

SIGAR

**Special Inspector General for
Afghanistan Reconstruction**

SIGAR 18-27 Financial Audit

Department of the Army's Spare Parts
Procurement and Repair Contract: Audit of
Costs Incurred by Lockheed Martin
Integrated Systems

**In accordance with legal requirements, SIGAR has redacted certain information deemed
proprietary or otherwise sensitive from this report.**



JANUARY
2018

SIGAR

Special Inspector General for Afghanistan Reconstruction

WHAT THE AUDIT REVIEWED

On September 30, 2009, the U.S. Army Space and Missile Defense Command (USASMDC) awarded a \$14.3 million contract to Lockheed Martin Integrated Systems (Lockheed) to procure and make repairs to spare parts for the Afghan Ministry of Defense's and Ministry of Interior's aircraft. The contract has been modified 60 times, increasing the total contract amount to \$503 million and extending the period of performance through December 31, 2016.

SIGAR's financial audit, performed by Mayer Hoffman McCann (MHM), reviewed \$50,224,601 in reimbursable costs incurred on the contract between September 28, 2013, and September 28, 2015. The objectives of the audit were to: (1) identify and report on significant deficiencies and material weaknesses in Lockheed's internal controls related to the contract; (2) identify and report on instances of material noncompliance with the terms of the contract and applicable laws and regulations, including any potential fraud or abuse; (3) determine and report on whether Lockheed has taken corrective action on prior findings and recommendations; and (4) express an opinion on the fair presentation of Lockheed's Special Purpose Financial Statement. See MHM's report for the precise audit objectives.

In contracting with an independent audit firm and drawing from the results of the audit, SIGAR is required by auditing standards to review the audit work performed. Accordingly, SIGAR oversaw the audit and reviewed its results. Our review disclosed no instances where MHM did not comply, in all material respects, with U.S. generally accepted government auditing standards.

January 2018

Department of the Army's Spare Parts Procurement and Repair Contract: Audit of Costs Incurred by Lockheed Martin Integrated Systems

SIGAR 18-27-FA

WHAT THE AUDIT FOUND

MHM identified one significant deficiency in Lockheed's internal controls and one instance of noncompliance with the terms and conditions of the contract. Specifically, MHM concluded that Lockheed had over-charged the government for the contract's fixed fee. Of two possible approaches for calculating the fixed fee, MHM concluded that the approach Lockheed used was neither supported by contract language nor consistent with the nature of the services provided. Based on the actual costs, the fixed fee amount should have been only [REDACTED], which was \$2,095,547 less than what Lockheed charged to the federal government.

Because of the internal control deficiency and instance of noncompliance, MHM identified \$2,095,547 in total questioned costs, consisting entirely of ineligible costs—costs prohibited by the contract, applicable laws, or regulations. MHM did not identify any unsupported costs—costs not supported with adequate documentation or that did not have required prior approval.

Category	Ineligible	Unsupported	Total Questioned Costs
Fixed Fee	\$2,095,547	\$0	\$2,095,547
Totals	\$2,095,547	\$0	\$2,095,547

MHM reviewed prior audit reports pertinent to Lockheed's activities under the contract and identified one finding that could have had a material effect on the Special Purpose Financial Statement. Based on the results of its testing, MHM determined that Lockheed has taken adequate corrective action to address the finding.

MHM issued a qualified opinion on Lockheed's statement because the \$2,095,547 in questioned costs was considered to be material to the Special Purpose Financial Statement.

WHAT SIGAR RECOMMENDS

Based on the results of the audit, SIGAR recommends that the responsible contracting officer at USASMDC:

- 1. Determine the allowability of and recover, as appropriate, \$2,095,547 in questioned costs identified in the report.**
- 2. Advise Lockheed to address the report's internal control finding.**
- 3. Advise Lockheed to address the report's noncompliance finding.**



SIGAR

Office of the Special Inspector General
for Afghanistan Reconstruction

January 26, 2018

The Honorable James N. Mattis
Secretary of Defense

The Honorable Mark T. Esper
Secretary of the Army

General Joseph L. Votel
Commander, U.S. Central Command

General John W. Nicholson, Jr.
Commander, U.S. Forces–Afghanistan and
Commander, Resolute Support

We contracted with Mayer Hoffman McCann (MHM) to audit the costs incurred by Lockheed Martin Integrated Systems (Lockheed) under a U.S. Army Space and Missile Defense Command (USASMDC) contract to purchase and make repairs to spare parts for the Afghan Ministry of Defense's and Ministry of Interior's aircraft.¹ MHM's audit covered \$50,224,601 in expenditures charged to the contract between September 28, 2013, and September 28, 2015. Our contract required that the audit be performed in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States.

Based on the results of audit, SIGAR recommends that the responsible contracting officer at USASMDC:

- 1. Determine the allowability of and recover, as appropriate, \$2,095,547 in total questioned costs identified in the report.**
- 2. Advise Lockheed to address the report's internal control finding.**
- 3. Advise Lockheed to address the report's noncompliance finding.**

The results of MHM's audit are in the attached report. We reviewed the report and related documentation. Our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on Lockheed's Special Purpose Financial Statement. We also express no opinion on the effectiveness of Lockheed's internal control or compliance with the contract, laws, and regulations. MHM is responsible for the attached auditor's report and the conclusions expressed in it. However, our review disclosed no instances where MHM did not comply, in all material respects, with generally accepted government auditing standards issued by the Comptroller General of the United States.

We will be following up with your agency to obtain information on the corrective actions taken in response to our recommendations.

John F. Sopko
Special Inspector General
for Afghanistan Reconstruction

(F-101)

¹ USASMDC awarded contract number W9113M-07-D-0006, task order 0032 to Lockheed.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
Afghan Air Force (AAF) Spare Parts Surge
Buy in Support of the Afghan Security Forces (ASF)

For the Period September 28, 2013 through September 28, 2015

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

For the Period September 28, 2013 through September 28, 2015

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Mayer Hoffman McCann P.C.
An Independent CPA Firm

2301 Dupont Drive, Suite 200 ■ Irvine, CA 92612
Main: 949.474.2020 ■ Fax: 949.263.5520 ■ www.mhmcpa.com

January 4, 2018

Enclosed is the final report on the financial audit of costs incurred by Lockheed Martin Integrated Systems, Inc. ("Lockheed") under Contract No. W9113M-07-D-0006-0032 Modifications 47, 48, 49, 50, 51, 52 and 53 ("Contract") for the Afghan Air Force Spare Parts Surge Buy in Support of the Afghan Security Forces. The audit covers the period September 28, 2013 through September 28, 2015.

Included within the final report is a summary of the work performed, our report on the Special Purpose Financial Statement, report on internal control and report on compliance, based on an audit of the Special Purpose Financial Statement performed in accordance with *Government Auditing Standards*. We do not express an opinion on the summary or any information preceding our reports.

When preparing our report, we considered comments, feedback and interpretations from Lockheed, the Special Inspector General for Afghanistan Reconstruction and the United States Army Space and Missile Defense Command. Management of Lockheed has prepared responses to the findings identified during our audit and those responses are included as part of this report. The responses have not been audited and we express no opinion on them.

Sincerely,

Mayer Hoffman McCann P.C.

A handwritten signature in blue ink, appearing to read "MD Davis", written over a horizontal line.

