



CENTRAL REGION
ARLINGTON BRANCH OFFICE
DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO
3311 820.5/keb

January 13, 2004

MEMORANDUM FOR CORPORATE ADMINISTRATIVE CONTRACTING OFFICER,
DEFENSE CONTRACT MANAGEMENT AGENCY SAN ANTONIO
(DCMAW-GEHC), 4100 CLINTON DRIVE, MAIL DROP 01-660,
HOUSTON, TEXAS 77020

SUBJECT: Status of Brown & Root Services (BRS) Estimating System Internal Controls

During the summer of 2002, DCAA conducted a full review of BRS's estimating system to assure controls were adequate to provide estimated costs that are reasonable, compliant with applicable laws and regulations, and subject to applicable financial control systems, and to evaluate BRS's compliance with the system's internal control requirements. Audit Report Number 3521-2001D24010001 was issued on August 20, 2002 which concluded BRS's estimating system and related internal control policies and procedures were adequate.

DCAA generally cycles internal control reviews on the 10 major contractor systems (e.g. estimating, accounting, labor, billing, budgeting, compensation, material, purchasing, EDP, Indirect/ODC) every three to four years. Based on this cycle, we were not scheduled to evaluate BRS's estimating system until FY 2005. However, since we issued the August 2002 audit report, conditions have dramatically changed. Operation Iraqi Freedom and significant increases in contract requirements to support the reconstruction of Iraq have resulted in the significant growth in the volume and dollar value of proposals issued by BRS. Presently, we are auditing five task order proposals proposed at approximately \$2.1 billion. Based on the government developed definitization schedule, the U.S. Army Field Support Command, Rock Island, Illinois is expecting BRS to submit 27 proposals between January 9, 2004 and July 2, 2004 at a rate of approximately one per week.

The purpose of this memorandum is to inform you DCAA no longer believes the opinion expressed on August 20, 2002 is accurate. Accordingly, we have initiated a full review of the BRS estimating system. The field work for this system review is scheduled to be completed by February 29, 2004. We are also in the process of conducting a subcontract management operations audit to identify process improvements that will assist BRS in implementing corrective action.

Based on proposal evaluations over the past three months, we consider BRS's estimates in the area of subcontracts to be inadequate. Our findings and recommendations with respect to our evaluation of the \$2.7 billion Task Order 59 proposal for Contract Number DAAA09-02-D-0007 were reported to you in our Flash Report on Estimating System Deficiencies dated December 31, 2003 (copy attached). Specifically,

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SUBJECT: Status of Brown & Root Services (BRS) Estimating System Internal Controls

- BRS's proposal did not contain current, accurate, and complete data regarding subcontract costs resulting in an approximate \$67 million overstatement of proposed costs;
- BRS did not disclose the termination of two subcontracts, proposed at \$70 million, with KCPC/Morris for food services at sites C-1 and C-2. These two subcontracts were the basis for over \$1 billion of projected food service costs for 26 sites. The proposal submitted to the Government on October 7, 2003 made no mention of the actual negotiated values with KCPC/Morris nor did BRS inform the government they had terminated the KCPC/Morris subcontract for default on or around July 31, 2003 and;
- BRS's proposal did not comply with the requirements of FAR 15.408, Table 15-2. Among other things, BRS did not (i) include a consolidated spreadsheet for proposed subcontract and equipment costs and (ii) provide or conduct cost analysis on sole-source subcontracts.

Our findings and recommendations with respect to our evaluation of the \$347.7 million Task Order 61 proposal for Contract Number DAAA09-02-D-0007 were reported to the Procurement Contracting Officer, Headquarters, U.S. Army Field Support Command in our December 15, 2003 memorandum. Specifically,

- BRS did not include a summary of their cost analysis and a copy of cost or pricing data in their proposal for prospective subcontractors exceeding \$10 million or more than 10 percent of BRS's proposed price as required by FAR 15.408, Table 15-2;
- Detailed support contained in procurement files in Kuwait did not reconcile to amounts contained in BRS's proposal;
- BRS did not clearly identify the basis of estimates for \$20.7 million proposed for Container Living Spaces under a Master Agreement and;
- Procurement files in Kuwait supporting \$25.1 million proposed for power generator tents were not readily available.

As a result of these deficiencies, we issued a memorandum to the Procurement Contracting Officer, U.S. Army Field Support Command, recommending proposals for Task Orders 59 and 61 be returned to BRS as inadequate. The delay associated with returning inadequate proposals increases government resources required to support the pre-award acquisition process. It also decreases the government confidence in and reliance on the contractor estimating system.

SUBJECT: Status of Brown & Root Services (BRS) Estimating System Internal Controls

In addition to the above, we identified four other Task Orders totaling \$227M where BRS did not use current, accurate and complete cost or pricing data. Collectively, the deficiencies described above bring into question BRS's ability to consistently produce well-supported proposals that are acceptable as a basis for negotiation of fair and reasonable prices.

We recommend you contact us to ascertain the status of the BRS' estimating system prior to entering into future negotiations. Any comments or questions regarding this memorandum should be directed to Darlene G. Brown, Supervisory Auditor, at (713) 753-2142, fax (713) 753-2919 or e-mail darlene.brown@dcaa.mil.

