

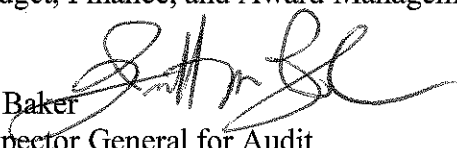


National Science Foundation • Office of Inspector General
4201 Wilson Boulevard, Suite I-1135, Arlington, Virginia 22230

MEMORANDUM

DATE: SEP 10 2014

TO: Martha Rubenstein, Director
Office Head and Chief Financial Officer,
Office of Budget, Finance, and Award Management (BFA)

FROM: Dr. Brett M. Baker 
Assistant Inspector General for Audit

SUBJECT: *Audit of NSF's Management and Oversight of the R/V Sikuliaq Construction Project*, Report No. 14-2-008

Attached is the final report on the subject audit. The report contains one finding with three recommendations on NSF's management and oversight of contingency for the R/V Sikuliaq Construction project.

In accordance with Office of Management and Budget Circular A-50, *Audit Followup*, please provide a written corrective action plan within 60 days to address the report recommendations. This corrective action plan should detail specific actions and milestone dates.

We appreciate the courtesies and assistance provided by so many NSF staff during the review. If you have any questions, please contact Louise Nelson, Director of Western External Audits, at (303) 844-4689.

Attachment

| | | |
|-----|--------------------|-----------------|
| cc: | Ruth David | Matthew Hawkins |
| | Michael Van Woert | Bauke Houtman |
| | Cliff Gabriel | Scott Horner |
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| | Joanne Rom | Susan Carnohan |
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Audit of NSF's Management and Oversight of the R/V *Sikuliaq* Construction Project

**National Science Foundation
Office of Inspector General**

**September 10, 2014
OIG 14-2-008**



TM#13-D-1-019

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Introduction

In August 2007, the National Science Foundation (NSF) entered into an agreement with the University of Alaska Fairbanks (UAF) for construction and operation of the Alaska Region Research Vessel – later named the *Sikuliaq*. The ship is expected to provide a larger platform for complex multidisciplinary research and to expand research capabilities in the Arctic up to 300 science days at sea annually. The project consisted of four phases with a total awarded cost of \$199.5 million. The Sikuliaq project was NSF's first and largest award made with American Recovery and Reinvestment Act (Recovery Act or ARRA) funds, and the \$148 million construction phase was funded entirely with Recovery Act funds. The \$148 million award also included \$31.7 million in contingency funds.

In recent years, NSF has instituted a policy of ensuring that its large facility construction projects do not exceed their planned budgets by requiring a level of “contingency” costs in the initial proposed budget. As of September 30, 2013, NSF had 16 active construction type cooperative agreements aggregating approximately \$1.9 billion in obligations, which includes approximately \$303 million in contingency funds, representing approximately 16 percent of the total award obligation amount.

Federal cost principles define how award funds may be budgeted and spent. Among other things, OMB Circular 2 CFR 220 does not allow “[c]ontributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, intensity, or with an assurance of their happening.” Based on audits of three of NSF's large construction projects and an audit of contingency in a \$197 million cooperative agreement, we identified compliance with Federal cost principles for contingency as a high-risk area.

We conducted an audit of the Sikuliaq project for two reasons —the large amount of Recovery Act funds awarded to the project and the problems previous audits disclosed with contingency funds in NSF's large construction projects, which placed federal funds at a heightened risk of being misused for non-contingent expenses or to hide cost overruns due to poor management or oversight.

Audit Results

NSF requires contingency estimates in the budgets of large Major Research Equipment and Facilities Construction projects in an effort to ensure that actual costs do not exceed planned costs. Thus, NSF required project officials to include contingency in the budget proposals for each of the project's four phases. The University of Alaska Fairbanks included \$38.1 million in contingency for the total project. Of this amount, \$31.7 million was for the construction phase and was funded entirely by Recovery Act funds.

We found that 1) the inclusion of the contingency for each project phase did not comply with the certainty requirement in the OMB cost principles; and 2) the contingency amounts in the proposed budgets were not supported by adequate cost data. Therefore, since the project's total awarded amount is based on the approved budget, there is a heightened risk that the contingency

funds will be misused. Additionally, since the contingency expenditures were not separately tracked in UAF's accounting system, we could not verify how the budgeted contingency funds were ultimately spent.

