through (h) of FAR 30.605 to correct the noncompliant cost accounting practice.
6. When evaluating a general dollar magnitude proposal (FAR 30.605(d)) or a detailed cost impact proposal (FAR 30.605(f)), abide by the decision of the Court and where Pratt argues that some portion of the revenue share payments represent payments for items other than parts, require that Pratt provide evidence that the revenue share payments included payments beyond that for the collaboration parts.
7. Obtain a legal counsel opinion regarding the applicability, if any, of the requirement in the Contracts Disputes Act that the government submit a claim to the contractor within 6 years after the accrual of the claim and how this may impact the U.S. Government's ability to recover any increased costs paid since 2005.
8. Provide semiannual updates to the Assistant Inspector General, Audit Policy & Oversight until all recommendations have been implemented.

We issue a Notice of Concern to alert DoD management of significant findings that we believe require immediate attention. The finding that generated this Notice of Concern and any corrective action taken by management will be included in an upcoming report. By issuing a Notice of Concern, DoD management can take proactive steps to mitigate the reported issue.

We acknowledge that the DCMA Director has notified us that they are moving forward on the recommendations detailed above. However, we respectfully request that the DCMA Director respond in writing to the recommendations as contained in this Notice of Concern by May 30, 2013. We appreciate the courtesies extended to the staff. Please direct questions to Ms.

Notice of Concern (cont'd)

[REDACTED] at [REDACTED] or [REDACTED]


Carolyn R. Davis
Assistant Inspector General
Audit Policy and Oversight

cc:
Executive Director of the Defense Contract Management Agency (Office of Independent Assessment)

Notice of Concern (cont'd)

Summary of Significant Events

Notice of Concern

DCMA Inappropriate Management of a Cost Accounting Standards Noncompliance at United Technologies Corporation, Pratt & Whitney (DoDIG Project No. D2010-DIP0AI-0023.000)

In 1991 DCAA issued Audit Report No. 2641-91L44200001 and 2641-91D44200804 finding that Pratt had not complied with the following cost accounting standards when accounting for the cost of material obtained through the use of collaboration agreements:

- Cost Accounting Standard 410 Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives,
- Cost Accounting Standard 418 Allocation of Direct and Indirect Costs, and
- Cost Accounting Standard 420 Accounting for Independent Research and Development Costs and Bid and Proposal Costs (IR&D and B&P)

The noncompliances were found in a DCAA audit of a Pratt incurred cost submission for Pratt fiscal year 1984. DCAA found that Pratt had not included any costs associated with its collaboration agreements with foreign parts suppliers in the allocation bases it used to allocate indirect costs, general and administrative expenses and the cost of independent research and development and bid and proposal costs to its U.S. Government contracts. The collaboration agreements provided that, in exchange for the parts they supply, Pratt would pay the suppliers a percentage of revenue received by Pratt from the sale of the respective jet engine (referred to as "revenue share"). The revenue share reflected the percentage of parts supplied to the program. Pratt had argued that title for the parts never passed from the supplier to Pratt under the collaboration agreements and therefore Pratt did not have any costs to include in the same allocation bases.

On December 2, 1996, DCMA determined that Pratt had not complied with the cited cost accounting standards and issued a demand for payment to Pratt in the amount of \$260 million. The demand was to recover the estimated increased costs paid by the U.S. Government to Pratt for the period 1984 through 1995. Pratt appealed the DCMA decision to the Armed Services Board of Contract Appeals (ASBCA) who decided in favor of Pratt on July 30, 2001. The U.S. Government appealed the decision to the United States Court of Appeals for the Federal Circuit and on January 15, 2003 the United States Court of Appeals for the Federal Circuit vacated the ASBCA decision. The United States Court of Appeals for the Federal Circuit ruled that the terms cost and material cost as used in the Cost Accounting Standards include the revenue share payments made by Pratt for the parts under the collaboration agreements. As such Pratt was required to include a cost for collaboration parts in its allocation bases. The United States Court of Appeals for the Federal Circuit remanded the case to the ASBCA to include a determination of damages. Of particular significance, the United States Court of Appeals for the Federal Circuit provided in Footnote 19 of the decision that:

Notice of Concern (cont'd)

To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts.