Sincerely,

/Signed/
William F. Daneke
Branch Manager

Copy furnished
Distribution

SUBJECT: Status of Brown & Root Services (BRS) Estimating System Internal Controls

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DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 3311-2004K24020001



December 31, 2003

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SUBJECT: Flash Report on Estimating System Deficiency Found in the Proposal for
Contract No. DAAA09-02-D-0007, Task Order No. 59

CONTRACTOR: Brown & Root Services (BRS)
A Division of Kellogg Brown and Root, Inc.
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REPORT RELEASE RESTRICTIONS: See Page 13

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SUBJECT OF AUDIT

Our price proposal audits include determining if Brown and Root Services (BRS) consistently complies with established estimating system internal controls for developing accurate, current and complete cost estimates. Consistent application of sound estimating procedures should reduce instances of defective pricing and facilitate audit and evaluation of the contractor's proposals submitted in connection with government procurement actions.

SCOPE OF AUDIT

Our examination was limited to certain contractor estimating practices used in preparing its proposal submitted in connection with Contract No. DAAA09-02-D-0007, Task Order No. 59. We did not perform sufficient audit procedures to constitute an examination of all applicable estimating system internal controls in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Certain contractor estimating practices used in preparing its proposal submitted in connection with Contract No. DAAA09-02-D-0007, Task Order No. 59, require corrective action to improve the reliability of future cost estimates. During our examination of the proposal, we noted certain significant deficiencies in complying with the Federal Acquisition Regulations (FAR), Defense Federal Acquisition Regulations Supplement (DFARS) and BRS' Estimating Manual. In our judgment, these deficiencies could adversely affect the organization's ability to propose subcontract costs in a manner consistent with applicable government contract laws and regulations. This condition is detailed in the Statement of Condition and Recommendation below.

STATEMENT OF CONDITION AND RECOMMENDATION

1. Condition

Based on our preliminary audit, we noted BRS did not use the most current, accurate and complete cost or pricing data available prior to the proposal submission to estimate subcontract cost proposed for Contract No. DAAA09-02-D-0007, Task Order No. 59. The proposed costs for Task Order No. 59 (thru Change Order 4) are approximately \$2.7 billion of which approximately \$1.7 billion relates to proposed subcontract costs. Specifically, the proposal did not contain current, accurate, and complete data regarding subcontract costs. For instance, BRS proposed \$208.8 million for food services at seven sites in their October 7, 2003 proposal without disclosing, referencing, or mentioning the fact they had already issued subcontracts for these sites in June through August 2003 totaling \$141.5 million. As such, based on our computation, subcontract costs for the seven sites alone were overstated by \$67.3 million as detailed in Appendix 1, page 14. In addition, BRS did not disclose the termination of two subcontracts, proposed at \$70 million, with KCPC/Morris for food services at sites C-1 and C-2.

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These two subcontracts were the basis for over \$1 billion of projected food service costs for 26 sites. The proposal submitted to the Government on October 7, 2003 made no mention of the actual negotiated values with KCPC/Morris nor did BRS inform the government they had terminated the KCPC/Morris subcontract for default on or around July 31, 2003.

In our opinion, we believe the deficiencies described above and detailed in Appendix 1 represent indicators of potentially significant estimating deficiencies as described in DFARS 215.407-5-70 (d) (3). Specifically, BRS estimators did not utilize relevant historical experience (e.g. use actual subcontracts issued) in preparing their estimates for subcontract food service costs. Also, management reviews of the proposal failed to identify data readily available to the company was not used in the proposal submitted to the Government.

We also found the proposal for Contract No. DAAA09-02-D-0007, Task Order No. 59 does not comply with the requirements of FAR 15.408, Table 15-2. Specifically, FAR 15.408, Table 15-2 requires:

- The contractor to submit, with its proposal, cost or pricing data (that is, data that are verifiable and factual and otherwise as defined at FAR 2.101).
- the contractor to provide a consolidated priced summary of individual material quantities included in the various tasks, orders, or contract line items being proposed and the basis for pricing (vendor quotes, invoice prices, etc.).
- the contractor to provide data showing the degree of competition and the basis for establishing the source and reasonableness of price for those acquisitions (such as subcontracts, purchase orders, material order, etc.) exceeding, or expected to exceed, the appropriate threshold;
- the contractor to conduct price analyses of all subcontractor proposals and to include the analyses as part of its own cost or pricing data submissions for subcontracts expected to exceed the appropriate threshold. The contractor did not perform prior to the award, the price analysis as required by FAR 15.404-3 to determine the reasonableness of subcontractor’s proposed cost on the following purchases:

Subcontract No.	Subcontractor	Date of Subcontractor Proposal	Award Date
KU-MA00009, Work Release #3	Daoud & Partners	July 1, 2003	July 12, 2003
KU-MA00007, Work Release #3	LaNouvelle/ESS	June 25, 2003	July 4, 2003

- the contractor to conduct cost analyses for all subcontracts when cost or pricing data are submitted by the subcontractor;
- The judgmental factors applied and the mathematical or other methods used in the estimate, including those used in projecting from known data;

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- the contractor to include the name and address of the offeror (subcontractor) in its proposal; and
- the contractor to include the type of subcontract action in its proposal (that is, new contract, change order, price revision/redetermination, letter contract, unpriced order, or other).

