NOTE:
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DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311-2004K17900055

October 8, 2004

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SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 5

REFERENCES: Prime Contract No. DACA63-03-D-0005, Task Order No. 5
Relevant Dates: See Page 29

CONTRACTOR: Kellogg Brown & Root Services, Inc.
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REPORT RELEASE RESTRICTIONS: See Page 30

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on May 14, 2004, we examined the Kellogg Brown & Root Services, Inc's. (KBR) Cost-Plus-Award-Fee task order (TO) 5 proposal, dated May 5, 2004, under the Restore Iraqi Oil (RIO) contract to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable TO price. The $875,255,894 proposal was submitted in response to the Notice to Proceed issued on May 4, 2003, and is for the import and distribution of fuel products in order to meet the domestic need for fuels for commercial and private use within Iraq. KBR proposed a period of performance (POP) of 229 days or until funds are expended, whichever occurs first. KBR represented the proposed costs were based on actual costs for fuel purchased from Turkey, Jordan and Kuwait.

KBR's proposed costs and the proposed Turkey and Jordan costs are subject to cost and pricing data. In contrast, the proposed costs for the Kuwait supplier, Altanmia, were subject to a cost and pricing data waiver granted by the Commanding General, COE, on December 19, 2003. As requested by Mr. Gordon Sumner, Director, Directorate of Contracting, COE, Southwestern Division on August 3, 2004, we also evaluated the reasonableness of the proposed costs for the refined fuels and related transportation from Kuwait which were subject to the waiver of the requirement to submit cost or pricing data. Refer to Page 15 for additional comments regarding the waiver.

The proposal and related cost or pricing data and information other than cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our examination.

EXECUTIVE SUMMARY

The cost or pricing data and the information other than cost or pricing data submitted by the offeror are not adequate. Our examination of the $875,255,894 proposal disclosed $108,409,622 in questioned costs and $1,255,333 in unresolved costs. We recommend contract price negotiations not be concluded until KBR provides the schedule of actual costs for the Turkey and Jordan fuel which reconciles to KBR's accounting records, and the results of the technical evaluation are considered by the contracting officer.

SIGNIFICANT ISSUES:

1. KBR represented the proposal is based on actual costs. The data provided did not reconcile to KBR's accounting records, and KBR was unable to demonstrate the proposal was based on actual costs. As discussed on page 5, in the Recorded Costs paragraph, KBR proposed direct costs of $800,765,540 while $817,899,175 was charged to the RIO 5 Job Cost Ledger (JCL) as of August 31, 2004. We requested a schedule of the actual costs for the procurement of the Turkey and Jordan fuel. In response, KBR provided a schedule of cost data, but the cost data did not reconcile to KBR's accounting records. We requested a revised schedule. To date, KBR has not provided the revised data; see Restriction paragraph 1, page 4, for further details. With $502,932,525 proposed for Turkey fuel and $10,601,096 for Jordan fuel, we believe it is essential this requested information be provided for government review before negotiations are

concluded. In addition, KBR has proposed a credit for material costs of $4,358,895 for kerosene purchased from Turkey vendors. It is illogical to have negative proposed costs for kerosene and KBR needs to explain the proposed credit. Refer to Note 5c (3), page 18 for further details.

KBR proposed $252,808,547 for unleaded gasoline and kerosene, and related transportation purchased from Kuwait vendors; however, when we requested supporting documentation for the proposed costs KBR provided spreadsheets which did not support the proposed amount. The supporting schedule reflected costs of $225,599,379, a difference of $27,209,168. Refer to Note 5c (1), page 11 for further details.

2. Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders negotiated in a very short time frame. Our audit found purchase orders and procurement files related to the Kuwait supplier did not contain data to support the reasonableness of the negotiated purchase orders. We recognize the challenges faced by KBR during the early stages of the war; however, KBR did not periodically update its purchase order files to document the reasonableness of the negotiated prices and the circumstances surrounding the purchase order awards within a reasonable period of time (e.g., 30 to 90 days after "urgent and compelling" circumstances subsided). It is not reasonable to use prices negotiated in only a few days, under extremely difficult circumstances, for the entire period of performance which extends for almost a year (229 days). Effective subcontract administration of purchase order files requires ongoing (e.g., monthly) documented reviews of the continued reasonableness of the Kuwait fuel prices and efforts to renegotiate these prices if such reviews indicated unreasonable prices. KBR's purchase order files submitted to us do not include adequate documentation to demonstrate the reasonableness of the Kuwait fuel prices over the life of the purchase orders. We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. However, KBR's purchase order files do not include documentation to demonstrate these updated transportation prices were fair and reasonable.

In the absence of adequate supporting data, we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the Defense Energy Support Center (DESC) awarded purchase orders in March 2004 to Altanmia for transportation and to Kuwait Petroleum Company (KPC) for unleaded fuel. We used the DESC negotiated prices as a benchmark to assess the reasonableness of the proposed KBR costs and questioned $62,046,284. We believe KBR should have actively pursued reducing its negotiated prices with Altanmia after the initial award in May of 2003. Refer to Note 5c (1) Kuwaiti Material & Subcontract Costs, page **Error! Bookmark not defined.** for further details.

3. KBR negotiated fixed-unit-rate and firm-fixed-price subcontracts with various Turkey vendors to deliver fuel into Iraq. During the performance of the subcontracts, the market price of the fuel increased. The Turkey subcontractors asked KBR to increase the unit price of the fuel to compensate for losses due to market increases. KBR agreed to pay the higher prices retroactively instead of the negotiated subcontract unit prices and issued change orders reflecting the higher unit prices. We do not believe it was appropriate to retroactively adjust the fuel unit prices of KBR's fixed-unit-rate and firm-fixed-price subcontracts when there are no provisions in the subcontracts to do so. We therefore questioned the retroactive application resulting in

$16,826,584 of questioned cost as further described on page 18 (Turkey Unleaded and Kerosene Fuel).

4. KBR proposed Liquefied Petroleum Gas (LPG) purchased from Kuwait at $82,100 for material (fuel) costs and $27,514,833 in LPG subcontract (transportation) costs. It is illogical that it would cost $27,514,833 to deliver $82,100 in LPG fuel. Refer to note 5c (2), page 17 for further details.

5. We unresolved the proposed demurrage costs totaling $1,255,333. Concurrent audit activity is being conducted by our office to determine the validity of the proposed demurrage charges. Therefore, the results of audit are limited to the extent that completion of the audit may result in additional questioned costs. Refer to Kuwaiti LPG Fuel and Transportation Costs on page 17.

