



# COMMISSION ON WARTIME CONTRACTING IN IRAQ AND AFGHANISTAN

CWC Special Report 1

September 21, 2009

## SPECIAL REPORT ON CONTRACTOR BUSINESS SYSTEMS

# Defense agencies must improve their oversight of contractor business systems to reduce waste, fraud, and abuse

## EXECUTIVE SUMMARY

Contractor business systems and internal controls are the first line of defense against waste, fraud, and abuse. Weak control systems—such as those for estimating, billing, purchasing, labor, and compensation, among other activities—increase the risk of unallowable and unreasonable costs on government contracts, especially in contingency environments like Iraq and Afghanistan. The potential increased cost attributable to weak systems is exacerbated by the government’s increased reliance on service-support contractors in the high-risk environment of contingency contracting and on an oversight process that has proven ineffective for the task.

On August 11, 2009, the Commission on Wartime Contracting in Iraq and Afghanistan conducted a hearing to obtain testimony from government officials and contractors on the adequacy of contractor business systems. The Commission learned that unreliable data from business systems produced billions of dollars in contingency-contract costs that government auditors often could not verify. The government’s ability to detect contract cost errors and material misstatements is seriously impeded by contractors’ inadequate internal controls over their business systems. Further, the two primary government agencies involved, the Defense Contract Management Agency (DCMA) and the Defense Contract Audit Agency (DCAA), are not effectively working together to protect government interests.

The Commission found five systemic problems with current oversight of contractor business systems and makes five recommendations to correct them:



It is our military, civilians, and contractor employees that most acutely feel the impact of contract waste, fraud, and abuse.

### FINDINGS

### RECOMMENDATIONS

<b>1</b>	DCMA's and DCAA's divergent and often contradictory behaviors send mixed messages to contractors.	Department of Defense (DoD) needs to ensure that government speaks with one voice to contractors.
<b>2</b>	Separate government reporting lines of authority complicate issue resolution.	DoD needs to improve government accountability by rapidly resolving agency conflicts on business systems.
<b>3</b>	Audit reports are not informative enough to help contracting officers make effective decisions.	DCAA needs to expand its audit reports to go beyond rendering a pass/fail opinion.
<b>4</b>	DCMA is not aggressive in motivating contractors to improve business systems.	DCMA needs to develop an effective process that includes aggressive compliance enforcement.
<b>5</b>	Agencies are under-resourced to respond effectively to wartime needs.	DCAA and DCMA need to request additional resources and prioritize contingency-contractor oversight workload.

Effective oversight of contractor business systems and internal controls is important and needs immediate attention. Every dollar wasted is a dollar not available for training, equipment maintenance, life-support services, and ultimately for accomplishing the mission. The Congress and taxpayers have a large stake in this issue, but our military, civilians, and contractor employees on the front line are the ones who most acutely feel the impact of contract waste, fraud, and abuse. This fiscal hemorrhaging must stop.

## BACKGROUND

Contractor business systems and internal controls are the first line of defense against waste, fraud, and abuse. Weak control systems increase the risk of unallowable and unreasonable costs on government contracts. Financial risks are greatly heightened in a contingency environment where business operations include new and unfamiliar business markets, foreign practices which often sanction graft, and poor communications that complicate home-office oversight.

The Defense Contract Management Agency is charged with managing the government oversight process with audit and financial advisory services provided by the Defense Contract Audit Agency. The Federal Acquisition Regulation (FAR) gives contracting officers wide latitude in exercising business judgment to make final decisions regarding the adequacy of contractor business systems. A key factor in applying this judgment is the DCAA input from its audits of the following 10 key business systems:

- Control Environment and Overall Accounting System Controls
- Purchasing (subcontracting) Controls
- Indirect and Other Direct Cost Controls
- Compensation System Controls
- Billing System Controls
- Budget and Planning System Controls
- Estimating System Controls
- Material Management and Accounting System Controls
- Labor System Controls
- IT General System Controls

Contracting officers must balance concerns for accomplishing the mission with the risk associated with poor or inadequate business systems.