In addition, we determined the contractor is in noncompliance with its Cost Estimating Manual (BRS Government Operations Cost Estimating Manual Section 17.0 - Subcontract Costs, dated July 2002) which also addresses the items described above, specifically those related to documentation of recommended subcontractor source selection and performance of subcontract cost/price analyses.

2. Recommendation

The estimating system deficiencies described above and in Appendix 1 resulted in the loss of significant audit resources both in Houston and Kuwait. Based on these preliminary findings, DCAA recommended to the PCO the proposal be returned to the contractor for revision. A commitment was obtained from BRS on November 13, 2003 stating they would formally revise their proposal using a November 7, 2003 cutoff date. The contractor's failure to provide current cost or pricing data has also resulted in delays in definitizing the Task Order No. 59 procurement.

We recommend the contractor take corrective action to ensure all proposals, which include subcontract costs comply with FAR 15.408, Table 15-2, and its Cost Estimating Manual, Section 17.0, Subcontract Costs. If the contractor does not within a reasonable time period correct the proposal inadequacies we also recommend withholding of the award until such time as the contractor complies with the requirements in FAR and provides a revised proposal permitting an adequate evaluation of the proposed subcontract prices.

3. Contractor's Reaction

In their response, dated December 4, 2003, BRS agreed it failed to use current, accurate, and complete information in estimating proposed subcontract costs for Contract No. DAAA09-02-D-0007, Task Order (TO) No. 59. However, BRS disagrees with DCAA on whether this constitutes a significant estimating system deficiency. BRS states this was a unique situation due to the large cost, amount of data, and volume of effort associated with the TO No. 59 proposal. Even though BRS does not think the condition is a significant deficiency, it reported a \$37 million difference between the proposed subcontract costs and updated estimated amounts using more current data instead of the \$67.3 million reported in DCAA's draft audit report. Further, in an attempt to avoid this issue on future LOGCAP III proposals, BRS agrees to establish a "cut-off date", and perform a "sweep" in an attempt to identify the most current information available which BRS will incorporate into its cost proposals for subcontracts equal to or exceeding \$550,000.

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BRS also responds to DCAA's findings that:

a. It agrees to provide DCAA with consolidated spreadsheets for subcontracts, equipment, other direct costs (ODC) and materials. In addition, BRS has agreed to provide clearer explanations in their proposals for the judgmental factors applied, the mathematical or other methods used, and subcontractor names, addresses, and other information to be included in the consolidated subcontract spreadsheet.

b. It disagrees with DCAA's position in respect to BRS failing to perform price analyses, prior to the award, as required by FAR 15.404-3, on master procurement agreements KU-MA00009, Work Release #3 and KU-MA00007, Work Release #3. BRS indicates in performing a price analysis FAR 15.404-1(b) (2) requires a comparison of competitive offers or the comparison of previously proposed prices and current prices for same or similar items. BRS stated it met these tests.

c. No cost analysis was required in the evaluation of the proposed subcontractors on Task Order No. 59, since BRS strives to obtain competition or obtain commercial items to the maximum extent possible.

d. Estimators have the latitude to depart from the requirements identified in BRS' Cost Estimating Manual since the manual states the guidelines do not cover every possible type of cost or fixed-price arrangement available to the Government and allows BRS to tailor and implement their procedures to the individual project contract requirements as established by the various Government Clients.

See Appendix 2 for a copy of BRS's complete response.

4. Auditor's Comments

BRS has agreed to correct most of the deficiencies identified in our condition. However, we do not believe these deficiencies are insignificant as opined by BRS.

The contractor has agreed in its response it failed to use current, accurate, and complete information in estimating proposed subcontract costs for Contract No. DAAA09-02-D-0007, Task Order No. 59. This failure is significant because Task Order No. 59 has an estimated total price of \$2.7 billion, and the subcontract costs constitute approximately \$1.7 billion of the proposed costs. Specifically, in our analysis shown in Appendix 1, we determined the difference in proposed amounts for food services as compared to negotiated subcontract amounts for seven purchases portrayed a material difference of \$67.3 million. These seven purchases were based on the negotiated number of troops estimated to be fed per day. In contrast, BRS's analysis was based on comparing proposed versus negotiated amounts for all 26 sites where food service would be provided. However, BRS did not use the negotiated troop strength with its vendors as the basis for its updated proposed amounts. Instead, it proposed the number of troops from its original proposal. For example at site B-1, BRS negotiated with the vendor 3,800 troops were to be fed but bid 4,800. Also, the 3,800 troops negotiated with the vendor and used by DCAA

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agree with the original statement of work. The impact of BRS’s approach for site B-1 compared to the DCAA approach shows a difference of \$6.4 million as shown below:

Analysis By	No. of Days	No. of Troops	Daily Cost	Total Cost
BRS	183	4,800	\$35.00	\$30,744,000
DCAA	183	3,800	\$35.00	\$24,339,000
Cost Difference				<u>\$ 6,405,000</u>

As the foregoing example shows, BRS did not use the negotiated number of troops which agrees with the original statement of work to compute its revised proposal amount. Also, BRS did not provide supporting data to show its proposed number of troops was based on current information. The result is BRS has proposed more subcontract costs than the data supports, thus its overall analysis shows a \$37 million difference between the original proposed and updated proposed amounts for subcontracts. However, a review of BRS’s revised proposal for Task Order No. 59 indicates proposed subcontract costs were reduced by approximately \$195 million for food services which is in accord with the DCAA position the condition cited above represents a significant estimating system deficiency.