Marcus D. Davis, CPA
Shareholder

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

For the Period September 28, 2013 through September 28, 2015

Background

On September 30, 2009, the United States Army Space and Missile Defense Command ("USASMDC") entered into Contract Number W9113M-07-D-0006, Task Order 0032 ("Contract"), with Lockheed Martin Integrated Systems, Inc. ("Lockheed"), to provide Repair of Repairable (RoR) services and spare parts/material procurement in support of the Ministry of Defense, Afghan National Army Air Corps, and the Ministry of the Interior Counter-Narcotics Aviation Squadron's ("MOD ANAAC/MOI-CN AVN SQ") maintenance and repair operations. A repairable item is defined as an item that can be economically restored to a serviceable condition when it becomes unserviceable. The Contract required Lockheed to purchase spare parts and material required for the direct support of AN-26, AN-32, MI-17 and MI-35 aircraft and other aircraft obtained in the future by the MOD ANAAC/MOI CN AVN SQ. The original Contract amount was \$14,328,792, consisting of firm fixed and cost components. The original period of performance was from September 30, 2009 through August 23, 2010. The Contract has been modified 60 times through September 28, 2017, increasing the total contract amount to \$502,997,048, and extending the period of performance through December 31, 2016.

Modifications 47, 48, 49, 50, 51, 52 and 53 were added to provide funding for Contractor Logistics Support ("CLS"), spares, repairables, equipment, storage and transportation for the Special Mission Wing ("SMW") and the Afghanistan MOD. The additional funding provided for the maintenance or restoration of repair and replacement parts for aircraft used in critical missions to Authorized Stockage List ("ASL") levels. This inventory also included parts which required extended lead times for manufacture and delivery. Details of these modifications are as follows:

- Modification 47 was awarded on September 28, 2013 with an obligated amount of [REDACTED] and extended the period of performance through September 30, 2014.
- Modification 48 was awarded on September 26, 2014 with an obligated amount of [REDACTED] and extended the period of performance through September 28, 2015.
- Modification 49 was awarded on September 29, 2014 with an obligated amount of [REDACTED].
- Modification 50 updated some administrative terms within the Contract and did not provide additional funding.
- Modification 51 was awarded on January 28, 2015 with an obligated amount of [REDACTED].
- Modification 52 updated some administrative terms within the Contract and did not provide additional funding.
- Modification 53 was awarded on May 20, 2015 with an obligated amount of [REDACTED].

The total amount of funding added for Modifications 47, 48, 49, 50, 51, 52 and 53 was \$92,135,556 consisting of [REDACTED] in cost reimbursement and [REDACTED] in fixed fee.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
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For the Period September 28, 2013 through September 28, 2015

Lockheed Martin Corporation is a global security and aerospace company that is principally engaged in the research, design, development, manufacture, integration, and sustainment of advanced technology systems, and products. The majority of Lockheed Martin Corporation's business is with the U.S. Department of Defense and other U.S. federal government agencies.

Lockheed Martin realigned its business units, separating and combining certain business segments with Leidos Holdings, Inc. The Contract and modifications under audit are being novated to Leidos, but as of the date of this report, that process is not complete. Lockheed Martin's Missiles and Fire Control business unit was the lead internal performer on the contract components subject to audit.

Work Performed

Mayer Hoffman McCann P.C. ("MHM") was engaged by the Office of the Special Inspector General for Afghanistan Reconstruction ("SIGAR") to conduct a financial audit of Lockheed's Special Purpose Financial Statement ("SPFS") for the period September 28, 2013 through September 28, 2015. Total costs incurred by Lockheed and subject to audit during this period were \$50,224,601.

Objectives, Scope, and Methodology

Objectives Defined by SIGAR

The objectives of the audit include the following:

- *Special Purpose Financial Statement (SPFS)* – Express an opinion on whether Lockheed's SPFS for the Contract presents fairly, in all material respects, revenues received, costs incurred, items directly procured by the U.S. Government, and balance for the period audited in conformity with the terms of the Contract and generally accepted accounting principles or other comprehensive basis of accounting.
- *Internal Controls* – Evaluate and obtain a sufficient understanding of Lockheed's internal controls related to the Contract; assess control risk; and identify and report on significant deficiencies including material internal control weaknesses.
- *Compliance* – Perform tests to determine whether Lockheed complied, in all material respects, with the Contract requirements and applicable laws and regulations; and identify and report on instances of material noncompliance with terms of the award and applicable laws and regulations, including potential fraud or abuse that may have occurred.
- *Corrective Action on Prior Findings and Recommendations* – Determine and report on whether Lockheed has taken adequate corrective action to address findings and recommendations from

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Financial Audit of Costs Incurred Under
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For the Period September 28, 2013 through September 28, 2015

previous engagements that could have a material effect on the SPFS or other financial data significant to the audit objectives.

Scope

The scope of this audit included the cost plus fixed fee component of the Contract in the amounts of [REDACTED] and [REDACTED], respectively. These amounts represent the budgeted ceiling for cost reimbursement, not the actual amount incurred and reimbursed. Our testing of the overhead rates was limited to verifying that the overhead rates were calculated using the rates approved by the Defense Contract Management Agency ("DCMA").

Methodology

In order to accomplish the objectives of this audit, we designed our audit procedures to include the following:

Entrance Conference

An entrance conference was held via conference call on February 28, 2017. Participants included MHM, Lockheed, Leidos, SIGAR and the USASMDC.

Planning

During our planning phase, we performed the following:

- Obtained an understanding of Lockheed;
- Reviewed the Contract and all modifications to date;
- Reviewed sections of the Federal Acquisition Regulation ("FAR") and the Defense Federal Acquisition Regulation Supplement ("DFARS") as applicable to the Contract;
- Performed a financial reconciliation; and
- Selected samples based on our approved sampling techniques. According to the approved Audit Plan, we used the detailed accounting records that were reconciled to the financial reports, and based upon the risk assessment and materiality included as part of the approved Audit Plan, we performed data mining to assess individual expenditure accounts and transactions that were considered to be high, medium or low risk for inclusion in our test of transactions. None of the populations were homogeneous in nature, thus statistical sampling was not used. All samples

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
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Modifications 47, 48, 49, 50, 51, 52 and 53
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For the Period September 28, 2013 through September 28, 2015

were selected on a judgmental basis. Our sampling methodology for judgmental samples was as follows:

- For accounts that appear to contain unallowable and restricted items according to the terms of the Contract, Federal Acquisition Regulation (FAR) and any other applicable regulations, we sampled 100% of the transactions.
- For high risk cost categories, we sampled individual transactions greater than \$251,100 not to exceed 50% of the total amount expended for each cost category.
- For medium risk categories, we sampled transactions greater than \$502,200 not to exceed 20% of the total amount expended for each cost category.
- For low risk categories, we sampled transactions greater than \$502,200 not to exceed 10% of the total amount expended for each cost category, not to exceed 50 transactions in total for all accounts comprising low risk categories.

Internal Control Related to the SPFS

We reviewed Lockheed's internal controls related to the SPFS. The system of internal control is intended to provide reasonable assurance of achieving reliable financial reporting and compliance with applicable laws and regulations. We corroborated internal controls identified by Lockheed and conducted testing of select key controls to understand if they were implemented as designed and operating effectively.

Compliance with Contract Requirements and Applicable Laws and Regulations

We reviewed the Contract and modifications and documented all compliance requirements that could have a direct and material effect on the SPFS. We assessed inherent and control risk as to whether material noncompliance could occur. Based upon our risk assessment, we designed procedures to test a sample of transactions to ensure compliance with the Contract requirements and laws and regulations.

Corrective Action on Prior Findings and Recommendations

We requested all reports from previous engagements, as well as searched publicly available information for other reports, in order to evaluate the adequacy of corrective actions taken on findings and recommendations that could have a material effect on the SPFS. See the Review of Prior Findings and Recommendations subsection of this Summary for this analysis.