We found that NSF generally complied with the Recovery Act requirements we reviewed.

Table: Four Cooperative Support Agreements for Sikuliaq Project

| | Phase | Award Amount(1) | Awarded Contingency (percentage of award amount) | Federal Funds Disbursed as of June 30, 2013 |
|---|---|----------------------|--|---|
| 1 | Phase 1&2 Contracting Procedures/Design Review | \$18,197,515 | \$1,462,906 (8%) | \$15,577,530 |
| 2 | Phase 3 Construction of the R/V <i>Sikuliaq</i> (ARRA only award) | \$148,070,000 | \$31,700,000(2) (21.4%) | \$119,949,124 |
| 3 | Phase 3 UAF Management/Oversight of Construction Phase | \$22,054,387 | \$3,484,195 (15.8%) | \$12,642,635 |
| 4 | Phase 4 Post Delivery and Sea Trials | \$11,178,098 | \$1,498,846 (13.4%) | \$0 |
| | Total | \$199,500,000 | \$38,145,947 (19.2%) | \$148,169,289 |

(1) includes estimated contingency

(2) awarded contingency was reduced by \$6.8 million due to [REDACTED] [REDACTED] [REDACTED] resulting in a revised contingency estimate of \$24.9 million

Inadequate Controls over Calculation and Expenditure of Nearly \$32 Million of Recovery Act Funds Budgeted for Contingency in Sikuliaq Construction

Inadequate Controls over Contingency in Proposed Budget for Sikuliaq Construction

The Sikuliaq project consisted of four phases (as shown above), and each phase included contingency funding at NSF's direction. NSF and the awardee estimated the contingency amount using a risk management plan, which they developed by identifying risk factors such as increases in vendor costs, late equipment delivery, and design changes. UAF officials then evaluated the risk factors by the probability that they might occur and conducted a Monte Carlo simulation¹ to reach a 90 percent confidence level that the estimates were sufficient.

¹A Monte Carlo simulation involves the use of random sampling techniques to obtain approximate solutions to mathematical or physical problems. This assessment technique is encouraged in NSF's *Guidelines for Planning, Use, and Oversight of Contingency in the Construction of Large Facilities* policy.

We focused our attention on contingency funds in the construction phase; however, it is important to note that the risk management plan estimated contingency for the project as a whole, not for each project phase individually. The NSF Program Officer overseeing the project told us that the basis for the estimate in the risk management plan was “personal knowledge, experience, and judgment.” When it was determined that the construction phase would be funded with Recovery Act dollars, the UAF project officer told us that he “identified which risk elements I felt were most closely associated with ship construction” and assigned the associated dollar amounts to the contingency in the construction phase. Additionally, he stated that he estimated risk based on the total project scope and that, for the construction phase, he made a “final adjustment in the contingency.” According to the project officer, he made this final adjustment because of additional risk factors he attributed to the use of Recovery Act funds.

The inclusion of contingency in the project’s proposed budget was unallowable based on OMB circular 2 CFR 220, which states, “[c]ontributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, intensity, or with an assurance of their happening, are unallowable.”

As discussed above, the awardee’s use of a risk management plan to estimate contingency in the project’s budget did not meet the certainty requirement in the cost principle. The documents provided by the awardee, as well as information from the NSF Program Officer and UAF officials, confirmed that the contingency estimates did not demonstrate how the certainty requirements were met, but rather demonstrated that contingency was based on professional judgment related to risk elements. We were unable to find, and project officials were unable to provide, supporting evidence to demonstrate that the contingency estimates derived from their risk management plan met the cost principle’s “with certainty” requirement, or that this requirement was a component of the personal “judgment” used to develop the contingency estimates. As we have previously stated, while it is important to estimate all contingency costs, only those which meet the cost principle’s certainty requirement should be added to a federal award.