Another important aspect making this a significant estimating system deficiency is the recurring nature of the deficiency. The DCAA Iraq Branch Office has determined BRS failed to utilize the most current, accurate and complete information in estimating proposed subcontract costs on other task order proposals under the LOGCAP III contract. The following schedule identifies other task orders and associated proposed costs for which the contractor did not use the most current, accurate, and complete cost or pricing data available prior to the proposal submission for estimating subcontract costs:

DAAA09-02-D-0007 Task Order Nos.	Proposed Subcontractor Costs
Proposal for Task Order 56	\$ 28,114,216
Proposal for Task Order 61	\$ 178,478,936
Proposal for Task Order 63	\$ 3,257,240
Proposal for Task Order 64	\$ 17,463,315
Total	<u>\$227,313,707</u>

The result is the estimating deficiency is not a one time occurrence; it is systemic. Therefore, due to the materiality of the issue and its systemic nature, we believe by not using current, accurate, and complete information in estimating proposed subcontract cost, the cited condition is a significant estimating system deficiency.

In reference to items 1 and 2 above, we concur with BRS’ response.

In reference to item 3 above, we determined the contractor was required to perform cost analysis. Several subcontracts were awarded based on sole source justification for food services. For instance, LaNouvelle/ESS was awarded a subcontract at site C-1 based upon sole source justification. The bid was for \$44.6 million for food services for 180 days. Support provided

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included a bid tabulation table, a justification memo, and a quote. The bid tabulation shows one bidder, LaNouvelle/ESS, who was awarded the contract based on sole-source justification. Even though the bid tabulation shows a comparison was performed to a prior purchase, no cost analysis was provided and no reference was made in the justification memo that a cost analysis was performed. This does not comply with the provisions of FAR 15.404-3 (b) (1) and FAR 15.408, Table 15-2, II Cost Elements, Paragraph A, which states contractors are to conduct appropriate cost analyses for all subcontracts when cost or pricing data are submitted by the subcontractor.

In reference to item 4 above, BRS' response implies the estimating manual does not apply to the condition cited above because the manual does not cover every possible contractual arrangement available to the government and the procedures can be tailored to individual project requirements. However, in this case BRS' estimating manual specifically addresses subcontract costs. Our review of the estimating procedures regarding subcontract requirements states BRS should "obtain all required cost/pricing data, including required certifications from the proposed vendor/subcontractor(s) as required by the RFP and certainly prior to agreement on price." This procedure is in accord with FAR and to tailor it for Task Order No. 59 is unnecessary. In addition, BRS provides no basis for not following company estimating procedures. BRS does not identify any extenuating circumstances warranting a major departure from its estimating procedures and the FAR. Neither does BRS provide justification that exempts it from following its own estimating procedures. BRS also does not identify any project-specific estimating procedures which it is relying on to compile estimated subcontract and other proposed costs. Therefore, since BRS' estimating manual addresses subcontract costs and no valid reason for deviating from the manual was provided, we believe BRS should comply with its own Cost Estimating Manual.

In summary, we believe our recommendations above should be fully implemented by BRS. The company is expected to comply with all provisions of FAR, including FAR 15.408, Table 15.2, and the provisions of its estimating manual.

This report is limited to the cited deficiency. Accordingly, we express no opinion on the adequacy of the contractor's estimating system internal controls taken as a whole.

Within approximately three months we will perform a follow-up audit on the contractor's estimating system internal controls to determine the status of the cited deficiencies, the status of the contractor's corrective action, and the impact of the deficiencies on the overall adequacy of the contractor's estimating system internal controls taken as a whole.

We discussed our findings with Mr. William Walter, Director, Government Compliance, BRS, Government Operations, in a teleconference on November 13, 2003. We provided the contractor a draft copy of this report on November 17, 2003. The contractor's written response is included in its entirety in Appendix 2.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

Kellogg Brown & Root, Inc. (KBR), also known as the Engineering and Construction Group (E&C), is one of the two operating subsidiaries of Halliburton. The other subsidiary is Halliburton's Energy Services Group (ESG). KBR consists of several segments which include Brown & Root Services (BRS) and other KBR Commercial units. The legal structure of Halliburton is different from its operational structure. Halliburton owns all the stock of DII Industries, LLC (DII). DII in turn owns all the stock of numerous Halliburton legal entities including KBR.

Halliburton's segments are organized around the products and services provided to the customers they serve. The ESG provides a broad array of products and services to upstream oil and gas customers worldwide, ranging from the manufacturing of drill bits and other down hole and completion tools and pressure pumping services to subsea engineering. The E&C under KBR deals with large-scale construction projects including construction and designing of oil and gas processing and refining plants, production facilities, and onshore and offshore pipelines. KBR's non-energy business meets the engineering and construction needs of governments and civil infrastructure customers.

KBR revenues were approximately \$5.736 billion (B) in contractor fiscal year (CFY) 2002 and \$5.235B in CFY 2001, or about 46 percent of Halliburton Company's total revenue of \$12.572B for CFY 2002 and about 40 percent of \$13.046B for CFY 2001. KBR's operating loss for CFY 2002 was \$685 million (M) and income for CFY 2001 was \$111M. Halliburton's total operating loss for CFY 2002 was \$112M and operating income for CFY 2001 was \$1.084B.