After the United States Court of Appeals for the Federal Circuit decision, DCMA initiated a dual-track approach with Pratt that included preparing for renewed litigation in front of the ASBCA while attempting to reach an out-of-court settlement. On November 24, 2003 DCMA issued an updated demand to Pratt in the amount of \$755 million to recover the estimated increased costs paid by the U.S. Government to Pratt for the period 1984 through 2002. The amount of the demand was computed by DCAA as a non-audit service. In early 2005, DCMA (with non-audit assistance from DCAA) exchanged data with Pratt regarding costs associated with the parts acquired through the use of collaboration agreements. DCMA never requested that DCAA perform an audit of this data and it was never audited. In March 2006 DCMA made a management decision to allow the DCMA contract management office at Pratt to negotiate an out-of-court settlement. DCMA cited factors such as conclusion of audit and legal effort on a case that has already spanned 20 years, settlement expectations from management, administrative costs of the ongoing CAS noncompliances, future litigative costs and the litigative risk of returning to the ASBCA where they had previously lost the case.

On June 5, 2006 the DCMA contract management office settled the damages associated with Pratt's failure to comply with Cost Accounting Standards 410, 418 and 420 for the period 1984 through 2004 for \$283 million. However, the DCMA prenegotiation memorandum (PNM) approving the settlement position did not demonstrate that DCMA made Pratt bear its burden and provide evidence to the U.S. Government that any portion of the revenue share payments represented payments for items other than parts. In fact, DCMA accepted approximately \$5 billion as revenue share payments for items other than parts without making Pratt bear its burden and provide evidence that some portion of the revenue shares represented payments for items other than parts. The \$5 billion was an amount equal to over 40 percent of the approximately \$12 billion (unaudited) in revenue share payments at issue. The record shows that to this date DCMA has yet to require that Pratt bear its burden and demonstrate with evidence that some portion of the revenue share payments represent payments for items other than parts.

Appendix E

DCMA Comments on the Notice of Concern



DEFENSE CONTRACT MANAGEMENT AGENCY

3901 A AVENUE, BUILDING 10500
FORT LEE, VA 23801-1809

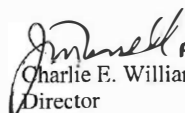
MAY 24 2013

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND
OVERSIGHT, OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Response to Notice of Concern - DCMA Inappropriate Management of a Cost
Accounting Standards (CAS) Noncompliance at United Technologies Corporation,
Pratt & Whitney (Project No. D2010-DIPOAI-0023.000)

The attached is in response to the subject Notice of Concern dated April 17, 2013 that
addresses the DCMA actions taken to implement the Recommendations stated in the notice.

POC for this response is [REDACTED] DCMA-AQD who may be contacted at
[REDACTED]


Charlie E. Williams, Jr.
Director

Attachments:

TAB A - DCMA Response to OIG Recommended Actions

TAB B - DACO's Determination of CAS Non-compliance, dated May 7, 2013

DCMA Comments on the Notice of Concern (cont'd)

DCMA Response to Notice of Concern – DCMA Inappropriate Management of Cost Accounting Standards (CAS) Noncompliance at United Technologies Corporation, Pratt & Whitney (Project No. D2010-DIPOAI-0023.000), dated April 17, 2013

DoD-IG Recommendation # 1: If legally required, make a second determination of compliance or noncompliance in accordance with FAR 30.605(b)(3)(ii).

DCMA Response: We concur with the IG recommendation. In accordance with (IAW) DoD Instruction 7640.02, dated August 22, 2008, we believe a second determination of compliance is necessary in order to resolve and disposition DCAA's allegations of P&W's noncompliance with CAS 418-50(a)(2) that were addressed in reportable DCAA Audit Report No. 2651-2010A19200004, dated September 22, 2011. The DACO made a determination of compliance IAW FAR 30.605(b)(3)(ii) on May 7, 2013 (copy attached) that found P&W in noncompliance with CAS 418.