Special Purpose Financial Statements

In reviewing the SPFS, we performed the following:

- Reconciled the costs on the SPFS to the Contract, modifications and general ledger;

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

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- Traced receipt of funds to the accounting records; and
- Sampled and tested the costs incurred to ensure the costs were allowable, allocable to the Contract and reasonable. If the results of a judgmental sample indicated a material error rate, our audit team consulted with our Audit Manager and Project Director as to whether the sample size should be expanded. If it appeared that based upon the results of the judgmental sample, an entire account was deemed not allowable, we did not expand our testing, but instead questioned the entire account.

Exit Conference

An exit conference was held on July 6, 2017 via conference call. Participants included MHM, Lockheed, Leidos, SIGAR and the USASMDC. During the exit conference, we discussed the preliminary results of the audit and established a timeline for providing any final documentation for consideration and reporting.

Summary of Results

Our audit of the costs incurred by Lockheed under the Contract with the USASMDC identified the following audit results. Findings are classified as either internal control, compliance, or a combination of internal control and compliance.

Auditor's Opinion on SPFS

We issued a qualified opinion on the fairness of the presentation of the SPFS. We also identified \$2,095,864 of questioned costs under the Contract. A summary of findings and questioned costs is as follows:

Summary of Findings and Questioned Costs

Finding Number	Nature of Finding	Matter	Questioned Costs	Total Cumulative Questioned Cost
2017-1	Internal control – significant deficiency	Excess fixed fee charged to Contract	\$2,095,547	\$2,095,547
	Compliance			

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
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For the Period September 28, 2013 through September 28, 2015

Internal Control Findings

Our audit discovered one internal control finding, which was considered to be a significant deficiency. See Independent Auditor's Report on Internal Control on page 17. The complete management response from Lockheed to the internal control findings can be found in Appendix A to this report.

Compliance Findings

As part of obtaining reasonable assurance about whether the SPFS is free from material misstatement, we performed tests of its compliance with certain provisions of the Contract and other laws and regulations, noncompliance with which could have a direct and material effect on the determination of the SPFS. The results of our tests disclosed one instance of noncompliance related to this audit. See Independent Auditor's Report on Compliance on page 19. The complete management response from Lockheed to the compliance findings can be found in Appendix A to this report.

Review of Prior Findings and Recommendations

We requested copies of prior engagements including audits, reviews and evaluations pertinent to Lockheed's activities under the Contract. In our review of five prior engagements we identified one finding that could have a material effect on the SPFS. We tested transactions and determined that Lockheed has taken adequate corrective action to address the finding. See the Status of Prior Findings on page 21 for a detailed description of the prior findings and recommendations.

Summary of Lockheed's Responses to Findings

The following represents a summary of the responses provided by Leidos, on behalf of Lockheed, to the findings identified in this report. The complete responses received can be found in Appendix A to this report.

- Finding Number 2017-1: Leidos disagrees with this finding stating that the modifications included in the scope of the audit should be classified as completion form instead of term form. Leidos believes that, based on their understanding of the contract and communication with the funding agency, their contract should be considered completion form. Under the completion form, Lockheed would be entitled to the entire fixed fee.
- Finding Number 2017-2: Leidos disagrees with this finding, indicating that the employees that were noted as not having background checks are long-time employees that were properly vetted based on existing regulations at the time of their hiring. Leidos acknowledged it was unable to provide certain historical employee data because it resides with Lockheed Martin, and Leidos is limited in what it is able to access under the acquisition. Leidos further argued that it is not

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required to retain employee records beyond the 4-year period prescribed by the FAR, and that E-Verify requirements do not apply to employees hired before 2007. Based upon our review of Leidos' disagreement, and our subsequent review of documentation provided in conjunction with the audit, we consider this finding to be resolved and have removed it from the report.



INDEPENDENT AUDITOR'S REPORT ON SPECIAL PURPOSE FINANCIAL STATEMENT

Lockheed Martin Integrated Systems
3000 Lincoln Drive
Marlton, New Jersey 08053

Office of the Special Inspector General for Afghanistan Reconstruction
2530 Crystal Drive
Arlington, Virginia 22202

Report on the Special Purpose Financial Statement

We have audited the accompanying Special Purpose Financial Statement of Lockheed Martin Integrated Systems, Inc. ("Lockheed") under Contract No. W9113M-07-D-0006-0032, Modifications 47, 48, 49, 50, 51, 52 and 53 ("Contract"), with the United States Army Space and Missile Defense Command ("USASMDC") for the Afghan Air Force Spare Parts Surge Buy in Support of the Afghan Security Forces for the period September 28, 2013 through September 28, 2015, and the related notes to the Special Purpose Financial Statement.

Management's Responsibility for the Special Purpose Financial Statement

Management is responsible for the preparation and fair presentation of the Special Purpose Financial Statement in accordance with the methods of preparation described in Note 2; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements (including the Special Purpose Financial Statement) that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the Special Purpose Financial Statement based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Special Purpose Financial Statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Special Purpose Financial Statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the Special Purpose Financial Statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Special Purpose Financial Statement in order to design audit procedures that are appropriate

Lockheed Martin Integrated Systems
3000 Lincoln Drive
Marlton, New Jersey 08053

Office of the Special Inspector General for Afghanistan Reconstruction
2530 Crystal Drive
Arlington, Virginia 22202

in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the Special Purpose Financial Statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

We identified questioned costs totaling \$2,095,547 that were ineligible based upon our review of the underlying support for the specified transactions and material to the Special Purpose Financial Statement. The questioned costs were due to Lockheed billing the entire amount of fixed fee per the Contract when only [REDACTED] of total estimated costs were actually incurred. The ultimate determination of whether the identified questioned costs are to be accepted or disallowed rests with the USASMDC.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Special Purpose Financial Statement referred to above presents fairly, in all material respects, the respective revenue received and costs incurred by Lockheed under the Contract for the period September 28, 2013 through September 28, 2015 in accordance with the basis of accounting described in Note 2.

Restriction on Use

This report is intended for the information of Lockheed Martin Integrated Systems, Inc., the United States Army Space and Missile Defense Command, and the Special Inspector General for Afghanistan Reconstruction ("SIGAR"), and is not intended to be and should not be used by anyone other than these specified parties. Financial information in this report may be privileged. The restrictions of 18 USC 1905 should be considered before any information is released to the public. However, subject to applicable laws, this report may be released to Congress and to the public by SIGAR in order to provide information about programs and operations funded with amounts appropriated or otherwise made available for the reconstruction of Afghanistan.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our reports dated January 4, 2018 on our consideration of Lockheed's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing

Lockheed Martin Integrated Systems
3000 Lincoln Drive
Marlton, New Jersey 08053

Office of the Special Inspector General for Afghanistan Reconstruction
2530 Crystal Drive
Arlington, Virginia 22202

and not to provide an opinion on internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Lockheed's internal control over financial reporting and compliance.