BRS consists of two operating segments that perform government contracts, Brown & Root Service Operations (BRSO) and KBR Civil Infrastructure (KBRCI). BRSO is the primary government segment that provides engineering, construction, operation, and maintenance services for the Air Force, Army, Navy, and NASA. It also provides logistical support services for the U.S. troops in foreign countries through contracts with the Army Corps of Engineers and Army Material Command. BRSO also operates as Management Logistics, Inc. (MLI) to perform projects with a union-represented work force.

KBRCI provides consulting and civil engineering services primarily for commercial projects. Projects include highways, bridges, stadiums, aviation and water and wastewater infrastructure, facilities modification, and on-call construction.

BRSO's CFY 2002 estimated costs incurred were approximately \$566M and for CFY 2001 costs incurred were approximately \$579M. For CFY 2003, costs are projected to increase to over \$1 billion. In CFY 2001, BRSO had 95 percent federal-government participation, of which 63 percent was cost reimbursable, 30 percent fixed-price work, and 2 percent time and material. KBRCI reported CFY 2001 revenues of \$95M with about 18 percent federal-government participation. Government participation was 10, 5, and 3 percent for cost

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reimbursable, time and material, and fixed-price contracts, respectively. The remaining 82 percent of KBRCI's costs was incurred on commercial contracts.

Effective in CFY 2003 a new subsidiary, KBR Services, Inc. (KBRSI), has been formed to include most government contracts. Under KBRSI, BRSO and KBRCI will remain the operating segments for the performance of government contracts.

In CFY 2002, corporate home office expenses such as executive management, accounting, communications, human resources, information technology, legal, risk management, and taxes were allocated to operating segments using the three-factor formula. Effective January 2003, a majority of corporate expenses were specifically identified either to KBR or ESG. The only expenses currently allocated using the three-factor formula from the Corporate home office are HALCO 21 costs relating to SAP software implementation and state taxes. Specific Corporate costs now identified to KBR are charged into the Intermediate Management III (IM-III) Home Office. IM-III provides management support, accounting, and business acquisition functions for all KBR's business units. The residual expenses for these services are allocated to the following business units using the three-factor formula: BRSO, KBRCI, Government Operations United Kingdom (UK) and Asia Pacific (AP), Commercial Infrastructure Americas, Commercial Infrastructure United Kingdom and Asia Pacific, and KBR Other Commercial.

Government OPS Intermediate Management II (IM-II) Home Office provides global business unit management and accounting and sales and marketing functions. Residual expenses are allocated to BRSO and Government Operations UK and AP using the three-factor formula.

Americas BRS Intermediate Management I (BRS IM-I) Home Office provides various functions including accounting, human resources, information technology, sales and marketing, government compliance, quality, and contract administration. The costs associated with these functions are allocated to only BRSO except for government compliance which is also allocated to KBRCI using the three-factor formula.

Infrastructure Intermediate Management II Home Office provides business unit management and accounting and finance to the Infrastructure business unit. Residual expenses are allocated to KBRCI and Commercial Infrastructure United Kingdom and Asia Pacific.

The Americas Infrastructure Intermediate Management I Home Office provides business unit management, accounting and finance, and chief engineer functions to the America Infrastructure activities. Residual expenses are allocated only to KBRCI.

2. Systems

a. Accounting System

We are currently performing a comprehensive review of the accounting system and expect to issue the report in the near future. KBR's accounting period is from January 1 to December 31. KBR's accounting system was developed in-house in 1983 and was specifically

designed for commercial use. The accounting system accumulates direct cost under individual project numbers but does not allocate indirect costs to its final cost objective. Therefore, KBR's Government Compliance department develops its indirect cost pools and bases from data runs generated by the accounting system and as required they adjust the financial data to comply with FAR and CAS requirements.

BRSO has one overhead pool and a G&A pool that allocates to final cost objectives. Overhead pool costs consist of indirect labor and associated burdens and benefits, consultants, relocation, travel, facility costs, supplies, data processing, engineering services, professional services, and other indirect type expenses. The Overhead pool costs are allocated over a prime cost base consisting of direct labor, fringe benefits, materials, equipment, subcontractor, and other direct cost. The G&A pool consist of costs from home office allocations and bid and proposal costs. Home office costs consist of allocations from Intermediate Management III, Intermediate Management II, and Intermediate Management I. The G&A pool costs are allocated over a total cost input (TCI) base.

KBRCI has two overhead pools, a use and occupancy pool, and a G&A pool. The two overhead pools, the Professional Services and Construction, are organized by function. Both overhead pools consist of indirect labor and associated burdens and benefits, consultants, relocation, travel, supplies, data processing, engineering services, professional services, and other indirect type expenses. The use and occupancy pool consists of communications and facility costs. The overhead pools and use and occupancy pool costs are allocated using a direct labor base. The G&A pool consist of costs from home office allocations and bid and proposal costs. Home office costs consist of allocations from Intermediate Management III, Intermediate Management I, Infrastructure Intermediate Management II, and Infrastructure Intermediate Management I. The G&A pool costs are allocated over a direct labor base.

b. Estimating System

BRS' estimating system was reported as generally adequate in Audit Report No. 3521-2001D24010001, dated August 20, 2002. However, due to the condition cited in this report, we assess the risk associated with proposed subcontract costs to be high. For all other elements of costs, we assess risk as low in relation to contract pricing actions.