DoD-IG Recommendation # 2: If legally required, notify the contractor of this determination in accordance with FAR 30.605(b)(3)(iii).

DCMA Response: We concur with the IG recommendation. P&W was notified of the Divisional ACO's (DACO's) Determination on May 7, 2013 via written letter (copy attached), IAW FAR 30.605(b)(3)(iii). The DCAA Auditor was copied on the letter. The DACO delivered the Determination letter in-person to the appropriate P&W Government accounting representatives and provided a brief discussion as to the basis of the Government's position that supports the Determination.

DoD-IG Recommendation # 3: Make a determination of materiality in accordance with the requirements of FAR 30.605(b)(4).

DCMA Response: We concur with the IG recommendation. The DACO made a determination of materiality IAW FAR 30.605(b)(4). The basis for this determination is explained in the DACO's May 7, 2013 Determination letter (copy attached).

DoD-IG Recommendation # 4: In making the decision on materiality as required by FAR 30.605(b)(4) abide by the decision of the United States Court of Appeals for the Federal Circuit and, where Pratt argues that some portion of the revenue share payments represent payments for items other than parts, require that Pratt provide evidence that the revenue share payments included payments beyond that for the collaboration parts.

DCMA Response: We concur with the IG recommendation. The DACO's decision on materiality (copy of DACO's May 7, 2013 determination letter attached) was consistent with the 2003 Federal Circuit decision. The DACO based his determination of materiality on an

DCMA Comments on the Notice of Concern (cont'd)

examination of the differences between the Partner's Revenue Share (also referred to as Gross Revenue Share or GRS) and Manufacturing Target Cost (MTC) from the following documents:

- The September 22, 2011 DCAA Audit Report which calculated a \$15.2 million impact to Government contracts in CY-2009, and
- P&W's "Collaborative Material Cost Impact Analysis" provided on August 10, 2012 that showed substantial differences between GRS and MTC for CYs 2005-2011.

The DACO's Determination also acknowledges that P&W may argue that some portion of revenue share payments represent payments for items other than parts.

DoD-IG Recommendation # 5: Follow the procedures in paragraphs (c) through (h) of FAR 30.605 to correct the noncompliant cost accounting practice.

DCMA Response: We concur with the IG recommendation. In the Determination letter (copy attached), the DACO has asked P&W to submit compliant accounting changes within 60 days of the date of the Determination letter, IAW FAR 30.605(c)(1). Once the DACO deems P&W's revised accounting practice for collaborative parts to be compliant with CAS 418, a general dollar magnitude (GDM) proposal will be requested from P&W per FAR 30.605(d). After P&W's GDM proposal is received, the DACO will ask DCAA to provide an audit evaluation and then, based on the audit findings, attempt to negotiate a settlement of the cost impact with P&W per FAR 30.605(e). A detailed cost impact proposal will be requested from P&W and evaluated if the DACO determines the GDM proposal to be insufficient for resolving the cost impact, per FAR 30.605(f). IAW subparagraphs (g) and (h) of FAR 30.605, the DACO will calculate the total cost impact, including applicable interest [per 26 U.S.C. 6621(a)(2)], if the noncompliance caused an increase in costs paid to P&W on Government CAS-covered prime contracts and subcontracts. The DACO will then negotiate a settlement with P&W or issue a Final Decision and pursue the recovery of any overpayments via a demand letter and/or price adjustments to affected Government contracts.

DoD-IG Recommendation # 6: When evaluating a general dollar magnitude proposal (FAR 30.605(d)) or a detailed cost impact proposal (FAR 30.605(f)), abide by the decision of the Court and where Pratt argues that some portion of the revenue share payments represent payments for items other than parts, require that Pratt provide evidence that the revenue share payments included payments beyond that for the collaboration parts.