6. The results of audit are restricted because we have not received the requested technical review of the proposed number and need for tanker trucks, number of LPG barges, quantity of fuel, and a determination if there was, or was not, a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait, a higher priced source. On July 20, 2004, we requested a status on the technical report; however, the COE has not provided us a response on our request. During our evaluation of proposals for RIO TOs 7 through 10, we were told a technical report would not be provided.

SCOPE OF AUDIT

We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance that the proposal is free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures in the proposal;
- assessing the accounting principles used and significant estimates made by the contractor;
- evaluating the overall proposal presentation; and
- determining the need for technical specialist assistance.

We evaluated the proposed costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR);
- Defense FAR Supplement (DFARS); and
- Cost Accounting Standards (CAS).

We consider KBR's estimating system to be inadequate (see Contractor Organization and System starting on Page 23 with Estimating System discussed on page 26). On August 4, 2004, we issued a report on the contractor's estimating system. Our examination of the estimating system disclosed the following five significant deficiencies in KBR's estimating system that result in proposed costs that are not current, accurate, and complete.

- Inadequate Cost Estimating Development
- Lack of Management Reviews;
- Lack of System Description and Integration;
- Insufficient Training, Experience and Guidance to Estimators; and
- Inadequate Policies, Procedures, and Practices for Providing Updates to the Government.

The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

RESTRICTIONS

1. KBR represented the proposal is based on actual costs; however, the data provided did not reconcile to KBR's accounting records. KBR proposed direct costs of $800,765,450 while $817,899,175 was charged to the RIO 5 JCL as of August 31, 2004. In addition, KBR was unable to demonstrate the proposal was based on actual costs. For example, KBR proposed $252,808,547 for unleaded gasoline and kerosene, and related transportation; however, when we requested supporting documentation for the proposed costs KBR provided spreadsheets which did not support the proposed amount. The schedule supports costs of $225,599,379, a difference of $27,209,168. Refer to Note 5c (1), page 11 for further details. In addition, we have requested a schedule of actual costs for the procurement of fuels from Turkey and Jordan, for $502,932,525, and $10,601,096, respectively. To date, KBR has not provided the requested data; therefore, the results of audit are limited accordingly. Refer to Note 5c (3 and 5), pages 18 and 19, for further details.

2. Concurrent audit activity is being conducted by our office to determine the validity of the proposed demurrage charges totaling $1,255,333 (Assignment No. 3311-2004K17900040, which will be issued during November 2004). Therefore, the results of audit are restricted to the extent the receipt of the above audit may result in questioned costs. Data was requested for these costs in June 13, 2004 and again on September 15, 2004 in our access to records letter addressed to the Chief Operating Officer of KBR. KBR recently provided some data on September 29, 2004, related to these costs. We are currently evaluating this data. Refer to Note 5c (2) Kuwaiti LPG Fuel and Transportation Costs, Page 17 for further details.

3. On June 4, 2004, we requested a technical evaluation from the COE to determine the reasonableness of the number and need for tanker trucks and LPG barges, the quantity of fuel, and a determination if there was or was not a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait. As of this report date, the COE has not provided DCAA a technical evaluation to incorporate into this audit report. We consider the technical analysis to be essential for our results of audit. Accordingly, the audit results are restricted to the extent additional costs could have been questioned based on a technical evaluation.

RESULTS OF AUDIT

In our opinion, the cost or pricing data and the information other than cost or pricing data submitted by the offeror are not adequate (see comments on Exhibit A, Note 5). The proposal was not prepared in all respects in accordance with applicable Cost Accounting Standards and appropriate provisions of FAR and the DoD FAR Supplement (see comments on Exhibit A, Note 5). We discussed these inadequacies and noncompliances with [redacted] on May 25, 2004 and [redacted] on October 8, 2004. Because the noncompliances and inadequacies are considered significant, we do not believe the proposal is an acceptable basis for negotiation of a fair and reasonable price. At your request, we have nevertheless, evaluated the proposal to the extent possible in the circumstances. To make the cost or pricing data adequate, it is essential for KBR to provide supporting cost data that reconciles to KBR accounting records for the proposed $502,932,525 for Turkey fuel and $10,601,096 for Jordan fuel. Also, the technical evaluation described above is significant enough to materially impact the results of audit. We recommend contract price negotiations not be concluded until (1) the supporting cost data for the Turkey and Jordan fuel is provided by KBR, (2) the results of the technical evaluation are considered by the contracting officer, and (3) our office is contacted concerning the status of the audit of demurrage costs.

Recorded Costs

As of August 31, 2004, recorded direct costs on TO 5 have exceeded the proposed direct costs by $17,133,635. Specifically, KBR proposed direct costs of $800,765,540 while $817,899,175 was charged to the RIO 5 Job Cost Ledger (JCL) as of August 31, 2004. KBR is currently analyzing the validity of all RIO transactions and expects to make adjustments to all RIO TOs upon completion of its analysis. The purpose of this analysis is to ensure the accuracy of recorded information and its consistency with supporting documents. This analysis has resulted in numerous adjustments to the JCL and more adjustments are expected. Since KBR has not reflected all adjustments in its official books and records, we are unable to perform our review of the correcting entries. KBR plans to complete its analysis and process the adjusting journal vouchers in the near future. Our office plans to review the adjusting entries when KBR's adjustments are completed. Any consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information.

Proposed Costs

Our examination of the $875,255,894 proposal disclosed $108,409,622 in questioned costs and $1,255,333 in unresolved costs, as summarized below.