BRS currently has about 18 employees who work in the Estimating Department. The Estimating Department begins preparing a proposal after the KBR Interest Review Committee, usually consisting of Business Development, Legal and Contract functions, has evaluated and decided to bid on a request for a proposal. Estimating is responsible for preparing the proposal, including the development of direct cost estimates and applying the latest indirect rates and factors. BRS' detailed estimating policies and procedures are described in its "BRS Cost Estimating Manual – Revision 12/1/2000."

c. Procurement Policies, Procedures, and Practices

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The ACO extended approval of KBR's Government Purchasing System effective April 30, 2001. The approval will continue in effect until the ACO withdraws the approval.

d. Compensation System

DCAA considers BRS' compensation system adequate to provide reasonable employee compensation costs to government contracts in accordance with FAR 31.205-6(a) and FAR 31.205-6(b). BRS' compensation system is based on a flow of authority and incorporated periodic compliance reviews, including written policies and procedures, and training for compensation administration employees.

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

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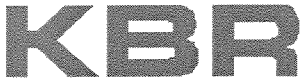
**Listing of Subcontracts Awarded Prior to Issuance of Task Order No. 59 Proposal
on October 7, 2003**

<u>Subcontract No.</u>	<u>Scope of Work/Site</u>	<u>Proposed Amount</u>	<u>Awarded Subcontract Amount</u>	<u>Difference</u>	<u>Award Date</u>
KU-MA00009 Work Release 3	Food Service Camp Site C-5 (Gunner)	\$ 24,906,081	\$ 18,576,000	\$ 6,330,081	July 12, 2003
KU-MA00007 Work Release 3	Food Service Camp Site D-6	26,064,504	17,581,046	8,483,458	July 4, 2003
KU-MA00003 Work Release 2	Food Service Camp Site E	46,336,896	12,806,852	33,530,044	June 19, 2003
KU-MA00007 Work Release 2	Food Service Camp Site C-3	27,802,137	24,793,193	3,008,944	June 19, 2003
KU-MA00009 Work Release 1	Food Service Camp Site B-1	27,802,137	23,940,000	3,862,137	July 1, 2003
KU-MA00007 Work Release 4	Food Service Camp Site D-7	19,693,181	16,348,870	3,344,311	July 4, 2003
KU-MA00004 Work Release 5	Food Service Camp Site H-2	<u>36,212,284</u>	<u>27,470,707</u>	<u>8,741,577</u>	August 6, 2003
	Total	<u>\$208,817,220</u>	<u>\$141,516,668</u>	<u>\$67,300,552</u>	

CONTRACTOR'S RESPONSE



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December 4, 2003

William F. Daneke
Branch Manager
Defense Contract Audit Agency
Arlington Branch Office
Arlington, TX 76006-6223

Dear Mr. Daneke:

The purpose of this letter is to respond to your draft audit report regarding the Task Order 59 cost proposal under Audit Report No. 3311-2004D24010001. Based on the comments contained in the report, we provide the following responses:

DCAA Comment #1: Based on our preliminary audit, we noted BRS did not use the most current, accurate and complete cost or pricing data available prior to the proposal submission to estimate subcontract cost proposed for Contract No. DAAA09-02-D-0007, Task Order No. 0059. The proposed costs for Task Order 59 (thru Change Order 4) are approximately \$2.7 billion of which approximately \$1.7 billion relates to proposed subcontract costs. Specifically, the proposal did not contain current, accurate, and complete data regarding subcontract costs. For instance, KBR proposed \$208.8 million for food services at seven sites in their October 7, 2003 proposal without disclosing, referencing, or mentioning the fact they had already issued subcontracts for these sites in June – August 2003 totaling \$141.5 million. As such, subcontract costs for the seven sites alone were overstated by \$67.3 million. In addition, BRS did not disclose the termination of two subcontracts, proposed at \$70 million, with KCPC/Morris for food services at sites C-1 and C-2. These two subcontracts were the basis for over \$1 billion of projected food service costs for 26 sites. The proposal submitted to the Government on October 7, 2003 made no mention of the actual negotiated values with KCPC/Morris nor did BRS inform the government they had terminated the KCPC/Morris subcontract for default on or around July 31, 2003.

In our opinion, we believe the deficiencies described above and detailed on Attachment 1 represent indicators of potentially significant estimating deficiencies as described in DFARS 215.407-5-70 (d) (3). Specifically, BRS estimators did not utilize relevant historical experience (e.g. use actual subcontracts issued) in preparing their estimates for subcontract food service costs. Also, management reviews of the proposal failed to identify that data readily available to the company was not used in the proposal submitted to the Government.

KBR Response: KBR agrees with the DCAA position that in the initial preparation of the proposal for TO 59, we did not use current, accurate and complete information that was available for pricing of subcontracts.

There are many excuses and reasons available – but – in the end, KBR did not include the most current data in our proposal. During the audit of this proposal, DCAA raised this issue and requested that KBR provide current cost or pricing data on selected subcontracts by November 7, 2003. KBR prepared and provided the DCAA with a comprehensive package of current cost or pricing data regarding the issues raised regarding the proposed subcontract costs – by the due date. In the response, we disclosed the fact that the vendor used by the estimators as the basis of estimate was terminated for default by KBR.