DCMA Response: We concur with the IG recommendation. The DACO's Determination (copy attached) includes language advising P&W that once the DACO deems P&W's cost accounting practice changes to be adequate and compliant, the DACO will ask P&W to submit a GDM proposal IAW FAR 30.605(c)(2)(i)(B). The Determination recognizes that P&W may argue that some portion of the revenue shares represented payments for items other than parts per Footnote 19 of the 2003 Federal Circuit decision. P&W will be asked to provide a GDM cost impact proposal that's based on cost accounting changes that are in line with the Court decision and that the DACO deems to be compliant with CAS.

DCMA Comments on the Notice of Concern (cont'd)

DoD-IG Recommendation # 7: Obtain a legal counsel opinion regarding the applicability, if any, of the requirement in the Contracts Disputes Act that the government submit a claim to the contractor within 6 years after the accrual of the claim and how this may impact the U.S. Government's ability to recover any increased costs paid since 2005.

DCMA Response: We concur with the IG recommendation. The DACO obtained a legal counsel opinion and considered the DCMA Counsel's legal advice in the development of the Determination (copy attached). The legal opinion addresses the impact that the Statute of Limitations (SoL) might have on the potential cost risk associated with the collaborations issue. Several retroactive years may be at risk at this time. Counsel's opinion also addresses the potential impact of the SoL risk in light of a very recent court decision on a Raytheon case that may be favorable to the Government.

DoD-IG Recommendation # 8: Provide semiannual updates to the Assistant Inspector General, Audit Policy & Oversight until all recommendations have been implemented.

DCMA Response: We concur with the IG recommendation. DCMA will provide semi-annual updates to the IG on the above recommendations until all such recommendations have been successfully implemented by the DACO. DCMA will submit its first semi-annual update by NLT November 30, 2013, which is 6 months post- the May 30, 2013 suspense date established for this response to the IG recommended actions.

Management Comments

Defense Contract Management Agency Comments



DEFENSE CONTRACT MANAGEMENT AGENCY
3901 A AVENUE, BUILDING 10500
FORT LEE, VA 23801-1809

MAR 13 2014

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND
OVERSIGHT, OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Response to OIG Draft Report on "Hotline Complaint Regarding the Settlement of
the Pratt & Whitney Commercial Engine Cost Accounting Standards Case,"
January 31, 2014 (Project No. D2010-DIPOAI-0023.000)

The attached is in response to the subject Draft Report dated January 31, 2014 that
addresses the DCMA actions taken to implement the Recommendations stated in the report.

POC for this response is [REDACTED] DCMA-AQD who may be contacted at
[REDACTED] or [REDACTED]


James M. Russell
Acting Director

Attachments:

DCMA Response to OIG Recommended Actions

Defense Contract Management Agency Comments (cont'd)

Comments to Draft Report on "Hotline Complaint Regarding the Settlement of the Pratt & Whitney Commercial Engine Cost Accounting Standards Case," January 31, 2014 (Project No. D2010-DIP0AI-0023.000)

Recommendation B: We recommend that the Director, Defense Contract Management Agency, implement a 2-step policy with guidelines that requires that a management official oversee an evaluation determining the extent to which data obtained from the trial attorney supporting litigation is sufficient to support and justify a settlement negotiated consistent with the Federal Acquisition Regulation.

1. Obtain a written evaluation considering at a minimum:
 - a. The objections of the trial attorney, if any, to pursuing a settlement.
 - b. A determination that the data and information obtained by the trial attorney to support litigation is sufficient to justify a contracting officer's determination in accordance with the Federal Acquisition Regulation.
 - c. Where it is determined that the data and information obtained by the trial attorney to support litigation is not sufficient to support and justify a contracting officer's determination in accordance with the Federal Acquisition Regulation, an assessment of the actions needed and time required to obtain sufficient information and data.
2. When the trial attorney disagrees with the written results of the evaluation, a board of review must assess the trial attorney's objections.