EXHIBIT A

Contractor Proposed & Results of Audit

Cost Element	Proposed	Questioned Costs	Unresolved Costs	Difference (Note 1)	Note
Direct Costs					
Labor	$ 2,732,978	$ 46,929		$ 2,686,049	2
Other Labor Related Cost (OLRC)	1,193,015			1,193,015	3
Equipment	316,935			316,935	4
Material	111,311,932	8,581,863		102,730,069	5
Subcontract	684,231,637	97,500,173	$ 1,255,333	585,476,131	5
Other Direct Cost (ODC)	979,043			979,043	6
Subtotal of Direct Costs	$ 800,765,540	$ 106,128,965	$ 1,255,333	$ 693,381,242	
Indirect Costs					
Overhead	4,564,364	604,935		3,959,429	7
Subtotal	$ 805,329,904	$ 106,733,900	$ 1,255,333	$ 697,340,671	
G&A	12,643,679	1,675,722		10,967,957	8
Facilities Capital Cost of Money	24,160			24,160	9
Total Costs	$ 817,997,743	$ 108,409,622	$ 1,255,333	$ 708,332,788	
Base Fee	16,359,472				
Award Fee	40,898,679				
Total Costs & Fee	$ 875,255,894				

Explanatory Notes

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and the sum of the related questioned and unresolved costs. You should not consider the amounts to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Labor

a. Summary of Conclusions

We questioned $46,929 of labor costs primarily due to KBR proposing danger pay and area differential in excess of Department of State Standardized Regulations (DSSR). We used DSSR rates effective as of February 2003. Questioned costs are summarized as follows:

Cost Element	Questioned
Danger Pay	$ 23,425
Area Differential	23,504
	$ 46,929

b. Basis of Contractor's Rates

KBR's proposed direct labor costs are based on KBR's representation of recorded costs (these representations do not reconcile to its JCLs). [redacted] In addition to basic pay, employees received premiums such as foreign service bonus, danger pay, and area differential based on location. KBR proposed danger pay and area differential rates of [redacted] percent for Kuwait and between [redacted] and [redacted] percent for Jordan and Turkey. [redacted] Labor rates used in this proposal are the actual labor rates currently being paid to the workforce; [redacted]

Rest and Relaxation (R&R) is based on [redacted] employment agreements which states, "Employees are eligible for 14 days paid leave and travel after working 12 weeks at site."

c. Audit Evaluation

We performed the following procedures:

We sampled and verified the proposed direct labor rates and corresponding labor categories to the contractor's records, SAP Display 0001 Organizational Assignment and Display 0008 Basic Pay. In addition, we verified the proposed direct labor costs to the contractor's labor representations. We compared the danger pay and area differential rates from the DSSR to the rates applied by KBR. We noted R&R charges were immaterial requiring no review.

Documentation describing the relationship of OAS and SEII to KBR was requested by our office. We asked for the rationale underlying why these costs are proposed as direct labor rather than subcontracts or inter-company costs. On May 21, July 13, and September 10, 2004, we requested organizational information on Halliburton owned legal entities. We received a partial response on September 24 and 25, 2004. We are reviewing the data provided to assess how the various Halliburton entities relate to each other and how costs are accounted for and allocated to government contracts.

We questioned $46,929 of danger pay and area differential which is in excess of the February 2003 DSSR for danger pay and area differential. KBR proposed [redacted] percent for area differential and danger pay for Kuwait and between [redacted] and [redacted] percent for Jordan and Turkey. According to the DSSR, as of February 2003, danger pay and area differential for Kuwait is 15 percent of employees' base pay and area differential for Turkey and Jordan is 10 percent (there is no danger pay for Turkey and Jordan).

d. Contractor's Reaction

KBR representatives do not concur with the questioned area differential and danger pay. KBR stated the DSSR does not apply to contractors but to federal employees; however, it does use the DSSR as a guideline. KBR set uplift percentages based on what it felt was needed to recruit and maintain employees for its work overseas. Also, KBR stated it should be paid the higher proposed rates instead of the DSSR rates because employees did not strictly stay in the countries where they performed most of their work because they often traveled into more dangerous countries to perform various tasks.

e. Auditor's Response

DCAA maintains that area differential and danger pay rates in excess of DSSR rates are unreasonable. The Department of State sets the DSSR rates to provide reasonable reimbursement of personnel and KBR has not demonstrated that the DSSR rates are not reasonable. We concur with KBR, if employees travel to more dangerous countries to work; those employees should be paid higher uplifts. However, KBR does not record on its timesheets where an employee is working. As a result, the contractor has no method for determining where employees work except for where they are assigned.

3. Other Labor Related Costs (OLRC)

Associated with the above questioned labor costs, there are questioned OLRCs. However, these costs are not material and do not significantly impact this proposal; therefore, we have not included these costs in our results of audit.

4. Equipment

Due to the insignificance of the individual equipment costs we did not review the proposed costs.

5. Materials and Subcontract Costs

a. Summary of Conclusions

We questioned $106,082,036 and unresolved $1,255,333 of proposed material and subcontract costs as detailed below:

	Proposed	Questioned	Unresolved
Material	$ 111,311,932	$ 8,581,863	
Subcontracts	684,231,637	97,500,173	$ 1,255,333
Total	$ 795,543,569	$ 106,082,036	$ 1,255,333

Questioned costs are due to:

- KBR's failure to demonstrate reasonable pricing for the Kuwaiti fuel and transportation costs of $62,046,284;
- Differences between proposed and supporting data of $27,209,168; and
- Unwarranted increases to the Turkey subcontracts for fuel which resulted in unreasonable costs of $16,826,584.

Unresolved costs of $1,255,333 are due to the audit of demurrage still in process. Data was requested for these costs in June 13, 2004 and again on September 15, 2004 in our access to record letter addressed to the Chief Operating Officer of KBR. KBR recently provided some data on September 29, 2004, related to these costs. Therefore, the results of audit are limited to the extent that our completion of the audit may result in additional questioned costs.

In addition, we requested a technical evaluation from the COE to determine the reasonableness of the proposed number and need for tanker trucks, number of LPG barges, quantity of fuel, and a determination if there was, or was not, a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait, a higher priced source. On July 20, 2004, we requested a status on the technical report; however, the COE has not provided us a response on our request. During our evaluation of proposals for RIO TOs 7 through 10, we were told a technical report would not be provided.

b. Basis of Contractor's Cost

Proposed Kuwaiti fuel and transportation costs are based on KBR's representation of actual costs. KBR provided a schedule of actual costs which is $27,209,168 less than proposed. KBR provided twelve purchase orders to support the costs; these purchase orders were negotiated in a very short time frame. The Kuwaiti transportation costs are based on a monthly rental fee, independent of the number of trips, and fuel costs are based on a unit price per liter. The Turkey proposed fuel costs are based on twelve purchase orders dated between May and September 2003. KBR issued change orders that retroactively increased the price on these Turkey fuel purchase orders. Proposed Jordan fuel costs are based on a subcontract with [redacted] (10/19/03). Proposed demurrage costs are based on subcontractor invoices.

c. Audit Evaluation: The following is a schedule of the material and subcontract costs:

		Questioned Costs				
Material Costs	**Proposed**	**Differences in Proposed and Scheduled Costs**	**Unreasonable Costs**	**Total Questioned Costs**	**Unresolved**	**Note**
Kuwait Unleaded Gasoline	$ 99,043,460	$ 3,742,385	$ 4,145,522	$ 7,887,907		1
Kuwait Kerosene	11,206,735	693,956		693,956		1
Kuwait LPG	82,100					2
Total Kuwait Fuel	$ 110,332,295					
Turkey Unleaded Gasoline	$ 2,293,685					3
Turkey Kerosene	(4,358,895)					3
Total Turkey Fuel	$ (2,065,210)					
Other	3,044,848					4
Rounding	(1)					
Total Material Costs	$ 111,311,932			$ 8,581,863		
Subcontract Costs						
Kuwait Unleaded Transportation	$ 115,444,439	9,165,829	$ 48,927,984	$ 58,093,813		1
Kuwait Kerosene Transportation	27,113,913	13,606,998	$ 8,972,778	$ 22,579,776		1
Kuwait LPG Transportation	27,514,833				$ 1,255,333	2
Total Kuwait Transportation	$ 170,073,185					
Subtotal Questioned Kuwait Costs		$ 27,209,168	$ 62,046,284		$ 1,255,333	
Turkey Unleaded Gasoline	$ 327,246,767					3
Turkey Kerosene	43,511,579					3
Turkey LPG	132,174,179					3
Total Turkey Fuel	$ 502,932,525		16,826,584	16,826,584		3
Jordan Kerosene	10,601,096					5
Other	624,832					4
Rounding	(1)					
Total Subcontract Costs	$ 684,231,637			$97,500,173		
Total for Material & Subcontract Costs	$ 795,543,571	$ 27,209,168	$ 78,872,868	$ 106,082,036	$ 1,255,333	

(1) <u>Kuwaiti Material and Subcontract Costs</u>

Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on KBR's representation of actual costs at the time the proposal was prepared. However, KBR was unable to reconcile the proposed costs to its accounting records as discussed in Restriction paragraph 1, page 4. During the audit KBR provided a schedule for the proposed costs. This schedule lists the fuel costs and summarizes the type of fuel delivered by liter, date, and bank report number. Using this schedule, we questioned $27,209,168, as shown below, due to the difference between the amounts proposed and those supported by the schedule. Both the proposed and scheduled costs do not reconcile to KBR accounting records (JCL).

Questioned Costs Due to Differences in Proposed and Scheduled Costs

	Proposed	Scheduled Costs	Questioned
Transportation			
Unleaded Gasoline	$ 115,444,439	$ 106,278,610	$9,165,829
Kerosene	$ 27,113,913	$ 13,506,915	13,606,998
Subtotal			$22,772,827
Fuel			
Unleaded Gasoline	$ 99,043,460	$ 95,301,075	$3,742,385
Kerosene	$ 11,206,735	$ 10,512,779	693,956
Subtotal			$4,436,341
Total	**$252,808,547**	**$225,599,379**	**$27,209,168**

In addition, KBR provided purchase orders it negotiated over a period of a couple of days with Altanmia. Our audit found purchase orders and procurement files related to the Kuwait supplier did not contain data to support the reasonableness of the negotiated purchase orders. We recognize the challenges faced by KBR during the early stages of the war; however, KBR did not periodically update (e.g., monthly) its purchase order files to document the reasonableness of the negotiated prices and the circumstances surrounding the purchase order awards, within a reasonable period of time (30 – 90 days).

Effective subcontract administration of purchase order files requires ongoing (e.g., monthly) documented reviews of the continued reasonableness of the Kuwait fuel prices and efforts to renegotiate these prices if such reviews indicated unreasonable prices. KBR's purchase order files submitted to us do not include adequate documentation to demonstrate the reasonableness of the Kuwait fuel prices over the life of the purchase orders. We found only two instances where KBR renegotiated prices. In November 2003 and January 2004, KBR negotiated minor reductions to the pricing for the Kuwait fuel transportation costs. However, KBR's purchase order files do not include documentation to demonstrate these updated transportation prices were fair and reasonable.

Throughout our audit of TO 5, we requested data from KBR supporting its analysis of the competitive bids and/or price analyses for the Kuwait fuel and transportation costs. We did not receive the requested data. As an alternative, to determine the reasonableness of the prices, we evaluated the consent packages KBR provided to the in-country ACO. These consent packages included a Request for Consent from KBR and a letter from the ACO granting KBR approval to enter into or extend the contract with the subcontractor. The Request for Consent included the type of subcontract, a list of previous change orders, and the process KBR used to select the subcontractor. The consent packages do not contain adequate data consistent with the FAR requirements to support KBR's claim it performed any price analyses. After reviewing the consent packages, we do not believe the consent packages are satisfactory for determining price reasonableness. In our opinion, the consent packages lack documentation of the price analysis KBR performed, and documentation to support the analysis, which includes competitive bids from other subcontractors in response to the fuel solicitation. Our review of the consent packages found KBR did not always provide accurate information. For instance, KBR stated it consulted the Brown & Root Worldwide Suppliers Listing before it negotiated with its fuel subcontractors. During our on going review of the subcontracts and purchase orders, we have found KBR does not currently maintain a Brown & Root Worldwide Suppliers Listing.

In the absence of adequate supporting data, we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the DESC awarded purchase orders in March 2004 to Altanmia for transportation and to KPC for unleaded gasoline. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned $62,046,284, as shown below:

Unreasonable Costs

	Scheduled Costs (a)	Proposed Costs for May 4 Thru Aug. 1 (90 days) (b)	KBR Liters Delivered From Aug. 2 Thru Dec. 20 (c)	DESC Benchmark Transportation Rate** (d)	Audit-Adjusted Costs From Aug. 2 Thru Dec. 20 (e = c x d)	Questioned Costs (f = a-b-e)
Transportation						
Unleaded Gasoline	$ 106,278,610	$ 32,899,670	216,380,140	$ 0.113	$ 24,450,956	$48,927,984
Kerosene	$ 13,506,915		40,125,110	$ 0.113	$ 4,534,137	8,972,778
Subtotal						$57,900,762
Fuel						
Unleaded Gasoline	$ 95,301,075	$ 29,987,071			$ 61,168,482	$ 4,145,522
Kerosene	$ 10,512,779				$ 10,512,779	
Subtotal						$ 4,145,522
Total Questioned Costs						**$62,046,284**

*Questioned costs are computed based on liters delivered 90 days after May 4th.