Note: Based on the information provided to the DCAA, the difference between the proposed cost of total dining facility costs and the amount using the current, accurate and complete data provided was a total of \$37M over a total food service cost proposed of \$1,179M – a difference of 3% as opposed to the DCAA's calculation of \$67.3M over 7 sites estimated at \$208.8M – a difference of 32%.

Although the additional information demonstrates that the use of the single vendor price for the project produced an estimated value that was within 3% of the total, we concur with the DCAA that the estimators should have taken the steps to obtain the more current data obtained during our “sweep” required by the DCAA prior to November 7, 2003.

We would also like to take this time to identify that this issue is not a “significant estimating system deficiency” as stated in the DCAA draft report. Rather, this was a unique situation due to the significant cost, amount of data and volume of effort that was associated with the TO 59 proposal. With earlier proposals prepared on the LOGCAP program, this was not an issue identified by the DCAA. For non-contingency proposals such as Ft. Leonard Wood and Bluegrass issued earlier this year, these issues did not arise either.

To avoid this issue on future LOGCAP proposals, KBR will establish a “cut-off date”, perform a “sweep” with procurement and other significant functions before the cost proposals are submitted in an attempt to identify, for those subcontracts that exceed \$550,000, the most current information available which we will incorporate into the cost proposal.

DCAA Comment #2: We also found the proposal for Contract No. DAAA09-02-D-0007, Task Order No. 0059 does not comply with the requirements of FAR 15.408, Table 15-2. Specifically, FAR 15.408 Table 15-2 requires:

- the contractor to submit, with its proposal, cost or pricing data (that is, data that are verifiable and factual and otherwise as defined at FAR 2.101).
- the contractor to provide a consolidated priced summary of individual material quantities included in the various tasks, orders, or contract line items being proposed and the basis for pricing (vendor quotes, invoice prices, etc.).
- the contractor to provide data showing the degree of competition and the basis for establishing the source and reasonableness of price for those acquisitions (such as subcontracts, purchase orders, material order, etc.) exceeding, or expected to exceed, the appropriate threshold;

KBR Response: Based on discussions with the DCAA, these issues were raised by the auditor at the entrance conference for the TO59 proposal. At that time, KBR prepared a consolidated summary of the subcontractors proposed identifying if the subcontracts were competitively awarded or not. In future LOGCAP proposals, KBR agrees to provide the DCAA with consolidated spreadsheets for subcontracts, equipment, ODC's and materials which can be sorted by the auditor on a number of fields to facilitate their review.

DCAA Comment #3: [FAR 15.408 Table 15-2 requires:] the contractor to conduct price analyses of all subcontractor proposals and to include the analyses as part of its own cost or pricing data submissions for subcontracts expected to exceed the appropriate threshold. The contractor did not perform prior to the award, the price analysis as required by FAR 15.404-3 to determine the reasonableness of subcontractor's proposed cost on the following purchases:

<u>Subcontract No.</u>	<u>Subcontractor</u>	<u>Date of Subcontractor Proposal</u>	<u>Award Date</u>
KU-MA00009, Work Release #3	Daoud & Partners	July 1, 2003	July 12, 2003
KU-MA00007, Work Release #3	LaNouvelle/ESS	June 25, 2003	July 4, 2003

KBR Comment: KBR does not agree with the DCAA position. As discussed in our response on November 7, 2003, the KBR procurement staff used a multiple award IDIQ proposal process which resulted in several bidders for the food service subcontracts. Based on the process of a multiple award process, there are generally multiple bidders for each site, however there may be times where only one bid is received. The procurement staff uses comparable bids on other site work releases to perform a price

reasonableness analysis. Per FAR 15.404-1(b)(2) the primary price analysis techniques include the comparison of competitive offers in response to the instant solicitation or the comparison of previously proposed prices and current proposed prices for the same or similar items. These tests were met by KBR procurement. Price is not the only factor involved in making an award decision as schedule and availability are also critical to the successful bidder.

DCAA Comment #4: [FAR 15.408 Table 15-2 requires:] the contractor to conduct cost analyses for all subcontracts when cost or pricing data are submitted by the subcontractor;

KBR Comment: No cost analysis was required in evaluation of the proposed subcontractors on this proposal. KBR strives to obtain competition or obtain commercial items to the maximum extent practical. If cost analysis is required per FAR 15.403, KBR procurement policies require cost analysis be performed and those results and analysis will be included in the procurement file which is available to the DCAA for review at the site of the procurement office performing the work.

DCAA Comment #5: [FAR 15.408 Table 15-2 requires:] The judgmental factors applied and the mathematical or other methods used in the estimate, including those used in projecting from known data;

KBR Comment: In the past, KBR provided brief explanations of factors and methods used in computing cost estimates and estimators assumed that the inclusion of a formula in an Excel[®] worksheet was satisfactory. As included in our November 7th submission. KBR will attempt to provide a clearer explanation in future cost proposals.

DCAA Comment #6: [FAR 15.408 Table 15-2 requires:] the contractor to include the name and address of the offeror (subcontractor) in its proposal; and the contractor to include the type of subcontract action in its proposal (that is, new contract, change order, price revision/redetermination, letter contract, unpriced order, or other).