In addition to including contingency costs that did not meet the cost principle’s certainty requirement, it is important to note that even if the proposed contingency expenses met the cost principle’s certainty requirement, the estimates used to quantify those costs did not rest on adequate supporting documentation. Contingency, like all other line items in a proposed budget, must be supported by documentation which establishes the reasonableness, allowability, and allocability of the costs. Instead, project officials produced detailed “risk sheets” for each risk identified in the plan, and we were told that the information supporting the material in the risk sheets was based on the “best available knowledge on hand.” Thus, according to statements from both the NSF Program Officer and the UAF project officer, personal knowledge, experience, and judgment, not verifiable cost information, were the basis for the amount of contingency in the project. NSF officials also confirmed that there was no additional supporting documentation (such as historical cost estimates or vendor estimates) to support the risk sheets provided

Inadequate Controls over Contingency Expenditures in Sikuliaq Construction

In addition to inadequate controls over the inclusion of contingency in the budget proposal, there were also inadequate controls and a lack of visibility over the expenditure of funds for contingent events because such expenditures were not separately tracked in the awardee's accounting system. Although the change control log showed how the contingency funds for change orders over \$50,000 were approved to be spent, the change order log was not integrated, nor was it electronically linked, with the university accounting system. As a result, we could not confirm that contingency funds were spent as requested and approved in the associated change orders.

While UAF was not required to track expenditures to budgeted contingency amounts, the lack of visibility over contingency expenditures increases the risk that contingency funds may be misused. This risk is particularly troubling given the fact that the \$32 million contingency for the Sikuliaq construction was Recovery Act funds.

Other Matters

Construction Contract

UAF entered into a firm fixed price contract with the [REDACTED] to construct the Sikuliaq. The initial contract was signed on December 18, 2009, for a total of [REDACTED]. As of May 17, 2012, there had been 45 modifications to the contract that increased the total amount by [REDACTED] up to [REDACTED]. The UAF project officer stated that a firm fixed price contract was used to help control the risks of the project. It is noteworthy that the UAF project official acknowledged that a different funding vehicle would have been more appropriate for the project.

Compliance with Recovery Act Requirements

We found that NSF generally complied with the Recovery Act requirements. We reviewed the Davis Bacon Act, the Buy America Act, suspension and debarment, accelerated spending and overall recipient reporting requirements. However, we did note three instances where the awardee and NSF did not comply with Davis Bacon prevailing wage requirements. First, NSF did not include the required prevailing wage provisions in the award terms and conditions, or ensure that the awardee included required provisions in the construction contract. Second, NSF did not obtain the required certification from the contractor and subcontractors confirming that they were complying with wage requirements. Finally, NSF released funds to UAF before it obtained the required wage certification from the awardee.

Our audit included testing a sample of certified payrolls against the prevailing wages to verify that workers were paid the required rate. Although we did not identify any instances of workers being paid less than the required wage rate as a result of these instances of noncompliance, the fact that the required certifications were not obtained increased the risk that workers would not be paid prevailing wage rates. When this oversight was pointed out to NSF during the course of the audit, NSF agreed and ensured that they would explore the lessons learned. It is important to

note that ensuring that workers are paid in accordance with Federal wage rate requirements is not limited to projects receiving Recovery Act funds, but may apply to future NSF construction projects as well.

Recommendations

We recommend that the NSF Chief Financial Officer take appropriate action to strengthen controls over the calculation and expenditure of contingency funds in construction projects.

Among other things, NSF should require awardees

- 1) to only include amounts for allowable contingencies in an award;
- 2) to support contingency estimates in budget proposals with adequate, verifiable, supporting data; and
- 3) to properly account for the funds consistent with their estimates and separately track budgeted versus actual contingency costs.

Summary of Agency Response and OIG Comments

In its response, NSF concurred with the OIG's first two recommendations, but disagreed with the assertion that it is not currently compliant with these requirements. NSF stated that the OIG extrapolated the "certainty requirement" to mean that all costs must be known in advance, and that if this were the case, there would be no need to budget for contingency risks. As stated in the report, the documents provided to the OIG did not demonstrate how the certainty requirement was met, but rather demonstrated that contingency was based on professional judgment related to risk elements. It is our position that the supporting documents that the contingency estimates relied upon were not of sufficient detail to provide the level of assurance necessary to meet the certainty requirement. Many of the estimates lacked any tangible support, and were based solely on professional judgment.