**Rate includes Management & Oversight Costs, see page 14.

Since KBR did not demonstrate the prices for Kuwaiti fuel and transportation were fair and reasonable for TO 5, we have, as an alternative evaluation technique, compared the proposed prices to recently negotiated prices used by DESC. DESC believes its negotiated prices are reasonable and can be used beginning January 2004. However, we believe KBR should have pursued negotiating lower prices after the "urgent and compelling" circumstances subsided, 30 – 90 days after the start of the contract. To compute our questioned costs, we gave KBR the maximum number of days (90 days). For fuel deliveries starting on the 91st day, we compared KBR pricing to the DESC negotiated methodology. Therefore, we have used DESC's prices as a benchmark for reasonableness for transportation costs and unleaded gasoline starting August 2, 2003. We took no exception to the proposed kerosene fuel price per liter. In addition, we took no exception to the proposed costs, $29,987,071 for unleaded gasoline and applicable transportation costs of $32,899,670, incurred during the first 90 days of the contract, May 4 through August 1, 2003.

DESC issued three contracts for the procurement of fuel from Kuwait as follows:

- The purchase of fuel from KPC (Contract No. SP0600-04-0491);
- Transportation services from Altanmia (Contract No. SP0600-04-D-0492); and
- Management and oversight of the fuel operation from the Public Warehousing Company (Contract No. SP0600-04-C-5418).

For the purchase of fuel, DESC negotiated a price per liter with KPC in the February/March 2004 timeframe. The negotiated base fuel price varies with market prices as indexed with the Platts Pricing Index. For every half month period the pricing is based on the previous half month period. For example, the average Platts price for July 16 through 31, 2003 was $0.276 per liter for unleaded gasoline, which included KPC's markup of $0.074 per liter. For fuel delivered during the time period of August 2 through 15, 2003, KPC would invoice DESC $0.276 per liter. KBR stated the follow-on TO, TO 7, started December 21, 2003; therefore, we have estimated a POP of May 4, 2003 through December 20, 2003 and used the Platts pricing index plus KPC's markup to compute a price per liter developed from the DESC contracts to question costs after 90 days of the start of the POP as shown below:

DESC - Platts Pricing Time Period	Audit Determined POP	Platts	Liters Delivered	Cost
July 16 - 31	Aug. 2 - 15	$ 0.276	24,628,000	$ 6,797,328
Aug. 1 -15	Aug. 16 - 31	$ 0.291	33,708,950	9,809,304
Aug. 16 - 31	Sept. 1 - 15	$ 0.289	25,246,000	7,296,094
Sept. 1 - 15	Sept. 16 -30	$ 0.275	28,070,500	7,719,388
Sept. 16 -30	Oct. 1 - 15	$ 0.262	20,506,000	5,372,572
Oct. 1 - 15	Oct. 16 -31	$ 0.284	17,902,000	5,084,168
Oct. 16 -31	Nov. 1 - 15	$ 0.287	17,970,690	5,157,588
Nov. 1 - 15	Nov. 16 - 30	$ 0.287	19,758,000	5,670,546
Nov. 16 - 30	Dec. 1 - 15	$ 0.285	20,494,000	5,840,790
Dec. 1 - 15	Dec. 16 - 20	$ 0.299	8,096,000	2,420,704
			216,380,140	$ 61,168,482

Our audit adjusted transportation price of $0.111 per liter is based on the current DESC subcontract with Altanmia for three round trips (turns) per month. DESC negotiated this liter price effective for contracts beginning in April 2004. Cost for management and oversight of $0.002 per liter is also added to the transportation costs resulting in a combined per liter price of $0.113. DESC negotiated a contract for management and oversight to provide services to distribute the imported fuel to the Iraqi civilian populace. In computing an audit adjusted price, we used the DESC contract rate as a benchmark for reasonableness. We believe this basis can be used for TO 5 and KBR should have pursued lower fuel and transportation costs within a reasonable timeframe, 90 days after the start of the contract, after the "urgent and compelling circumstances" it faced in May 2003. DESC believes its negotiated prices are reasonable and can be used beginning January 2004. However, we believe KBR should have pursued negotiating lower prices after the "urgent and compelling" circumstances subsided, 30 – 90 days after the start of the contract. We have allowed the proposed costs for the first 90 days; however, we have applied DESC's fuel and transportation methodology to the remaining scheduled costs thereafter, August 2 through December 20, 2003. We believe it is more reasonable to use the DESC benchmark prices, which are based on industry standards, than to use a purchase order price negotiated in two days under war time conditions. This is particularly true when considering the length of the entire POP of 229 days.

Using the negotiated rates by DESC as a benchmark for reasonableness, we compared the proposed unleaded gasoline fuel and transportation costs to the current DESC contracts. We believe these differences in prices are unreasonable. As a result, using the DESC negotiated prices adjusted by the Platt Pricing Index as a benchmark for reasonableness; we questioned the difference between the proposed fuel prices and the DESC negotiated prices as discussed above.

We questioned as unreasonable costs $8,972,778 of kerosene transportation from Kuwait. DESC has not issued a contract for kerosene fuel; therefore, we were unable to compare the reasonableness of the proposed kerosene fuel price to negotiated DESC prices. As a result, we compared the proposed kerosene fuel liter prices to other proposed kerosene fuel liter prices and took no exception. However, DESC did negotiate transportation costs at $0.42 per gallon, or $0.111 per liter, for kerosene in its contract with Altanmia under Contract No. SP0600-04-D-0492. We believe KBR's practice of negotiating transportation prices on a monthly basis instead of using the quantity delivered is unreasonable and have questioned transportation costs in excess of the DESC negotiated transportation and management and oversight price per liter of $0.113.

KBR's procurement files do not include adequate documentation to justify the selection of other than the lowest bidder. Our review disclosed on May 4, 2003, KBR procured unleaded fuel including the subcontractor's additive factors and the fuel transportation. On May 8, 2003, the contractor rebid the transportation component for some unknown and undocumented reason(s). Thus, the Kuwaiti supplier was relieved of the transportation component. The same Kuwaiti supplier subsequently won the transportation component less than a week later. In effect, the government is now paying separately for the transportation costs which should have already been included as part of the initial bid.

During our audit, we learned the COE waived KBR's requirement for submission of cost and pricing data from the Kuwaiti subcontractor (Altanmia) on Contract No. DACA63-03-D-0005. The waiver from General Robert B. Flowers states,

<u>Excerpts from General Flowers' Waiver on December 19, 2003</u>

> "I have hereby determined that it is in the best interest of the United States Government to waive the requirement for cost and pricing data from Kellogg Brown and Root Services regarding its award of a subcontract for gasoline to Altanmia. By the authority delegated to me as the Head of the Contracting Agency, in accordance with FAR 15.403-1(c)(4), and upon reviewing the foregoing facts, authorities and analysis, I concur with the recommendation of my Contracting Officer and grant this Request for Waiver to Kellogg Brown and Root Services to exempt KBR from providing any cost and pricing data pertaining to its subcontract with Altanmia for the purchase of fuels under Task Orders 0005, 0007, and subsequent task orders involving the purchase of fuel under DACA63-03-D-0005."