Davis Fark LLP

Irvine, California
January 4, 2018

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-01-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

Special Purpose Financial Statement

For the Period September 28, 2013 through September 28, 2015

	Budget	Actual	Questioned Costs			Notes
			Ineligible	Unsupported	Total	
Revenues:						
W9113M-01-D-006-0032	\$ 92,135,556	\$ 50,224,601	\$ -	\$ -	\$ -	(4)
Total revenues	<u>92,135,556</u>	<u>50,224,601</u>	<u>-</u>	<u>-</u>	<u>-</u>	
Costs incurred by CLIN:						
401801			-	-	-	(3),(5)
401802			-	-	-	(3),(5)
401803			-	-	-	(3),(5)
401804			-	-	-	(3),(5)
401805			-	-	-	(3),(5)
401901			-	-	-	(3),(5)
402001/402003			-	-	-	(3),(5)
402002/402004			-	-	-	(3),(5)
401902			-	-	-	(3),(5)
Fixed Fee			(2,095,547)	-	(2,095,547)	(6),(A)
Total costs incurred by CLIN	<u>92,135,556</u>	<u>50,224,601</u>	<u>(2,095,547)</u>	<u>-</u>	<u>(2,095,547)</u>	
Outstanding fund balance	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (2,095,547)</u>	<u>\$ -</u>	<u>\$ (2,095,547)</u>	(7),(B)

See Notes to Special Purpose Financial Statement
and Notes to Questioned Costs Presented on Special Purpose Financial Statement

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

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Notes to Special Purpose Financial Statement¹

For the Period September 28, 2013 through September 28, 2015

(1) **Background**

On September 30, 2009, the United States Army Space and Missile Defense Command ("USASMDC") entered into Contract Number W9113M-07-D-0006, Task Order 0032 ("Contract"), with Lockheed Martin Integrated Systems, Inc. ("Lockheed"), to provide Repair of Repairable (RoR) services and spare parts/material procurement in support of the Ministry of Defense, Afghan National Army Air Corps, and the Ministry of the Interior Counter-Narcotics Aviation Squadron's ("MOD ANAAC/MOI-CN AVN SQ") maintenance and repair operations. A repairable item is defined as an item that can be economically restored to a serviceable condition when it becomes unserviceable. The Contract required Lockheed to purchase spare parts and material required for the direct support of AN-26, AN-32, MI-17 and MI-35 aircraft and other aircraft obtained in the future by the MOD ANAAC/MOI CN AVN SQ. The original Contract amount was \$14,328,792, consisting of firm fixed and cost components. The original period of performance was from September 30, 2009 through August 23, 2010. The Contract has been modified 58 times through September 30, 2015, increasing the obligated ceiling amount to \$502,997,048, and extending the period of performance through September 30, 2015.

- Modification 47 was awarded on September 28, 2013 with an obligated amount of [REDACTED] and extended the period of performance through September 30, 2014.
- Modification 48 was awarded on September 26, 2014 with an obligated amount of [REDACTED] and extended the period of performance through September 28, 2015.
- Modification 49 was awarded on September 29, 2014 with an obligated amount of [REDACTED].
- Modification 50 updated some administrative terms within the Contract and did not provide additional funding.
- Modification 51 was awarded on January 28, 2015 with an obligated amount of [REDACTED].
- Modification 52 updated some administrative terms within the Contract and did not provide additional funding.
- Modification 53 was awarded on May 20, 2015 with an obligated amount of [REDACTED].

The total amount of funding added for Modifications 47, 48, 49, 50, 51, 52 and 53 was \$92,135,554 consisting of [REDACTED] in cost reimbursement and [REDACTED] in fixed fee.

¹The Notes to Special Purpose Financial Statement are the responsibility of Lockheed.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

Notes to Special Purpose Financial Statement

(Continued)

(2) **Summary of Significant Accounting Policies**

Basis of Presentation

The accompanying Special Purpose Financial Statement ("SPFS") includes costs incurred for the Afghan Air Force ("AAF") Spare Parts Surge Buy in Support of the Afghan Security Forces ("ASF") for the period September 28, 2013 through September 28, 2015. Because the SPFS presents only a selected portion of the operations of Lockheed, it is not intended to and does not present the financial position, changes in financial position, or cash flows of Lockheed. The information in the SPFS is presented in accordance with the requirements specified by the Special Inspector General for Afghanistan Reconstruction ("SIGAR"), accounting principles generally accepted in the United States of America, and is specific to the Contract.

Basis of Accounting

Expenditures reported on the SPFS are required to be presented in accordance with accounting principles generally accepted in the United States of America and, therefore, are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in Federal Acquisition Regulation ("FAR") Part 31 – *Contracts with Commercial Organizations*.

Currency

All amounts presented are shown in U.S. dollars, the reporting currency of Lockheed. Lockheed did not pay any amounts under the Contract in a foreign currency. Accordingly, no foreign conversion was required.

(3) **Contract Line Item Numbers**

The SPFS reports costs per Contract Line Item Number (CLIN). A description of those CLINs is as follows:

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
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AAF Spare Parts Surge Buy in Support of the ASF

Notes to Special Purpose Financial Statement

(Continued)

(3) **Contract Line Item Numbers (Continued)**

<u>CLIN</u>	<u>Description</u>
401801	SMW funding for CLS spares for Fiscal Year (FY) 2014 consisting of CLS spares, repairables, equipment, storage and transportation
401802	SMW funding for CLS spares for FY 2014 consisting of CLS spares, repairables, equipment, storage and transportation
401803	SMW funding for CLS spares for FY 2014 consisting of CLS spares, repairables, equipment, storage and transportation
401804	SMW funding for CLS spares for FY 2014 consisting of CLS spares, repairables, equipment, storage and transportation
401805	MOD funding for CLS spares for FY 2014 consisting of CLS spares, repairables, equipment, storage and transportation
410901	SMW funding for CLS spares for FY 2015 consisting of CLS spares, repairables, equipment, storage and transportation
402001/402003	AAF funding for CLS spares for FY 2015 consisting of CLS spares, repairables, equipment, storage and transportation
402002/402004	SMW funding for CLS spares for FY 2015 consisting of CLS spares, repairables, equipment, storage and transportation
401902	AAF funding for CLS spares for FY 2015 consisting of CLS spares, repairables, equipment, storage and transportation

Each of the above CLINs includes a fixed fee. However, the fixed fee has been aggregated and presented separately in the SPFS.

(4) **Revenue**

As of September 28, 2015, Lockheed has reported \$50,224,601 in revenue. This revenue equals the expenditures plus fixed fee invoiced to the USASMDC for the period September 28, 2013 through September 28, 2015.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
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AAF Spare Parts Surge Buy in Support of the ASF

Notes to Special Purpose Financial Statement

(Continued)

(5) Indirect Cost

Lockheed's indirect costs rates in effect during the period September 28, 2013 through September 28, 2015 are as follows. The rates were approved by the Defense Contract Management Agency (DCMA). Additionally, the indirect costs are not separately reported on the SPFS, but are reported as part of each individual CLIN.

<u>Rate Type</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
LMIS G&A – DoD			
LMIS G&A – non-DOD			
LMIS T&B			
Overhead (OH)			
Program Support Pool (PSP)			
MHX<\$100K			
LMPS G&A – DoD			
LMPS G&A – non-DoD			
Benefits & OH Rate			
LMIS G&A – Net			
LMPS G&A – Net			
LMIS PSP			
LMIS & LMPS MHX			
ACE IT PMO Pool			
LMIS Labor Pool			
MHX			

(6) Fixed Fee

The Contract modifications included a fixed fee for each CLIN. The SPFS was prepared to report the fixed fee in total as a separate cost category.

(7) Outstanding Fund Balance

As of September 28, 2015, there was no outstanding fund balance under the Contract as the SPFS is prepared under the accrual basis of accounting described in Note 2.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
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Notes to Special Purpose Financial Statement

(Continued)

(8) Subsequent Events

Lockheed has evaluated subsequent events through January 4, 2018, which is the date the SPFS was available to be issued. There were no subsequent events identified that would impact the SPFS as of this date.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

Notes to Questioned Costs Presented on Special Purpose Financial Statement²

For the Period September 28, 2013 through September 28, 2015

(A) Fixed Fee

Lockheed reported fixed fee in the amount of [REDACTED] for the period September 28, 2013 through September 28, 2015. During our audit of these costs, we noted that the fixed fee charged to the Contract was in excess of the allowable amount by \$2,095,547. See Finding Number 2017-1.