NSF's response also discusses that the GAO Cost Estimating and Assessment Guide (GAO Guide) states "...the data used in program risk analysis are often based on individuals' expert judgment..." While it is true that the GAO Guide makes this statement, it also states that if historical data is not available, "... how qualitative judgment was applied should be explained..." Further, "because the quality and availability of the data affect the cost estimate's uncertainty, these should be well documented and understood." The documentation provided did not adequately describe or support the basis for many of the risk elements that were evaluated based on professional judgment. Considering that nearly 20% of the project was comprised of contingency funds, it was of the utmost importance that the method of estimating the risks be verifiable and in compliance with all applicable laws and regulations. However, the

documentation provided did not provide adequate, verifiable support for how the risks were estimated or how the contingency amounts were derived.

In response to the third recommendation, NSF disagrees that budgeted versus actual contingency costs should be separately tracked. NSF pointed out that this level of tracking is not required by OMB, and thus views this recommendation as an extra administrative requirement that it declines to administer. However, by not tracking budgeted versus actual contingency costs and because the contingency budget and change order processes do not tie to the accounting system, there is no way of verifying that contingency funds were actually used in the manner proposed in the associated change orders. If there is no way to ensure that contingency funds were used in the manner proposed, the entire change order process becomes invalidated and meaningless. The only way to ensure that the change order process is effective is to be able to track budgeted versus actual contingency expenditures in the accounting system itself.

We have included NSF's response to this report in its entirety as Appendix A.

OIG Contact and Staff Acknowledgements

Louise Nelson - Director of Western External Audits
(303) 844-4689 or lnelson@nsf.gov

In addition to Ms. Nelson, Lisa Hansen, Susan Crismon, and Ken Lish made key contributions to this report.

Appendix A: Agency's Response



National Science Foundation

4201 Wilson Boulevard, Arlington, Virginia 22230

MEMORANDUM:

Date: June 11, 2014

From: Ms. Martha A. Rubinstein
Martha
Office Head and Chief Financial Officer
Office of Budget, Finance, and Award Management

To: Dr. Brett M. Baker
Assistant Inspector General for Audit
Office of Inspector General

Subject: Response to Official Draft Report: *Audit of NSF's Management and Oversight of the R/V Sikuliaq Construction Project*

This memorandum's purpose is to set forth comments on the conclusions reached and the three recommendations in the draft audit report referenced above. Though we disagree with the report's interpretation of OMB policies and the impact of that interpretation on validity of the detailed findings of the report, the agency is presently taking steps to strengthen its controls and process over future agreements for project development and project execution (i.e., large facility construction). These steps are detailed in two corrective action plans prepared in response to:

- OIG Report No. 12-2-010, titled *Management of Contingency in the EarthScope Awards*, and
- OIG Report No. 12-6-001, titled *NSF's Management of Cooperative Agreements*

The four actions the agency is undertaking, all in the form of revisions to NSF's Large Facilities Manual, are summarized as follows:

- Preparation of standards for analysis of recipient cost estimates,
- Preparation of standards for project cost book preparation,
- Preparation of policy guidance for use of auditing in overseeing and closing out cooperative agreements, and
- Preparation of policy guidance on the use of contingency budgets

Our comments with respect to each of the draft report's three recommendations follow.

Rec 1. NSF should require awardees to only include amounts for allowable contingencies in an award.

Rec 2. NSF should require awardees to support contingency estimates in budget proposals with adequate, verifiable, supporting data.

Resp. We agree with the recommendations as stated. We do not agree with the audit report's assertions that NSF is not currently compliant with these requirements.

Specific to Recommendation 1, NSF does and should require awardees to budget only for allowable contingencies. What is at issue is what constitutes acceptable budgeting practices for a contingency. In the audit report the auditors conflate the concept of responsibly **budgeting** for contingencies, using a risk-based methodology to estimate variations in established allowable construction costs under the cost principles with **the cost of paying into** a general, non-specific contingency reserve. The latter is a separate cost category and we agree with the auditors that such payments are not allowable costs. OMB has recently clarified the difference between the two different concepts (see below). Further, the auditors, by relying on this conflation, extrapolate the term "certainty requirement" to mean that all costs must be known in advance. This is paradoxical; if certainty existed, there would be no need, nor professional industry standards, for budgeting for contingency risks.