KBR Comment: As discussed in response to DCAA Comment #2 above, this information, if available, will be included in the consolidated table of subcontracts.

DCAA Comment #7: In addition, we determined the contractor is in noncompliance with its Cost Estimating Manual (KBR Government Operations Cost Estimating Manual Section 17.0 - Subcontract Costs, dated July 2002) which also addresses the items described above, specifically those related to documentation of recommended subcontractor source selection and performance of subcontract cost/price analyses.

KBR Comment: The Managing Statement to the Cost Estimating manual states that the manual “guidelines are intended to provide general estimating procedures

Mr. Bill Daneke
DCAA – Arlington Branch Office
December 4, 2003
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normally found in Government contracts. However these guidelines are not intended to cover every possible type of cost or fixed-price arrangement available to the Government. These procedures should be tailored and implemented to the individual project contract requirements as established by the various Government Clients.”

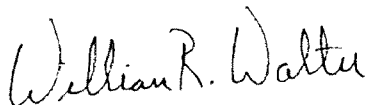
Further, FAR 15.403-5(b)(1) provides that a proposal can be submitted in the “format specified in FAR table 15-2 of FAR 15.408, specify an alternative format, or permit submission in the contractor’s format.” Since the beginning of the contract, and as a carryover from prior contingency contracts, the cost proposal format presented has been used for preparing cost proposals for contingency operations. Proposals submitted under this format have been audited and evaluated over the past 12 months. Accordingly, KBR has not had any reason to change the proposal format until the significant issues that TO59 generated.

KBR does not concur that with the DCAA position that this issue is a “significant estimating system deficiency” This situation was a unique situation due to the significant cost and volume of effort that was associated with the TO 59 proposal.

However, in meeting with DCAA auditors this morning, KBR proposed that we work together on the update to the TO59 to obtain an acceptable format and process for developing and evaluating this and future cost proposals under contingency programs. We look forward to achieving a mutually acceptable plan to move forward on this most important program.

Should you have any questions regarding this matter, please feel free to contact me at bill.walter@halliburton.com, at (713) 753-4931 or my cell phone (703) 627-1007.

Sincerely,



William R. Walter
Director, Government Compliance

cc: Mr. Gary Catt, Supervisory Auditor, DCAA
Ms. Catharina Ignacio, CACO, DCMA
Mr. Al Neffgen, Chief Operating Officer, KBRSI
Mr. Bob Herndon, Vice-President, KBRSI

OTHER MATTERS TO BE REPORTED

Halliburton reported in its Securities and Exchange Commission (SEC) filing dated June 30, 2003 and on its corporate web site that in December 2002 it reached an agreement in principle to settle asbestos and silica litigation of claimants against its subsidiaries DII Industries and Kellogg Brown & Root and their current and former subsidiaries with United States operations. Subsequently, in 2003, DII Industries and Kellogg Brown & Root entered into a definitive written agreements finalizing the terms of the agreements in principle with attorneys representing more than 95% of the current asbestos and silica claimants. The settlement consists of up to \$2.775 billion in cash (limited to this amount as of November 6, 2003), 59.5 million shares of Halliburton stock, and notes with a net present value for less than \$100 million, or approximately \$4 billion in total. The plan intends to resolve fully and permanently all personal injury asbestos and silica liabilities against the company for all present claims and future claims.

In addition, the company has entered into Chapter 11 Bankruptcy filings for Dresser Industries, Inc. and Kellogg Brown & Root. Halliburton Company, Halliburton Energy Services, Inc., Landmark Graphics Corporation, BRS's U.S. Government operations business and most other Halliburton subsidiaries will not be included in the filing. The Chapter 11 Bankruptcy filing has been "prepackaged" in that the company has already obtained agreement from all the affected creditor groups on the Plan. The company asserts that such Pre-packaged filings differ significantly from other Chapter 11 filings since the outcome is much more certain, because all affected parties have agreed in advance to the Plan of Reorganization. Contractor representatives indicate the company will remain financially strong, and all BRS contracts, which include government contracts, will be fully honored and all obligations performed. According to contractor representatives, there will be no impact to employees, all creditors will be paid in full, and there will be no effect on present or future projects. Also, a new subsidiary, BRS Services, Inc., would be formed to include all government contracts.

According to Halliburton June 30, 2003 SEC filing there were 425,000 open claims pending against Halliburton. Total open claims have increase by 78,000 since December 31, 2002. But Halliburton states it has factored all claims into the calculation of its asbestos liability. Halliburton asserts it manages asbestos claims to achieve settlement of valid claims for reasonable amounts. On November 18, 2003, DII Industries, Kellogg Brown & Root, and other affected subsidiaries have completed amendments to documents implementing the companies' planned asbestos and silica settlement and are mailing supplemental solicitation materials to asbestos and silica creditors in connection with voting on the amended plan of reorganization. The Company also announced that the proposed filing entities have set December 11, 2003 as the deadline for voting, or changing votes, on the proposed plan. Of the votes validly cast, over 98 percent of asbestos claimants and over 99 percent of silica claimants have voted to accept the proposed plan of reorganization. However, at this time, since all the requirements surrounding the bankruptcy have not been finalized, we do not know what effect, if any, this will have on the cost of government contracts.