(B) Outstanding Fund Balance

The total outstanding fund balance as of September 28, 2015 in the amount of \$(2,095,864) represents the total questioned costs, consisting of \$2,095,547 of ineligible costs.

² The Notes to Questioned Costs presented on the Special Purpose Financial Statement were prepared by the auditor for informational purposes only and as such are not part of the audited Special Purpose Financial Statement.



**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
BASED ON AN AUDIT OF THE SPECIAL PURPOSE FINANCIAL STATEMENT
PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

INDEPENDENT AUDITOR'S REPORT

Lockheed Martin Integrated Systems
3000 Lincoln Drive
Marlton, New Jersey 08053

Office of the Special Inspector General for Afghanistan Reconstruction
2530 Crystal Drive
Arlington, Virginia 22202

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Special Purpose Financial Statement of Lockheed Martin Integrated Systems, Inc. ("Lockheed") representing revenues received and costs incurred under Contract No. W9113M-07-D-0006-0032, Modifications 47, 48, 49, 50, 51, 52 and 53 ("Contract"), with the United States Army Space and Missile Defense Command ("USASMD") for the Afghan Air Force Spare Parts Surge Buy in Support of the Afghan Security Forces for the period September 28, 2013 through September 28, 2015, and the related Notes to the Special Purpose Financial Statement, and have issued our report thereon dated January 4, 2018.

Internal Control over Financial Reporting

In planning and performing our audit of the Special Purpose Financial Statement, we considered Lockheed's internal control over financial reporting (internal control) to determine the audit procedures that were appropriate in the circumstances for the purpose of expressing our opinion on the Special Purpose Financial Statement, but not for the purpose of expressing an opinion on the effectiveness of Lockheed's internal control. Accordingly, we do not express an opinion on the effectiveness of Lockheed's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a

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combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify one deficiency in internal control, described in the accompanying Detailed Audit Findings as Finding Numbers 2017-1 that we consider to be a significant deficiency.

Lockheed's Response to Findings

Lockheed's response to the finding identified in our audit is included verbatim in Appendix A. Lockheed's response was not subjected to the auditing procedures applied in the audit of the Special Purpose Financial Statement and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the result of that testing, and not to provide an opinion on the effectiveness of Lockheed's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

This report is intended for the information of Lockheed Martin Integrated Systems, Inc., the United States Army Space and Missile Defense Command, and the Special Inspector General for Afghanistan Reconstruction ("SIGAR"), and is not intended to be and should not be used by anyone other than these specified parties. Financial information in this report may be privileged. The restrictions of 18 U.S.C. 1905 should be considered before any information is released to the public. However, subject to applicable laws, this report may be released to Congress and to the public by SIGAR in order to provide information about programs and operations funded with amounts appropriated or otherwise made available for the reconstruction of Afghanistan.



Irvine, California
January 4, 2018



Mayer Hoffman McCann P.C.

An Independent CPA Firm

2301 Dupont Drive, Suite 200 ■ Irvine, CA 92612
Main: 949.474.2020 ■ Fax: 949.263.5520 ■ www.mhmcpa.com

**REPORT ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF THE SPECIAL PURPOSE FINANCIAL STATEMENT
PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

INDEPENDENT AUDITOR'S REPORT

Lockheed Martin Integrated Systems
3000 Lincoln Drive
Marlton, New Jersey 08053

Office of the Special Inspector General for Afghanistan Reconstruction
2530 Crystal Drive
Arlington, Virginia 22202

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Special Purpose Financial Statement of Lockheed Martin Integrated Systems, Inc. ("Lockheed") representing revenues received and costs incurred under Contract No. W9113M-07-D-0006-0032, Modifications 47, 48, 49, 50, 51, 52 and 53 ("Contract"), with the United States Army Space and Missile Defense Command ("USASMD") for the Afghan Air Force Spare Parts Surge Buy in Support of the Afghan Security Forces for the period September 28, 2013 through September 28, 2015, and the related Notes to the Special Purpose Financial Statement, and have issued our report thereon dated January 4, 2018.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Lockheed's Special Purpose Financial Statement is free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and the aforementioned Contract, noncompliance with which could have a direct and material effect on the determination of Special Purpose Financial Statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. As we performed our testing, we considered whether the information obtained during our testing indicated the possibility of fraud or abuse. The results of our tests disclosed one instance of noncompliance or other matters that are required to be reported under Government Auditing Standards and which is described in the accompanying Detailed Audit Findings as Finding Number 2017-1.

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Lockheed's Response to Findings

Lockheed's response to the findings identified in our audit is included verbatim in Appendix A. Lockheed's response was not subjected to the auditing procedures applied in the audit of the Special Purpose Financial Statement and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

This report is intended for the information of Lockheed Martin Integrated Systems, Inc., the United States Army Space and Missile Defense Command, and the Special Inspector General for Afghanistan Reconstruction ("SIGAR"), and is not intended to be and should not be used by anyone other than these specified parties. Financial information in this report may be privileged. The restrictions of 18 U.S.C. 1905 should be considered before any information is released to the public. However, subject to applicable laws, this report may be released to Congress and to the public by SIGAR in order to provide information about programs and operations funded with amounts appropriated or otherwise made available for the reconstruction of Afghanistan.

Davis Fark LLP

Irvine, California
January 4, 2018

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF


Status of Prior Findings

For the Period September 28, 2013 – September 28, 2015

We requested copies of prior engagements including audits, reviews and evaluations pertinent to Lockheed's activities under the Contract. We reviewed the corrective actions taken to address findings and recommendations from prior engagements that could have a material effect on the SPFS. There were five prior engagements included in the scope of our audit. One of these engagements identified one finding with a potential material effect on the SPFS and/or control deficiencies effect on the Contract. Based on our review, adequate corrective action was implemented on this prior finding.

Defense Contract Audit Agency ("DCAA") Independent Audit Report on Lockheed's Proposed Amounts on Unsettled Flexibly Priced Contracts for Fiscal Year (FY) 2011

This audit performed by DCAA represented an audit of proposed direct and indirect amounts for contract reimbursement on unsettled flexibly priced contracts contained in its FY 2011 final indirect rate proposal.



LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

Detailed Audit Findings

For the Period September 28, 2013 – September 28, 2015

Finding 2017-1: Excess Fixed Fee

Nature of Finding:

Internal control – significant deficiency
Compliance

Criteria:

The individual CLINS within Contract No. W9113M-07-D-0006, Task Order 0032, Modifications 47, 48, 49, 50, 51, 52 and 53 all state that the “Fixed fee is [REDACTED].”

48 CFR 16.306, *Cost-plus-fixed-fee contracts*, states, in part:

“...(d) *Completion and term forms.* A cost-plus-fixed-fee contract may take one of two basic forms – completion or term.

(1) The completion form describes the scope of work by stating a definite goal or target and specifying an end product. This form of contract normally requires the contractor to complete and deliver the specified end product (e.g., a final report of research accomplishing the goal or target) within the estimated cost, if possible, as a condition for payment of the entire fixed fee. However, in the event the work cannot be completed within the estimated cost, the Government may require more effort without increase in fee, provided the Government increases the estimated cost.