In making these recommendations the OIG cites the contingency provision of 2 CFR 220¹ and concludes that the project's budget did not meet the certainty requirement of the aforementioned cost principle nor did the estimate rest on adequate supporting documentation. However, the Office of Management and Budget has recently addressed these matters in publishing its *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (refer to 2 CFR 200, hereinafter Uniform Guidance) and the rule-making process.

Early in this process OMB noted that the text addressing the use of contingency budgets in federal awards included in the proposed rule represented a clarification, not the adoption of a revised cost principle. (78 FR 7290)² That same text notes that use of contingency estimates is

¹ "Contributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, intensity, or with an assurance of their happening, are unallowable." (2 CFR 220, Appendix A, Section J.11)

² "The ANPG [Advance Notice of Proposed Guidance] discussed clarifying that budgeting for contingency funds associated with a Federal award for the construction or upgrade of a large facility or instrument, or for IT systems, is an acceptable and necessary practice ..." OMB made a similar statement when publishing the Uniform Guidance: "Many commenters noted that this proposed section [2 CFR 200.433] made positive and helpful

an acceptable and necessary practice, planned for in accordance with Generally Accepted Accounting Principles and standard project-management practices. It goes on to distinguish between the acceptable use of contingency as an estimating practice, versus the unacceptable practice of recipients establishing a front-loaded reserve fund through draw down of award funds in advance of particular events actually occurring. This same construct carries through to the final form of the Uniform Guidance. Compare 2 CFR 200.433, paragraph (b), that states it is permissible for contingency amounts to be explicitly included in **budget estimates** provided they are estimated using broadly-accepted cost estimating methodologies, with its paragraph (c), that states that **payments** by federal agencies "... made for events the occurrence of which cannot be foretold with certainty as to the time or intensity, or with an assurance of their happening, are unallowable ..." (78 FR 78650)

Specific to Recommendation 2, in this case the recipient estimated contingency and supported its estimate consistent with the broadly-accepted methodology set forth in the GAO Cost Estimating and Assessment Guide. (pp. 159-175, hereinafter GAO Guide) A risk register was prepared and scored by project personnel to identify project risk, and assess the likelihood of an event occurring and corresponding consequences. (pp.164-165) As noted in the GAO Guide,

... the data used in program risk analysis are derived from in-depth interviews or in risk workshops. In other words, the data used in program risk analysis are often based on individuals' expert judgment ... (p. 161)

Once this step was accomplished, a Monte Carlo simulation was performed (pp. 172-173), a cumulative probability distribution calculated (p. 173), and an amount of contingency budgeted to provide 90 percent confidence that the project could be accomplished within the total amount budgeted (pp. 173-174).

Finally, we note that while the agency and its recipient are compliant with OMB regulation and consistent with GAO recommended practice for estimating contingency, NSF has identified publication of policy requirements for the development of cost estimates, including contingency estimates, as an area to be addressed in strengthening its controls over future cooperative agreements for project development and project execution, as stated in the aforementioned corrective action plans. Our emphasis will be on documenting the judgments and conclusions made by recipients when assessing project schedule, technical and cost risk, and their monetization.³

clarifications which enable a better understanding of how contingency costs may be budgeted and charged." (78 FR 78602)

³ Refer to the CAP for OIG Report No. 12-2-010, Response to Recommendation 1 and Recommendation 2, and the CAP for OIG Report No. 12-6-001, Response to Recommendation 2, both dated April 3, 2014.

Rec 3. NSF should require awardees to properly account for the funds consistent with their estimates and separately track budgeted versus actual contingency costs.

Resp. We agree that NSF should continue to require awardees to properly account for funds. We disagree with the premise that costs incurred will always conform with the originally estimated budgets for a project at the cost element level. We further disagree with the asserted requirement to separately track budgeted versus actual contingency costs.

In making this recommendation the OIG concludes that inadequate controls and a lack of visibility over the expenditure of funds exists because expenses reimbursed using contingency funds were not separately tracked in the recipient's financial accounting system. However, OMB squarely addressed this matter when publishing the Uniform Guidance, discussing comments received during the rule-making process.