DCMA Response:

1. We appreciate and concur with the IG's recommendation that management officials should oversee the evaluation of the sufficiency of a proposed settlement documented in writing.
 - a. Management oversight of disagreement regarding settlement is specifically required in DCMA Instruction 905, "Contract Claims and Disputes" dated December 17, 2013 at paragraph 3.4.3., which states, "[i]n the event of any material disagreement between the contracting officer and the CDRC trial attorney concerning the best course of action for the agency, the Contracting Officer shall elevate the matter for resolution at least one level above each individual." The Director of the DCMA Contracts Disputes and Resolution Center confirmed that the UTC matter, which led to this IG investigation, was a unique case as there have been no other material disagreements that have not been able to be resolved either directly between the trial attorney and the ACO or at one level above these individuals. In the UTC case, resolution of the disagreement had to be resolved by elevating it to the DCMA General Counsel and to the Commander of the DCMA Eastern District. The DCMA General Counsel at that time had received the trial attorney's risk assessment but agreed with the Commander of the DCMA Eastern District, that an attempt should be made to settle the case without additional input from the trial attorneys of either party. We have checked with our trial attorney group and confirmed that this is the only instance we know of in the Agency where there was a continuing disagreement between the trial attorney and ACO over the terms of a negotiated settlement. In the future, in order to ensure documentation of deliberations and proper resolution of issues regarding settlement, we will amend our Boards of Review policy by July 2014

Defense Contract Management Agency Comments (cont'd)

Comments to Draft Report on "Hotline Complaint Regarding the Settlement of the Pratt & Whitney Commercial Engine Cost Accounting Standards Case," January 31, 2014 (Project No. D2010-DIP0AI-0023.000)

to require ACOs to, either in the pre-negotiation memorandum or post negotiation memorandum, identify the issues (including any disagreement between the ACO and trial attorney, which pursuant to DCMA policy had to be elevated at least one level above each of those individuals), describe steps taken to resolve the issues, and explain the basis for going forward with the settlement after escalation of the matter.

- b. Subsequent to the settlement that gave rise to the hotline complaint that is the subject of this report, DCMA established the CACO/DACO group of the Cost and Pricing Center. This organization was established to ensure fairness and consistency of decision making both inside major corporations and across major suppliers in the defense industry. To achieve these objectives, it was necessary to create a common reporting chain staffed with experienced personnel at the GS 15 level and an efficient set of internal controls for the review and approval of business processes. Our policy in regard to the settlement actions of CACOs and DACOs reflects what we have determined to be adequate control of an ACO settlement in lieu of litigation. DCMA Instruction 134, "Boards of Review," dated November 4, 2014, at paragraph 3.1.5.1.2. states, "[o]nly GS-1102-15 Supervisory Team Leader review is required of CACO/DACO PNOMs for contract actions in litigation or Alternate Dispute Resolution (ADR) procedures. We will amend our Boards of Review policy by July 2014 to apply this same type of management review to the settlement actions of all ACOs.

- c. We addressed condition 1.c. in our responses to conditions 1.a. and 1.b.

2. We do not believe that a Board of Review is necessary or practicable to be required to settle cases which are in active litigation. Usually there are very short time constraints over settlement discussions and the Government representative needs to be able to respond quickly to settlement offers. Based on our response to recommendation B.1., we conclude we are taking, and will continue to take, proper steps to document the resolution of any stakeholders' objections (including any objections or concerns of a DCMA trial attorney) raised during the negotiations that precede the settlement of cases in litigation.

Recommendation D: We recommend that the Director, Defense Contract Management Agency, evaluate the Defense Contract Management Agency Instruction 134, "Boards of Review," and determine the feasibility of requiring that 'material disagreements' between a contracting officer and a Trial Attorney regarding the decision to seek a negotiated settlement with the contractor be elevated to a board of review.

DCMA Response: As stated in our response to recommendation B.1., we concur it is appropriate to review and modify DCMA Instruction Boards of Review by July 2014 to ensure documentation of deliberations and proper resolution of issues regarding settlement are addressed in either the pre-negotiation memorandum or post negotiation memorandums.