(2) The term form describes the scope of work in general terms and obligates the contractor to devote a specified level of effort for a stated time period. Under this form, if the performance is considered satisfactory by the Government, the fixed fee is payable at the expiration of the agreed-upon period, upon contractor statement that the level of effort specified in the contract has been expended in performing the contract work. Renewal for further periods of performance is a new acquisition that involves new cost and fee arrangements.

(3) Because of the differences in obligation assumed by the contractor, the completion form is preferred over the term form whenever the work, or specific milestones for the work, can be defined well enough to permit development of estimates within which the contractor can be expected to complete the work.

Contract No. W9113M-07-D-0006, Modification P00031 states, in part:

“...The following have been modified:

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Contract No. W9113M-07-D-0006-0032 Mods 47, 48, 49, 50, 51, 52, and 53
Afghan Air Force (AAF) Spare Parts Surge Buy in Support of the Afghan Security Forces

Detailed Audit Findings

(Continued)

"CALCULATION FOR FIXED FEE

FOR TERM FORM TASK ORDERS (FAR 16.306)

a. The fixed fee of each Task Order issued on a term basis is based upon the furnishing of the specified level of effort. In the event that the contractor expends no less than 90 percent nor no more than 110 percent of the specified level of effort in performance of the Order, the fixed fee of the Task Order shall not be adjusted under this clause.

b. In the event that the contractor expends less than 90 percent of specified level of effort of the Task Order, the fixed fee shall be reduced in proportion to the ratio of the DPPH actually provided to 100 percent of the specified DPPH on the Task Order. Below is the formula for adjusting fixed fee on Task Orders when required under this subparagraph:

Actual DPPH / Task Order DPPH * Task Order Fixed Fee = Adjusted Fixed Fee

EXAMPLE:

Actual DPPH = 800 hours

DPPH on Task Order = 1,000 hours

Task Order Fixed Fee =\$5,000

Adjusted Fixed Fee = 800 / 1,000 * \$5,000

= 80% * \$5,000

= \$4,000..."

Condition:

Modifications 47, 48, 49, 50, 51, 52 and 53 to the Contract are each on a cost plus fixed fee basis. Modifications 47, 48, 49, 50, 51, 52 and 53 were made to the Contract and extended and increased the amount of the cost plus fixed fee contract. The modifications added funding, extended the period of performance or updated administrative matters. The fixed fee for each CLIN included in the modifications remained at [REDACTED]. Accordingly, the total fixed fee included in the modifications is as follows:

Estimated costs [REDACTED]

Fixed fee percentage [REDACTED]

Total fixed fee charged [REDACTED]

Actual costs incurred were [REDACTED]. Lockheed billed the maximum authorized fixed fee amount of [REDACTED] to the USASMD, and final payment of the fixed fee was received in November 2016. As a ratio of actual costs incurred this equates to an effective fixed fee of [REDACTED].

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Contract No. W9113M-07-D-0006-0032 Mods 47, 48, 49, 50, 51, 52, and 53
Afghan Air Force (AAF) Spare Parts Surge Buy in Support of the Afghan Security Forces

Detailed Audit Findings

(Continued)

Although not specified in the modifications, the nature of the modifications suggests that they should be classified as term form, and not as completion form as Lockheed concluded. The modifications required Lockheed to devote a specified level of effort for a stated period i.e. provide repairable services and spare parts/material procurement as needed, not deliver a specified end product within estimated cost. The nature of the services and items Lockheed provided is a better match to the term form than the completion form. As such, the fixed fee should have been pro-rated to match the level of effort Lockheed performed. The following calculation shows the excess fixed fee charged when comparing the completion form, used by Lockheed, to the term form:

Actual costs incurred	[REDACTED]
Estimated costs	[REDACTED]
Actual costs incurred as a percentage of estimated costs	[REDACTED]
Total fixed fee including modifications	[REDACTED]
Allowable fixed fee (pro-rated to [REDACTED] of costs incurred)	[REDACTED]
Excess fixed fee	<u>\$2,095,547</u>

Cause:

Lockheed treated the task order as a "completion form" type contract and chose to bill the full fixed fee. However, the task order did not state whether it is "completion form" or "term form", and no modifications were made to state that cost-plus-fixed-fee CLINs were "completion form." Without confirmation that these modifications are "completion form", there is a reasonable basis to question the costs.

Effect:

By not applying the negotiated fixed fee percentage to the actual costs incurred, Lockheed overcharged the Federal government for its profit and thus Federal funds were not used efficiently.

Questioned Costs:

Total ineligible fixed fee is \$2,095,547.

Recommendation:

- (1) We recommend that Lockheed return \$2,095,547 to the USASMD C for excess fixed fees charged.
- (2) We recommend that Lockheed establish policies and procedures that specifically address the need to have the calculation of the fixed fee clearly detailed in its contracts to ensure that it complies with Federal regulations.

Finding 2017-1: Excess Fixed Fee

Nature of Finding:

Internal control – significant deficiency

Compliance

APPLICABLE TASK ORDER

Task Order Number 0032 under Prime Contract W9113M-07-D-0006 was awarded 30 September 2009 (“TO 0032”). The scope for this TO 0032 was for providing “Repair of Repairable (ROR) services and spare parts / material procurement in support of the MOD ANAAC/MOI-CN AVN SQ maintenance and repair operations.” The award was a hybrid contract type with both Firm Fixed Price (“FFP”), Cost Type (“Cost”) and Cost-Plus-Fixed-Fee (“CPFF”) Contract Line Item Numbers (“CLIN”). The contract award did not include specific language designating the Task Order (“TO”) “form” type (i.e. whether it was a ‘CPFF Term Form’ or a ‘CPFF Completion Form’), nor did any subsequent Contract Modifications (“Mod”).

APPLICABLE FAR PROVISIONS

FAR 16.306 (Cost-plus-fixed-fee contracts) defines a CPFF contract as one that:

“provides for payment to the contractor of a negotiated fee that is fixed at the inception of the contract. The **fixed fee does not vary with actual cost**, but may be adjusted as a result of changes in the work to be performed under the contract”. (emphasis added)

As provided at FAR 16-306(d)(1) a “cost-plus-fixed-fee contract may take one of two basic forms – completion or term.” FAR 16.306 (d) (1) defines a CPFF “completion form” as one that “describes the scope of work by stating a definite goal or target and specifying an end product. This form of contract normally requires the contractor to complete and deliver the specified end product (e.g., a final report of research accomplishing the goal or target) within the estimated cost, if possible, as a condition for payment of the entire fixed fee.”

As provided at FAR 16.306(d)(2) a term form “describes the scope of work in general terms and obligates the contractor to devote a specified level of effort for a stated time period. Under this form, if the performance is considered satisfactory by the Government, the fixed fee is payable at the expiration of the agreed-upon period, upon contractor statement that the level of effort specified in the contract has been expended in performing the contract work. Renewal for further periods of performance is a new acquisition that involves new cost and fee arrangements”.

FAR 16.306(d)(3) goes on to also provide that “the completion form is preferred over the term form whenever the work, or specific milestones for the work, can be defined well enough to permit

development of estimates within which the contractor can be expected to complete the work,” and FAR 16.306(d)(4) provides that “The term form shall not be used unless the contractor is obligated by the contract to provide a specific level of effort within a definite time period”.

In effect FAR 16.306 makes it clear that any CPFF contract will be a completion form unless, per FAR 16-306(d)(4), the contractor is obligated by the contract to provide a specific level of effort within a definite time period.

Neither the Prime Contract nor the TO 0032 Award documents and/or attachments designate TO 0032 as either a Completion Form or a Term Form. Also the individual funding lines on the contract did not include any designation of the CPFF as either a Completion Form or a Term Form. As such, FAR 16.306 provides that the CPFF contract portions will be Completion Form unless the contract issued by the Government required that Leidos provide a specific level of effort within a definite time period. As will be shown below this did not happen.