Specifically, OMB stated that "... commenters suggested adding a requirement to track funds that are spent as contingency funds throughout the non-Federal entity's records." (78 FR 78602) OMB went on to say in pertinent part:

The COFAR (i.e., the Council on Federal Assistance Reform) reviewed the language [of the contingency cost principle, 2 CFR 200.433] and concluded that it does provide sufficient controls to Federal agencies to manage Federal awards. The COFAR noted that ... actual costs incurred must be verifiable from the non-Federal entity's records. The COFAR considered this last requirement to be sufficient for tracking the use of funds, as contingency funds should most properly be charged not as "contingency funds" specifically, but according to the cost category into which they would naturally fall. The COFAR did not recommend any changes to the proposed language. (78 FR 78602-78603)

Given that one objective of the Uniform Guidance is to ease administrative burden (78 FR 78590), we decline to add an administrative requirement already identified as unnecessary by OMB.

Thank you for the opportunity to provide our comments on the draft report. You may contact Mr. Jeff S. Leithead of the Division of Acquisition and Cooperative Support by telephone at Extension 4595 or by e-mail at jleithea@nsf.gov for information of an administrative nature. Contact Mr. Bob Houtman of the Division of Ocean Sciences by telephone at Extension 7704 or by e-mail at bhoutman@nsf.gov for information of a technical nature.

Appendix B: Objectives, Scope, and Methodology

The objectives of this audit were to review NSF's processes for overseeing the construction project and managing the associated risks (including contingency), and compliance with Recovery Act requirements. The scope of our audit focused on the four cooperative support agreements (CSAs) awarded to complete the *Sikuliaq* construction project.

We conducted this performance audit from February 2012 to May 2014. To answer our objectives, we obtained information on the contingency from NSF and UAF officials and NSF's eJacket reporting system for the project period of August 1, 2007 through June 30, 2013.

To meet our objectives, we:

- Obtained and reviewed relevant laws, regulations, policies, and procedures,
- Obtained and reviewed prior Federal audits and reviews,
- Communicated with the NSF OIG Office of Investigations,
- Consulted with NSF OIG Legal Counsel,
- Interviewed and communicated with NSF and UAF officials,
- Obtained and reviewed CA and CSA award documents,
- Obtained and reviewed UAF award and invoice documents,
- Obtained and reviewed contingency change orders and supporting documentation for the three awards using contingency funds through June 30, 2013, and
- Observed the 2012 R/V *Sikuliaq* Annual Review and participated in the shipyard tour.

We reviewed NSF's compliance with applicable provisions of pertinent laws and regulations including:

- 2 CFR Part 220, Cost Principles for Educational Institutions,
- 2 CFR Part 215, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations,
- 2 CFR Part 176, Requirements for Implementing Sections 1512, 1605, and 1606 of the American Recovery and Reinvestment Act of 2009 for Financial Assistance Awards,
- 2 CFR Part 180, OMB Guidelines to Agencies on Government wide Debarment and Suspension (Nonprocurement),
- 2 CFR Part 2520, Nonprocurement Debarment and Suspension, and
- 29 CFR Parts 1, 3, 5, 6, 7, Labor.

We also obtained an understanding of the management controls over NSF's process for reviewing, managing, and overseeing contingency as well as its implementation of Recovery Act requirements through interviews and communications with NSF officials and by reviewing NSF policies and procedures. We identified internal control deficiencies, which we discuss in this report. However, we did not identify any instances of fraud, illegal acts, or abuse.

Our work required reliance on computer-processed data obtained from NSF and UAF. We obtained NSF data by directly accessing NSF's Federal Financial Report (FFR) system and it's

Award Cash Management Service (ACM\$). We assessed the reliability of the data provided by UAF by comparing costs charged to the NSF award account within UAF's accounting records to the federal share of expenditures, as reflected in UAF's FFRs submitted to NSF as of September 30, 2012. Based on our testing, we found UAF's computer-processed data sufficiently reliable for the purposes of this audit. We did not review or test whether the data contained in, or controls over, NSF's FFR and ACM\$ systems were accurate or reliable.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our first audit objective to examine the sufficiency of NSF's oversight of awardees' expenditure of contingency.

We held an exit conference with NSF officials on May 5, 2014.