On July 29, 2004, we issued a letter to the COE Director of Contracting requesting clarification on the waiver. Specifically, we requested clarification on whether a contracting officer determination had been made the costs proposed and incurred by KBR for Altanmia refined fuels and transportation are fair and reasonable. On August 3, 2004, COE Director of Contracting responded stating a DCAA audit was needed to assist in determining if KBR's proposed prices for Altanmia are fair and reasonable.

Our reading of the waiver does not relieve KBR of its responsibility to conduct a price analysis of the proposed Altanmia subcontract prices to demonstrate reasonableness. FAR 15.404-1(a)(2) states, "Price analysis shall be used when cost or pricing data are not required."

FAR 15.404-3(b), Subcontract Pricing Considerations, states, "The prime contractor or subcontractor shall…Conduct appropriate cost or price analysis to establish reasonableness of the proposed subcontract prices." Despite the waiver granted by the COE, KBR states the fuel and transportation procurement is competitively priced. However, KBR has failed to demonstrate adequate competition in its procurement decision. In this procurement, KBR asserts only one supplier, Altanmia, could satisfy the requirement because they were the only supplier licensed by the KPC to procure and distribute petroleum products in Kuwait. Our review of the documentation provided by KBR disclosed it had obtained vendor quotes on May 4, 2003, from three firms, with Altanmia being the lowest bidder. This information was communicated to the contracting officer who requested the Kuwait Oil Minister approve Altanmia as the subcontractor to provide fuel to Iraq. However, on May 5, 2003, Altanmia provided a quote for the supply of gasoline; a day after KBR approved Altanmia as the low bidder.

Additionally, in early May 2003, during a period of a few days, KBR obtained three supplier quotes and awarded a purchase order in the amount of $7.4 million to Altanmia for unleaded fuel. During this process, KBR determined Altanmia to be the only qualified provider of Kuwaiti fuel. Over the next several months, KBR made additional awards to Altanmia of over $90 million for unleaded gasoline using the May 2003 price. Our review of KBR's procurement files for these additional awards did not find any cost or price analyses to justify the reasonableness of the purchase order prices. Since none of the other vendors could meet the requirement, the procurement does not result in a competitive award, and must be considered a sole source procurement. FAR 15.403-1(c) states,

> (1) *Adequate price competition*. A price is based on adequate price competition if-
> (i) Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and if-
> (A) Award will be made to the offeror whose proposal represents the best value (see 2.101) where price is a substantial factor in source selection; and
> (B) There is no finding that the price of the otherwise successful offeror is unreasonable. Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer;
> (ii) There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers in response to the solicitation's expressed requirement, even though only one offer is received from a responsible offeror and if-
> (A) Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, *e.g.*, circumstances indicate that-
> (1) The offeror believed that at least one other offeror was capable of submitting a meaningful offer; and
> (2) The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and

(B) The determination that the proposed price is based on adequate price competition, is reasonable, and is approved at a level above the contracting officer; or

(iii) Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items, adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from adequate price competition.

In this procurement, KBR did not meet the first and second conditions because there was only one responsible offeror. The third provision of FAR 15.403-1(c) is not met because the price analysis was not adequate and there are no recent purchases based on adequate price competition for comparison. Altanmia was the only subcontractor with the license to provide the fuel. There could not be an expectation of competition when the other bidders were not licensed to provide the fuel. In our opinion, the other bids are irrelevant for determining competition.

In summary, in our opinion, KBR should have actively pursued reducing the price for fuel and transportation within a reasonable timeframe after the "urgent and compelling circumstances" it faced in May 2003. As demonstrated by DESC, reasonable prices could be negotiated with Altanmia and KPC for transportation and fuel. As a result of KBR's failure to act in negotiating a lower price for the purchase of Kuwaiti fuel and transportation, the proposed price is unreasonable.

(2) <u>Kuwaiti LPG Fuel and Transportation Costs</u>

KBR provided a schedule for fuel and transportation costs to reconcile to the proposal. KBR proposed $82,100 for LPG material (fuel) costs and $27,514,833 in LPG subcontract (transportation) costs. It is illogical that it would cost $27,514,833 to deliver $82,100 in LPG fuel. We believe KBR should review its accounting data again for misclassification of costs.

Review of the purchase order disclosed the proposed LPG prices are based on "Saudi Aramco government stated prices plus Altanmia's stated fee." KBR prepared an estimate based on historic LPG pricing for the last two years, Altanmia's proposed price was within the relevant range of the historical prices. In addition, KBR allowed for market fluctuation in the contract price.

We unresolved the proposed demurrage costs totaling $1,255,333. Based upon concurrent audit activity conducted by our office, we have determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. We received an e-mail from [redacted], KBR Government Compliance, on June 23, 2004, stating only TOs 5 and 7 received demurrage costs. He also stated that two invoices for demurrage had not been identified with a TO. When we reviewed these invoices, we found the invoices were dated in 2003, indicating they could only be charged to TOs 5 or 7 since those were the only TOs worked on in 2003. In the event the demurrage costs are allowable and allocable in our concurrent audit activity, the demurrage costs are appropriately charged to TO 5. Data was requested for these costs in June 13, 2004 and again on September 15, 2004 in our access to record letter addressed to the Chief Operating Officer of KBR. KBR recently provided some data on September 29, 2004, related to these costs. We are currently evaluating this data.

(3) Turkey Unleaded and Kerosene Fuel

KBR represented the proposal is based on actual costs. The data provided did not reconcile to KBR's accounting records. In addition, KBR was unable to demonstrate the proposal was based on actual costs. We requested a schedule detailing the actual costs for the procurement of the Turkey fuel in the amount of $502,932,525. As discussed in the Restriction paragraph 1, page 4, KBR has not provided the requested data; therefore, the results of audit are limited. In addition, KBR has proposed a credit of $4,358,895 for kerosene costs; however there is no other proposed kerosene material costs. It is illogical to have negative proposed costs for kerosene. KBR needs to provide an explanation and reconciliation for this proposed credit.