Defense Contract Management Agency Comments (cont'd)

Comments to Draft Report on "Hotline Complaint Regarding the Settlement of the Pratt & Whitney Commercial Engine Cost Accounting Standards Case," January 31, 2014 (Project No. D2010-DIP0A1-0023.000)

Recommendation E: We recommend that the Director, Defense Contract Management Agency, implement a best practice wherein general counsel conflict of interest and impartiality reviews are documented in writing at the time concerns are identified.

DCMA Response: We concur. The Office of the General Counsel will implement this as a best practice. At the time, the trial attorney informed the then DCMA Counsel to the DCMA Naval and Aeronautical Divisions, of the potential conflict of interest. That Counsel investigated and concluded there was no conflict of interest. He then provided the then Director of Naval and Aeronautical Divisions an oral opinion but did not document that meeting or opinion in writing. At the time, Counsel believed that there was no request for a written opinion so he did not provide one, given that the question arose from a fellow General Counsel colleague and not from a client. Neither the person who was the subject of this inquiry nor his Command management asked for a written legal opinion.

Recommendation F: Our Notice of Concern (Appendix D) included eight recommendations. DCMA concurred with each recommendation (Appendix E) and agreed to provide the OIG with semiannual updates until each recommendation is successfully implemented.

DCMA Response: We concur and will provide updates on request.

Defense Contract Audit Agency Comments



DEFENSE CONTRACT AUDIT AGENCY

OFFICE OF THE DIRECTOR
6725 JOHN J. KINGMAN ROAD, SUITE 213B
FORT BELVOIR, VA 22060-6219

March 21, 2014

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT
POLICY AND OVERSIGHT, OFFICE OF THE INSPECTOR
GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Response to Office of Inspector General, Department of Defense, Final Report on a
Hotline Allegation Regarding the Settlement of the Pratt & Whitney Commercial
Engine Cost Accounting Standards Case, dated January 31, 2014 (Project Number
DoDIG-2010-DIP0A1-0023.000)

Thank you for the opportunity to respond to the subject project in which you identified in
Finding C that DCAA Assistance Negatively Impacted the Settlement Amount and you
recommend that the Director, DCAA perform an internal review to assess auditor adherence with
the requirements of DCAA Contract Audit Manual 15-506.2, "Support Government Trial
Attorney," and take necessary corrective action, where warranted.

The enclosed comments provide explanations for our position on the recommendation.

Please direct questions to me or [REDACTED] Assistant Director, Integrity and Quality
Assurance at [REDACTED]


Patrick J. Fitzgerald
Director

Enclosure: As Stated

Defense Contract Audit Agency Comments (cont'd)

DCAA Final Comments to DoDIG Recommendation (Project No. DoDIG-2014-DIP0AI-0023.000)

DoDIG Finding C:

The DCAA Settlement Position of \$234 million offered by DCMA senior management was not consistent with the principles articulated in the Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS) or the intent of Footnote 19 from the decision of U.S. Court of Appeals for the Federal Circuit. DCAA did not perform sufficient work to validate the \$12.2 billion in revenue share payments asserted by Pratt. In making its recommendations, DCAA inappropriately provide advice on litigative risk. Additionally, the DCAA position did not consider the DCMA Senior Trial Attorney's litigative strategy to have Pratt bear the burden in court regarding the legitimacy of the revenue share payments. The DCAA settlement recommendation of \$234 resulted in a substantial reduction in the settlement expectation anticipated by DCMA.

DoDIG Recommendation:

The Director, Defense Contract Audit Agency, needs to perform an internal review to assess auditor adherence with the requirements of DCAA Contract Audit Manual 15-506.2, "Support Government Trial Attorney," and take necessary corrective action, where warranted.

DCAA Comments:

The Director, DCAA concurs that DCAA auditor's should exercise special care to avoid expressing opinions on subjects outside the accounting field and follow Agency guidance in DCAA Contract Audit Manual 15-506.2, Support Government Trial Attorney. We consider the work DCAA performed in support of this litigation to have complied with Agency guidance. Accordingly, we do not consider it necessary to perform an internal review, however as part of our internal quality reviews we will continue to assess auditor compliance with GAGAS and Agency Policy and we will take appropriate corrective action when necessary. Additionally we have engaged our General Counsel to review and coordinate with our regional leadership on all significant activities which are or could potentially be subject to litigation.