In addition to supporting the DCMA's contracting-officer assessment of contractors' internal-control compliance, auditing standards generally require that the auditor obtain an understanding of the contractors' systems of internal controls in order to plan the nature, timing, and extent of auditing procedures—that is, substantive tests. In other words, the government auditor does not look at every financial transaction of every contract to determine the reasonableness and reliability of the charges. This would be highly inefficient. Rather the auditor relies on contractor internal controls to limit substantive testing and gives more attention to areas of greatest audit risk.

Theoretically, decisions by DCMA contracting officers are supported and strengthened by professionally sound DCAA business-system audits. When all the pieces in the process work, the government should be able to rely on contractor business systems to substantially reduce risk of waste, fraud, and abuse—especially when significant amounts of taxpayer dollars flow quickly to contingency contractors.



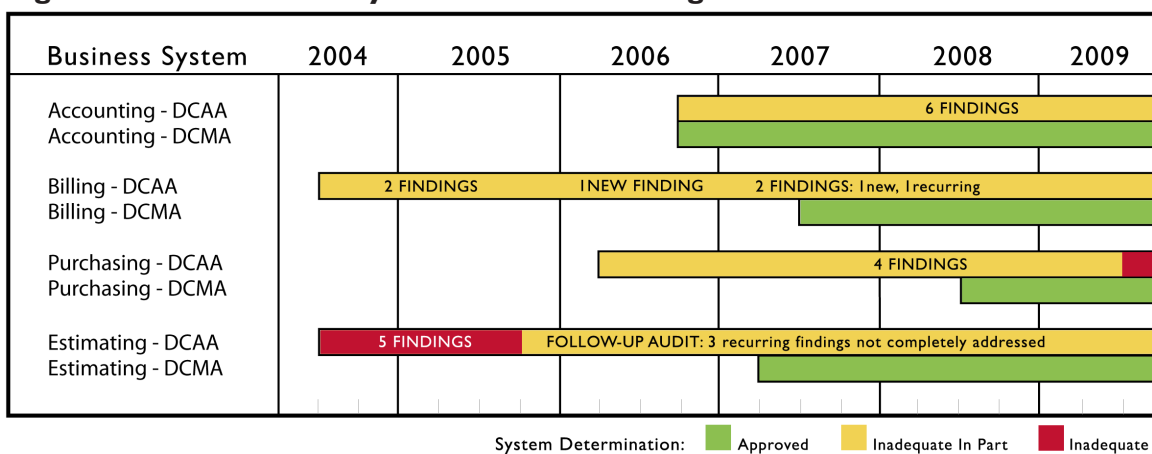
# FINDINGS

## DCMA's and DCAA's divergent and often contradictory behaviors send mixed messages to contractors

A key difference between the roles of DCMA and DCAA must be emphasized: only DCMA contracting officials have the responsibility and authority to enforce contract terms and conditions. In contrast, DCAA's role is advisory. DCMA, as the administrative contracting office, has authority to accept or reject DCAA's advice regarding the adequacy of business systems. While DCAA acts only in an advisory role, its auditors are recognized experts on accounting matters, internal controls, and business systems. Contracting officers are not typically trained in these complex audit and accounting procedures and sometimes make questionable decisions, seemingly ignoring DCAA recommendations.<sup>1</sup> If contracting officials consistently override reasoned audit opinions without proper consideration and DCAA coordination, the result is likely to be continued system deficiencies and increased contract costs.<sup>2</sup> This is a longstanding issue that remains unresolved.<sup>3</sup>

Through research and hearings, the Commission learned that many contractor business systems cannot be relied upon to ensure that proposed and incurred contract costs are reasonable. Many deficiencies identified by the DCAA have remained uncorrected for years because the government failed to insist that the contractor make the necessary corrections. DCAA conducts audits and offers recommendations, but the power to accept audit recommendations, compel action, and impose consequences rests with the DCMA. For example, the Commission reviewed records that show DCMA contracting officials generally contradicted DCAA's negative audit findings of Kellogg Brown & Root International, Inc. (KBR) business systems. As reflected in the figure 1 below, in every case, DCMA found KBR's systems adequate, overruling DCAA's professional audit opinion.