KBR entered into fixed-unit-rate and firm-fixed-price subcontracts with various Turkey vendors to deliver fuel into different parts of Iraq. During the performance of the subcontract agreements, the market price of the fuel increased. The Turkey subcontractors asked KBR to increase the unit price of the fuel to compensate for losses due to market increases. KBR agreed to pay the higher prices instead of the negotiated subcontract unit prices and issued change orders reflecting the higher unit prices.

We reviewed the Turkey subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Turkey to Iraq. A review of the subcontract clauses disclosed the contractor was required to negotiate the price on a monthly basis after the initial subcontract delivery period was complete. The original period was for 30 days. Further review of the subcontract change orders disclosed KBR did not comply with the stated terms and conditions of its own subcontract clauses by not re-negotiating the price for future requirements after the initial delivery period nor did it re-negotiate the price on a month-to-month basis.

We do not believe it was appropriate to retroactively adjust the fuel unit prices of KBR's fixed-unit-rate and firm-fixed-price subcontracts when there are no provisions in the subcontracts to do so. We therefore questioned the retroactive application resulting in $16,826,584 of questioned cost as shown below:

Vendor	Subcontract No.	Invoice No.	Fuel Type	Cost
[redacted]	GU64-TURIO-S0006	KBR/P.DIFF/141/U	Gasoline	$ 240,704
	GU64-TURIO-S0006	KBR/P.DIFF/183/1	Gasoline	910,177
	GU64-TURIO-S0006	KBR/311203/P.DIFF/B/D	Gasoline	1,385,740
	GU64-TURIO-S0027	KBR/311203/P.DIFF/K	Kerosene	3,095,465
	GU64-TURIO-S0027	KBR/260504/P.DIFF/K	Kerosene	196,093
	GU64-TURIO-S0008	65137	LPG	503,262
	GU64-TURIO-S0003	074885-1	LPG	2,448,367
	GU64-TURIO-S0005	092110/Price Differences	Gasoline	1,344,204
	GU64-TURIO-S0005	092111/Price Differences	Gasoline	52,223
	GU64-TURIO-S0005	092112/Price Differences	Gasoline	1,777,740
	GU64-TURIO-S0025	092113/Price Differences	Kerosene	634,149
	GU64-TURIO-S0005	074883-B	Gasoline	2,035,221
	GU64-TURIO-S0005	074876	Gasoline	2,203,238
				$ 16,826,584

(4) Other Material and Subcontract Costs

We did not audit these costs due to immateriality.

(5) Jordan Kerosene Fuel Costs

KBR represented the proposal is based on actual costs. The data provided did not reconcile to KBR's accounting records (JCL). In addition, KBR was unable to demonstrate the proposal was based on actual costs. We requested a schedule of the actual costs for the procurement of the Jordan fuel of $10,601,096. As discussed in the Restriction paragraph 1, page 4, KBR has not provided the requested data; therefore, the results of audit are limited.

KBR provided its Jordan subcontract procurement files. KBR obtained five bids and selected the lowest bidder. We reviewed the Jordan subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Jordan to Iraq. The subcontract was a Firm-Fixed-Price contract and the price of the proposed fuel did not change in the subcontract.

d. Contractor's Reaction

KBR did not provide any comments concerning factual matters during the exit conference in regards to the Kuwaiti and Turkey fuel and transportation and the demurrage costs. However, based on discussions and correspondence received during the audit, KBR does not concur in our position for Kuwaiti fuel and transportation costs and stated it had a contract for a fixed rate and there was no reason to renegotiate fuel prices. For Turkey fuel purchases, based on prior discussions during the audit, KBR feels paying Turkish vendors for increases due to market fluctuations even when subcontract modifications were executed retroactively is acceptable because the subcontract fixed rates were lower than rates paid to the Kuwaiti subcontractor. KBR stated it was very busy during the contract POP and was unable to negotiate monthly price increases. KBR finally stated it wanted to definitize the TO with all of the costs proposed in order to obtain fee for the costs it may incur in the future for subcontractor claims.

e. Auditor's Response

We maintain our position as stated above that Kuwaiti fuel and transportation costs are unreasonable. We do not concur with KBR's position that it was unnecessary to monitor its purchase order prices and, if necessary, renegotiate the prices for changing conditions. For the Turkey fuel prices, the subcontracts were negotiated as fixed rate purchases without any provisions to adjust prices based on market fluctuations.

6. Other Direct Costs

Due to the insignificance of the individual ODCs, we did not review the proposed costs.

7. Overhead

a. Summary of Conclusions

We questioned overhead costs of $604,935. Questioned costs result from base differences.

b. Basis of Contractor's Cost

The contractor's overhead is computed by applying a proposed [redacted], FPRR rate of [redacted] percent to total direct costs.

c. Audit Evaluation

We compared the proposed overhead rate to the current [redacted] FPRR rate of [redacted] percent and found no differences. We computed the questioned overhead costs by applying the FPRR rate to the questioned base costs to determine questioned costs due to questioned base costs.

Questioned costs are computed as follows:

Costs Questioned Due to Base	
Questioned Base	[redacted]
Audit Position Overhead Rate	[redacted]
Total Questioned Overhead	$ 604,935

d. Contractor's Reaction

KBR did not provide any comments concerning factual matters regarding the questioned indirect costs due to questioned base costs.

8. G&A

a. Summary of Conclusions

We questioned G&A costs of $1,675,722. Questioned costs result from base differences.

b. Basis of Contractor's Cost

The contractor's G&A is computed by applying a proposed [redacted] rate of [redacted] percent to total direct and overhead costs.

c. Audit Evaluation

We compared the proposed G&A rate to the [redacted] rate of [redacted] percent and found no differences. We computed the questioned G&A costs by applying the FPRR rate to the questioned base to determine questioned costs due to questioned base and overhead costs.

Questioned costs are computed as follows:

Costs Questioned Due to Base	
Questioned Base	[redacted]
Audit Position G&A Rate	[redacted]
Total Questioned G&A	$ 1,675,722

d. Contractor's Reaction

KBR did not provide any comments concerning factual matters regarding the questioned indirect costs due to questioned base costs.

9. Facilities Capital Cost of Money (FCCM)

We compared the proposed FCCM rate to the FPRR dated [redacted] and took no exception. However, in questioning direct costs there are associated FCCM questioned costs; we have determined these costs to be insignificant.