Regarding DoDIG Finding C, we do not agree that we negatively impacted negotiations. We have reviewed pertinent documents and correspondence in our files and consider the advisory services provided by the DCAA to have complied with Agency guidance. However, because the event in question occurred in April 2005 and settlement effort occurred between November 2004 and June 2006, many of the individuals are no longer with DCAA and as a result we cannot substantiate the source underlying some of the correspondence which occurred in this settlement process. DCAA's advisory services were provided as part of the government team working under the Federal Rules of Evidence as litigation was ongoing in an effort to arrive at a settlement amount.

The DCAA computation of \$234 million provided to DCMA senior management as a "reasonable settlement" was the result of applying the level of Government's risk in order to establish a settlement amount which would resolve the litigation. Government team discussions about litigative risk occurred as early as 2004 based on meeting minutes dated December 14, 2004. The purpose of these meetings was "to assess the Government's risk in the

Enclosure
Page 1 of 2

Defense Contract Audit Agency Comments (cont'd)

DCAA Final Comments to DoDIG Recommendation (Project No. DoDIG-2014-DIP0AI-0023.000)

ongoing litigation between the Government and UTC related to collaboration parts and to establish a settlement range to resolve the litigation." DCAA's computation of the \$234 million was the application of a risk of litigation percent reduction to the \$334 million cost impact using Manufacturing Target Costs (MTC). However, due to the dated nature of this issue we cannot substantiate the source for the 30% reductions DCAA applied to the MTC in recommending a reasonable settlement. It should be noted that the final settlement of \$283 million, was significantly more than the \$234 million DCAA computed.

DCMA Counsel verbally requested DCAA advisory services under the Federal Rules of Evidence to validate the contractor's gross revenue share baseline in order to establish common ground with the contractor in arriving at a settlement. DCAA provided factual support by validating the \$12.2 billion in revenue share payments to the contractor's books and records. DCAA was never requested to nor did we perform an audit in compliance with FAR, CAS, or the U.S. Court of Appeals decision.

It is our position DCAA did not provide advice on litigative risk or express an opinion on subjects outside the accounting field. DCAA complied with its guidance by providing basic accounting information and factual support to the contracting officer and DCMA Counsel. For example, DCAA computed an "Estimate of Cost Impact of Collaboration Noncompliance" in September 2003, calculated a 30% reduction on the MTC for litigative risk in April 2005, and prepared a worksheet of the sixteen government determined scenarios in May 2005. Finally, any litigative strategy relating to this issue was within the sole discretion and direction of the DCMA Contracting Officer and Trial Attorneys.

Enclosure
Page 2 of 2

Acronyms and Abbreviations

ASBCA	Armed Services Board of Contract Appeals
CAS	Cost Accounting Standards
CAFC	U.S. Court of Appeals for the Federal Circuit
CFR	Code of Federal Regulations
CMO	Contract Management Office
DACO	Divisional Administrative Contracting Officer
DCAA	Defense Contract Audit Agency
DCAM	DCAA Contract Audit Manual
DCMA	Defense Contract Management Agency
DoD	Department of Defense
FAR	Federal Acquisition Regulation
OIG	Office of Inspector General
UTC	United Technologies Corporation

Whistleblower Protection

U.S. DEPARTMENT OF DEFENSE

The Whistleblower Protection Enhancement Act of 2012 requires the Inspector General to designate a Whistleblower Protection Ombudsman to educate agency employees about prohibitions on retaliation, and rights and remedies against retaliation for protected disclosures. The designated ombudsman is the DoD Hotline Director. For more information on your rights and remedies against retaliation, visit www.dodig.mil/programs/whistleblower.

For more information about DoD IG reports or activities, please contact us:

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