**Figure 1. KBR Business Systems - DCAA findings and DCMA resolution**



Yellow or red bars indicate a negative DCAA audit finding; green bars indicate areas where DCMA determined otherwise.

Source: Data provided to the Commission by DCAA and DCMA in July 2009.

1. DoD Inspector General Oversight Review Report No. D-2009-6-004, *Defense Contract Management Agency Actions on Audits of Cost Accounting Standards and Internal Control Systems at DoD Contractors Involved in Iraq Reconstruction Activities*, April 8, 2009, 8-13.

2. Testimony of April Stephenson, Director, Defense Contract Audit Agency, before the Commission on Wartime Contracting in Iraq and Afghanistan, ". . . [KBR] could not support . . . \$1.5 billion [in LOGCAP III contract costs]," May 4, 2009, 5, [http://www.wartimecontracting.gov/images/download/documents/hearings/20090504/Stephenson\\_DCAA\\_testimony\\_5-4-09.pdf](http://www.wartimecontracting.gov/images/download/documents/hearings/20090504/Stephenson_DCAA_testimony_5-4-09.pdf).

3. <http://www.dodig.mil/Audit/reports/fyod/03-6-001.pdf>.

There seems to be a significant disparity between the importance DCAA and DCMA assign to business systems and internal-control deficiencies. This disparity is exemplified in KBR-related data in Figure 1; however, similar results occur to varying degrees with many of the contingency-contractor business-system audits the Commission examined for logistics support-service contracts in Iraq and Afghanistan. For example, DCAA and DCMA reviewed the same KBR purchase orders and subcontracts issued against the Army logistics civil augmentation program (LOGCAP III) contract from the period January 1 through December 31, 2007, and identified the same deficiencies, but came to different conclusions on the adequacy of KBR's purchasing system. Despite the DCAA inadequacy recommendation, DCMA approved the system. Consistent assessment and reliability of contractors' purchasing systems are especially important because subcontractors provide more than 70 percent of the LOGCAP III services in theater.<sup>4</sup>

Contractors have noticed—and openly discussed—the disagreements and inconsistent approaches between DCAA and DCMA. These two agencies and the contractors have often spent years arguing over whether corrective actions must be accomplished or have been satisfactorily completed in specific cases under dispute. This creates an environment in which contractors can exploit the agencies' mixed messages and game the system to their advantage.

## Separate government reporting lines of authority complicate issue resolution

There is no common line of authority or arbiter to resolve significant differences between DCAA and DCMA, the primary participants in overseeing contingency-contracting business systems. The DCAA reports to the Under Secretary of Defense (Comptroller), while DCMA reports to Under Secretary of Defense (Acquisition, Technology, and Logistics). Their common point of resolution is the Office of the Secretary of Defense—a level too high in the organization structure to effectively resolve differences that continually occur. The Commission is not aware of any instance in which a dispute between the two agencies has risen to the Secretarial level—possibly a sign that disputes may go unresolved because parties are reluctant to push them up the chain of command. These separate lines of authority contribute to a lack of interagency cooperation and collaboration, and make it difficult for the oversight process to work as well as it should.

## Audit reports are not informative enough to help contracting officers make effective decisions

In December 2008, DCAA changed its policy, eliminating “inadequate-in-part” opinions and “suggested management improvements.” Now, all deficiencies reported by DCAA will render the contractor's system “inadequate,” resulting in many more adverse audit opinions. But this does not improve matters. Rather than giving system deficiencies more importance, it seems to have the opposite effect—undermining the significance of the audit findings and weakening their effectiveness. Use of a binary system involving a pass/fail rating does not adequately depict relative degrees of impact. Without any reasonable provision for more accurately describing systems that are less than perfect, contractors and contracting officers find the “adequate/inadequate” options



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4. Ibid., 27.

too restrictive. Moreover, since only significant deficiencies are now reported, there is no provision to report and track recommendations for other desirable improvements.