Exit Conference:

We discussed factual matters concerning our findings with Brian Fee, Sr. Compliance Analyst; Mike Morrow, Contract Manager; Ramesh Shah, Project Control Manager; and Susan Stoj, Government Compliance; in exit conferences held on October 5, 2004 and on October 7, 2004. The factual matters discussed are detailed below:

- KBR did not provide adequate data to demonstrate the reasonableness of proposed fuel prices for the Kuwait supplier, Altanmia;
- KBR failed to provide the requested Turkey and Jordan fuel spreadsheets which reflect the actual costs for TO 5; and
- KBR increased Turkey costs due to retroactive fuel price increases when its fuel contracts were fixed-unit-rate and firm-fixed-price contracts.

We did not provide the dollar impact of our findings. KBR did not agree with our questioned costs concerning area differential and danger pay and questioned fuel prices from Kuwait and Turkey. KBR stated it would provide a detailed written response to the negotiation team. Since we expect the contractor to contest the area differential and danger pay costs and questioned fuel costs, we recommend you invite a DCAA representative to attend the negotiations conference.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

On May 21, July 13, and September 10, 2004 we requested organizational information on Halliburton owned legal entities. We received a partial response on September 24 and 25, 2004. We are reviewing the data provided to assess how the various Halliburton entities relate to each other and how costs are accounted for and allocated to government contracts.

Per SEC filings, Halliburton claims its business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group (E&C) operates as KBR. This group provides engineering, procurement, construction, project management, facilities operation, and maintenance for oil and gas to industrial and Governmental customers.

In 2003, KBR transferred its U.S. Government contracts to Kellogg Brown & Root Services, Inc. (KBRSI), a division of KBR, and Halliburton provided a performance guarantee for the transferred contracts. KBRSI is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III, with a ceiling of $11.3 billion, provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO consists of two contracts: one for the rebuilding of Iraqi oil infrastructure with a contract value of $2.6 billion and one for the restoration of southern Iraqi oil fields with a contract value of $563 million. The Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee for the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004*	2003	2002	2001
Total revenues (in millions)	[redacted]	$16,271	$12,572	$13,046
U.S. Government sales	[redacted]	26%	<10%	<10%
Personnel		101,000	83,000	85,000

*Estimated Data

2. Systems

a. Accounting System

[redacted]

[redacted]

[redacted]

[redacted]

[redacted] an IBM mainframe legacy system placed into production in 1983. [redacted] data was blank, incomplete, or incorrect for most of 2003 and early 2004.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

b. Estimating System

We consider KBR's estimating system to be inadequate. On August 4, 2004, we issued Audit Report No. 3311-2004K24010001 on the contractor's estimating system. Our examination of the estimating system disclosed the following five significant deficiencies in KBR's estimating system, resulting in proposed costs that are not current, accurate, and complete:

(i) KBR does not provide adequate: (i) disclosure and basis of estimates for incurred cost and estimates-to-complete; (ii) cost/price analysis of subcontract proposals; and (iii) submission of cost or pricing data on a timely basis.

(ii) KBR does not: (i) maintain policies and procedures that require periodic management reviews of its estimating system process and (ii) perform adequate reviews of individual cost proposals and periodic reviews of its Estimating Manual.

(iii) KBR's system description and integration and related internal controls do not: (i) provide for adequate segregation of duties, (ii) adequately describe its system, (iii) ensure proper integration of other functions/systems, and (iv) provide timely notification of changes to the system as required by DFARS 215.407-5-70.

(iv) KBR does not ensure assigned personnel have sufficient training, experience, and guidance to perform estimating tasks in accordance with DFARS 215.407-5-70 and its established policies and procedures.

(v) KBR does not ensure all cost or pricing data are current, accurate, and complete as of the date of agreement on price in accordance with the requirements of DFARS 215.407-5-70.

KBR's response also states the issues identified in the audit report are attributable to a "contingency contracting environment." Our audit results are not exclusive to "contingency contracting" – a term used by KBR. As such, we do not believe separate estimating procedures for "contingency" and "new business" are necessary. If "contingency" desk procedures are developed, they must address all applicable Government requirements.

On July 14, 2004, KBR provided its response to our draft Statement of Conditions and Recommendations. KBR generally concurs there are areas for improvement. On August 5, 2004, the Corporate Administrative Contracting Officer (CACO) issued a Notification Letter (i) requesting KBR to submit a corrective action plan (CAP) by September 5, 2004; (ii) giving KBR 60 days from the date of the letter to correct the deficiencies; and (iii) noting the CAP must result in complete corrective action by October 5, 2004. On September 5, 2004, KBR provided its corrective action plan, which provides a root-cause analysis of the five cited deficiencies with short-term and long-term corrective action plans and dates. We issued our comments to the CACO on September 23, 2004, noting that KBR's CAP is not adequate to ensure the identified actions correct deficiencies noted in our audit report.

c. Purchasing System:

[redacted]

We found significant purchasing system deficiencies during related audits and issued flash Audit Report No. 3311–2004K12030001, dated March 5, 2004. We reported the following deficiencies:

(i) KBR does not adequately maintain file documentation on subcontractor selection or cost.

(ii) KBR does not maintain an approved/preferred supplier listing.

(iii) KBR does not adequately maintain documentation as to why other than the lowest bidder is chosen.

As a result of significant increases in dollar values of purchases and amounts of subcontract awards, the Defense Contract Management Agency (DCMA) conducted a Contractor Purchasing System Review. The initial results were provided to KBR for response on May 13, 2004. The team provided the following seven recommendations:

- identify DPAS rating on all purchase orders/subcontracts;
- obtain small business subcontracting plan;

- fully support purchases awarded to other than low bidder;
- document attempts to obtain competition and market analysis and ensure solicited vendors could respond;
- assure adequate lead-time for procurements;
- assure buyer obtains all representations and certifications before making award, and
- review and update policies and procedures.

On September 7, 2004, the CACO approved KBR's purchasing system for a period of one year. Our examination of the purchasing system is in-process and we plan to issue our report during October 2004.

[redacted]

[redacted]

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General information on audit matters is available at http://www.dcaa.mil.

RELEVANT DATES

Request for Audit: PCO – dated and received May 14, 2004
Revised Due Date – October 15, 2004

AUDIT REPORT AUTHORIZED BY:

/signed/

William F. Daneke
Branch Manager

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

DISTRIBUTION

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RESTRICTIONS

1. Information contained in this audit report may be proprietary. It is not practical to identify during the conduct of the audit those elements of the data which are proprietary. Make proprietary determinations in the event of an external request for access. Consider the restrictions of 18 U.S.C. 1905 before releasing this information to the public.

2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.

3. The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of KBR.

4. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.