The initial award was funded with FFP Sub-Contract Line Item Numbers (“SLINs”).

The initial CPFF CLIN was awarded on Mod 02 and included a value for “Max Cost” and a value for “Fixed Fee” with no mention of the fee as a ‘percentage of cost’. The funding for each of the CPFF CLINs was used to fund various SLINs and each SLIN included only a SLIN total funding value but with the breakout of the “Max Cost” and “Fixed Fee” denoted as “Undefined”. This same approach continued for the awards of Mod 03 through Mod 23 with fixed fee value included at the CLIN level and the cost and fixed fee values shown as “undefined” at the SLIN level. The clear import was that the fee was fixed and not intended to be a percentage of the funds expended under any of the Mods, and in effect a Completion Form.

Incremental funding was provided for Mod 24 dated 29 September 2011 under CPFF SLIN 400501. This was the first time the contract explicitly listed the ‘cost’ value and the ‘fixed fee’ value. However, the contract did not state that the fee was a percentage of cost.

On 22 November 2011 LM received Mod 27 which awarded additional CPFF SLINs and included language in Section B that stated the ‘fixed fee’ amount was established as ■■■ of the SLIN cost amount. All SLINs awarded after Mod 27 included the same reference to ■■■ or that the fixed fee was established at ■■■ of the awarded cost. Again, the contract did not state that the fixed fee was a percentage of cost.

SLIN 401902 was initially funded on Mod 51 dated 28 January 2015 in the amount of ■■■■■■■■■■
(See contract excerpt as Item 1 below).

Item 1

SECTION B - SUPPLIES OR SERVICES AND PRICES

SUBCLIN 401902 is added as follows:

ITEM NO	SUPPLIES/SERVICES	MAX QUANTITY	UNIT	UNIT PRICE	MAX AMOUNT
401902	AAF Funding for CLS Spares - FY 2015 CPFF Funding for CLS Spares, Repairables, Equipment, Storage, and Transportation associated with AAF. Fixed fee is [REDACTED]	UNDEFINED	Lot	UNDEFINED	\$0.00

[REDACTED]

FOB: Destination

PURCHASE REQUEST NUMBER: 0010644575

MAX COST	UNDEFINED
FIXED FEE	UNDEFINED
TOTAL MAX COST + FEE	\$0.00

ACRN CM
CIN: GFEBS001064457500010

[REDACTED]

Mod 55 dated 22 December 2016 partially de-obligated the funding on SLIN 401902 but did not decrease the fixed fee. The Section B narrative showed the de-obligation amounts in the total funding. (See contract excerpt as Item 2 below).

Item 2

SUBCLIN 401902:

CM: 097201020XX8242000AEQ10HJCHG252 E 0001815 1 1 1 6100 0000031001 A5XGO (CIN: GFEBS001064457500010) wa [REDACTED]

ITEM NO	SUPPLIES/SERVICES	MAX QUANTITY	UNIT	UNIT PRICE	MAX AMOUNT
401902	AAF Funding for CLS Spares - FY 2015 CPFF Funding for CLS Spares, Repairables, Equipment, Storage, and Transportation associated with AAF. Fixed fee is 5%	UNDEFINED	Lot	UNDEFINED	\$0.00

[REDACTED]

FOB: Destination

PURCHASE REQUEST NUMBER: 0010644575

ACRN CM
CIN: GFEBS001064457500010

[REDACTED]

Prior to invoicing for the full fixed fee LM Contracts corresponded with the Government to gain confirmation on the CPFF being a Completion Form type. LM requested this information specifically to confirm the fixed fee in accordance with Prime Contract Modification Number P00031 fixed fee calculation. The purpose was to ensure that Leidos' view that in the absence of any contrary direction from the Government a CPFF contract would be a Completion Form. LM had numerous email correspondences and verbal conversations with USG Army Contracting Command ("ACC") Contracting Officer, Ms. Daryll Nottingham and Contract Specialist, Ms. Cynthia Smith. *Please see "attachment 1" for complete correspondence.*

On 15 September 2010, prior to invoicing the full awarded fixed fee, the LM Contract Administrator, [REDACTED] attempted to obtain written confirmation on TO 0032 (and other task orders under Prime Contract W9113M-07-D-0006) as to whether the TO was properly designated CPFF - Completion Form or if it was not then to provide an explanation of how the Government arrived at a determination that it was CPFF - Term Form. This email eventually led to a teleconference with the Government.

The teleconference took place on 4 November 2010 between ACC Contracting Officer, Ms. Nottingham and LM Contract Manager, [REDACTED]. The outcome of the meeting was that LM would provide a list of task orders in question and ACC would review the individual task orders and provide written determination for each task order on CPFF - Term Form or CPFF - Completion Form. [REDACTED] provided the list via email dated 4 November 2010.

On 9 November 2010, Leidos' [REDACTED] sent a follow-up request to the Government on the status of the Government's response to the information supplied by Leidos on 4 November 2010. On 16 November 2010, ACC Contract Specialist, Ms. Cynthia Smith provided written guidance to LM via email which effectively confirmed that the expectation is that CPFF contracts are Completion Form unless the Government provides direction to the contrary. In the 16 November 2010 email Ms. Smith stated that "The majority of the CPFF orders should be completion type. We will do a scrub of the task orders to determine if additional language should be added to the task." There was no indication that any of the CPFF orders were being considered Term Form.

On 18 November 2010, [REDACTED] responded via email to Ms. Smith's 16 November 2010 email reiterating our request for confirmation on the form type designation for the orders and explaining that we were asking for the Government to include its determination in the form of a modification to make it clear for future auditors stating:

"The Lockheed Martin Team requests contract modifications for each of our CPFF task orders designating the "form" type (Term or Completion)", and "if this is not feasible, a modification to the Basic Contract which states that **all CPFF task orders under this ID/IQ will fall under Completion Form unless otherwise specified in the task order award** would also suffice", and "Absent any formal documentation regarding this matter, LM is very concerned about questions which will likely arise during a DCAA audit and may lead to questioned/disallowed billings by the contractor". (Emphasis added).

On 18 November 2010, Ms. Smith responded to [REDACTED] "It is definitely feasible to modify the basic contract to state that CPFF task orders are completion form, however, a due date as to when that will happen is up in the air. We will provide a schedule for this language after the CNTPO PMR." This response effectively confirmed that the Government had determined at that time that all of the orders were Completion Form.

However, as of both the Prime ID/IQ Contract Period of Performance end date and Task Order Period of Performance end date, a modification to the basic contract to incorporate the requested language confirming that the orders were Completion Form was never completed.

Notwithstanding, it is also clear that based on the work scope as defined in the performance work statement ("PWS") incorporated as Section C of the contract, TO 0032 meets the FAR 16.306 (d) (1) definition of CPFF Completion Form. LM was required to provide a specified end product in accordance with FAR 16.306 (d) (1) in the form of "services when requested by the Field Service Representatives (FSR)" under PWS Paragraph 3.1 and "spare parts and material required for the direct support of the MOD ANAAC/MOI CN AVN SQ" under PWS paragraph 3.1.1. All parts were delivered and accepted by the USG customer. In short, Leidos had to provide a specific result, i.e. services when requested and spare parts and material required. This is clearly not an order for hours (specified level of effort) over a definite time period.

FAR 16.306 (d) (2) defines a CPFF Term Form as one that "describes the scope of work in general terms and obligates the contractor to devote a specified level of effort". FAR 16.306 (d)(4) goes on to state "The term form shall not be used unless the contractor is obligated by the contract to provide a specific level of effort within a definite time period." TO 0032 lacks a specified level of effort and therefore cannot be considered a CPFF Term Form.

Task Order Number 0032 was therefore determined to be a CPFF Completion Form type contract based on Ms. Smith's 16 November 2010 written determination, and this determination was consistent with the FAR 16.306 definition of a CPFF Completion Form Type contract.

Pursuant to Prime Contract W9113M-07-D-0006 Mod P00031, LM is therefore entitled to the full awarded fixed fee. P00031 "CALCULATION FOR FIXED FEE FOR COMPLETION FORM TASK ORDERS (FAR 16.306)" paragraph b. states that "The Contractor will complete the requirements of the Task Order within the estimated cost and will receive the agreed upon fixed fee". P00031 "CALCULATION FOR FIXED FEE FOR COMPLETION FORM TASK ORDERS (FAR 16.306)" paragraph d. states that "In accordance with FAR 16.306(d)(1), entitlement to the total fixed fee is subject to (1) certification by the Contractor, and acceptance by the Government, of the specified end products, and (2) the tasks performed and reports provided are considered satisfactory to the Government." The USG accepted and paid for all parts delivered by LM and the tasks performed were considered satisfactory to and paid for by the USG.

In view of the above, the fee calculation method SIGAR detailed on page 23 of the Audit Report (*see below excerpt as Item 3*) conflicts with FAR 16.102(c) which clearly states "The cost-plus-a-percentage-of-cost system of contracting shall not be used (see 10 U.S.C. 2306(a) and 41 U.S.C. 3905(a))."

Item 3**Condition:**

Modifications 47, 48, 49, 50, 51, 52 and 53 to the Contract are each on a cost plus fixed fee basis. Modifications 47, 48, 49, 50, 51, 52 and 53 were made to the Contract and extended and increased the amount of the cost plus fixed fee contract. The modifications added funding, extended the period of performance or updated administrative matters. The fixed fee for each CLIN included in the modifications remained at [REDACTED]. Accordingly, the total fixed fee included in the modifications is as follows:

Estimated costs	[REDACTED]
Fixed fee percentage	[REDACTED]

Total fixed fee charged	[REDACTED]
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Actual costs incurred were [REDACTED]. Lockheed billed the maximum authorized fixed fee amount of [REDACTED] to the USASMDC, and final payment of the fixed fee was received in November 2016. As a ratio of actual costs incurred this equates to an effective fixed fee of [REDACTED].

The SIGAR calculation effectively assumes that the CPFF contracts were all Term Form, but the SIGAR Report offers no explanation as to how they arrived at this determination. In the section entitled "Basis for Qualified Opinion" the Audit Report simply concluded that the amount they questioned, \$2,095,547, was 'ineligible' because Lockheed billed "the entire amount of fixed fee per the Contract when only [REDACTED] of total estimated costs were actually incurred." This statement would only be correct if the CPFF was a Term Form (but it was not, as demonstrated above). But the Audit Report also acknowledged that that ultimate determination on whether the questioned costs were appropriate rested "with the USASMDC" and that the auditor did not have the authority to make the determination of whether the CPFF orders were Term Form instead of Completion Form.

As explained above, the determination that the CPFF orders were Completion Form had already been made by the Government in the response provided in the 18 November 2010 email from Ms. Smith.

Finding 2017-2: Missing Background Checks for Employees

Nature of Finding:

Internal control – significant deficiency

Compliance

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

The information provided to the Auditor was fully adequate to evidence compliance.

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Financial Audit of Costs Incurred Under
Contract No. W9113M-07-D-0006-0032
Modifications 47, 48, 49, 50, 51, 52 and 53
AAF Spare Parts Surge Buy in Support of the ASF

Auditor's Rebuttal to Lockheed's Response to Findings

For the Period September 28, 2013 – September 28, 2015

Leidos, on behalf of Lockheed, provided disagreements to both findings presented in this report. We have reviewed its management responses and provide the following comments and rebuttals to each of the findings to which it disagreed.

Finding Number 2017-1: Excess Fixed Fee

Leidos disagrees with this finding, indicating that it does not agree with our classification that the contract is a term contract.

We were provided the communications noted in the management response during the audit and prior to preparation of the finding. The November 16, 2010 email from the funding agency to Lockheed stated that the funding agency would review all task orders to determine if language should be added clarifying whether each task order was term or completion form. As indicated in the funding agency's response, it states that "the majority" of the task orders should be completion type, as opposed to all of the task orders. This implies that some of the task orders should be term form. The email was silent as to which specific task orders would be completion and which would be term.

Neither the contract nor subsequent modifications included specific language designating the Task Order "form" type (i.e., whether it was a 'CPFF Term Form' or a 'CPFF Completion Form'). Lockheed is correct to point out that some communications from the government may indicate that it would have been "feasible to modify the basic contract to state that the CPFF [cost-plus-fixed-fee] task orders are completion form...." However, this is hardly proof that the contract was in fact modified to state that CPFF task orders would be completion form. Additionally, the government even stated at the time that the date for any such modification "is up in the air." Therefore, rather than confirming that, as Lockheed appears to claim, all of the task orders were Completion Form, this response from the government suggests that the contract would need to be modified in order for the task orders to be completion form.

The modifications included in the scope of the audit are general in terms. The modifications include funding for CLS, spares, repairables, equipment, storage and transportation for the SMW and the Afghanistan MOD. The additional funding also provided for the maintenance or restoration of repair and replacement parts for aircraft used in critical missions to ASL levels. This inventory also included parts which required extended lead times for manufacture and delivery. There were no specifics in the modifications as to what spares, repairables, equipment, storage and transportation were to be procured, or the level of effort required. There was no specification in the modifications as to what the end product actually was.

Given the general nature of what was to be procured under the modifications, given the lack of specificity of an actual end product, and given the absence of a modification clarifying which task orders or

LOCKHEED MARTIN INTEGRATED SYSTEMS, INC.

Contract No. W9113M-07-D-0006-0032 Mods 47, 48, 49, 50, 51, 52, and 53
Afghan Air Force (AAF) Spare Parts Surge Buy in Support of the Afghan Security Forces

Auditor's Rebuttal to Lockheed's Response to Findings

(Continued)

modifications are completion form versus term form, we believe that modifications 47 through 53 should be classified as term form in accordance with 48 CFR 16.306(d), *Completion and term forms*.

Finding Number 2017-2: Missing Background Checks for Employees

Leidos disagrees with this finding, indicating that the employees that were noted as not having background checks are long-time employees that were properly vetted based on existing regulations at the time of their hiring. Leidos acknowledged it was unable to provide certain historical employee data because it resides with Lockheed Martin, and Leidos is limited in what it is able to access under the acquisition. Leidos further argued that it is not required to retain employee records beyond the 4-year period prescribed by the FAR, and that E-Verify requirements do not apply to employees hired before 2007. Based upon our review of Leidos' disagreement, and our subsequent review of documentation provided in conjunction with the audit, we consider this finding to be resolved and have removed it from the report.

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- improve management and accountability over funds administered by U.S. and Afghan agencies and their contractors;
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- prevent fraud, waste, and abuse; and
- advance U.S. interests in reconstructing Afghanistan.

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- Phone DSN International: 312-664-0378
- U.S. fax: +1-703-601-4065

Public Affairs

Public Affairs Officer

- Phone: 703-545-5974
- Email: sigar.pentagon.ccr.mbx.public-affairs@mail.mil
- Mail: SIGAR Public Affairs
2530 Crystal Drive
Arlington, VA 22202