Contracting officers need audit opinions with clear and quantifiable risk information. They need DCAA's expert opinion about the relative impact or dollar value (or even an estimated range of risk) of the deficiency in order to consider making a contract award or a contract-incentive determination in the face of an "inadequate" audit opinion. Further, cost-impact information provided by DCAA could help the contracting officer determine withhold amounts when necessary. Although DCAA has increased the number of its recommendations to withhold payment, it does not always estimate a cost impact for the deficiencies it has identified. This is of utmost importance to the contracting officer who must make a decision that balances the cost risk against the importance of the mission—that is, making a critical award in the face of an inadequate opinion.

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Federal regulations instruct the contracting officer to consider *significant deficiencies* as distinct from giving an overall opinion on adequacy.

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When contracting officers making decisions about contract actions are presented with multiple and potentially differing opinions, their ability to make an overall assessment of system acceptability is severely limited. Apart from contractor systems specifically addressed in the FAR (e.g. the accounting system), there is no regulatory requirement for DCAA to render an overall opinion regarding the adequacy of many of the 10 business systems audited by DCAA. In fact, with respect to audit resolution procedures, DoD

FAR Supplement (DFARS) 242.7502 instructs the contracting officer to consider *significant deficiencies* as opposed to an overall opinion regarding adequacy.

## **DCMA is not aggressive in motivating contractors to improve business systems**

When confronted with significant audit findings, contractors generally promise to improve their business systems by providing corrective-action plans to contracting officers. These plans, as opposed to completed corrective actions, are often accepted by contracting officers, thus effectively rendering a system adequate.<sup>5</sup> Subsequently, there is no basis to pursue any suspension of percentage-of-progress payments, withhold reimbursement of costs, or use other incentives to ensure that contractors implement thorough and effective improvements. The Director of DCAA testified that contract withholds have a proven capacity to cause contractors to remedy inadequate business systems.<sup>6</sup> For example, a "withhold" was placed on Titan Corporation's in-theater linguist contract as a result of DCAA's "inadequate" opinion on its labor system. As much

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5. Testimony of David Ricci, Executive Director, Contracts, Defense Contract Management Agency, before the Commission on Wartime Contracting in Iraq and Afghanistan, August 11, 2009, 25, <http://wartimecontracting.gov/images/download/documents/hearings/20090811/Transcript%20-%20August%2011%202009%20Business%20Systems%20Hearing.pdf>.

6. Testimony of April Stephenson, August 11, 2009, 36.

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DCMA has felt "a kind of almost direction to work with your industry counterparts," an agency official testified.

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as \$40 million was withheld, with portions returned to the contractor as each system deficiency was corrected.<sup>7</sup> This approach motivated the contractor to fix the deficiency as quickly as possible while mitigating the government's risk during the process. Each of the contractors at the Commission's August 11 hearing agreed that contract withholds serve as a motivator to correct reported deficiencies.<sup>8</sup> The CEO of DynCorp said it does not take a big withhold to catch a contractor's attention.<sup>9</sup>

Nevertheless, the contract withhold remedy is rarely used even though the DFARS 242.7502 clearly instructs contracting officers to "consider whether it is appropriate" to suspend some payments until contractors submit a plan and correct deficiencies. Despite this regulatory coverage, DCMA's Executive Director, Contracts, testified that he does not believe that DCMA has the authority to conduct withholds under cost-reimbursement or incentive-type contracts without an implementing clause or without showing a "logical nexus or causality between the specific system deficiency and the cost."<sup>10</sup> DCAA does not always provide this nexus, but DCMA has also been very conservative in its application of the available DFARS option. The DCMA's Executive Director, Contracts, testified at the Commission's August 11 hearing about "a kind of almost direction to work with your industry counterparts ... to the extent that DCMA perhaps has not taken the strongest action that maybe it could have."<sup>11</sup> This conservative approach results in little, if any, motivation for contractors to improve their business systems, and ultimately has a direct impact on the warfighting mission.

## Agencies are under-resourced to respond effectively to wartime needs

Poor alignment of personnel to meet wartime needs has resulted in a spiraling down of business-system oversight in contingency contracting. There have been too few experts to conduct reviews and too few personnel to validate that contractor corrective action was properly implemented.

As a result of personnel shortfalls, DCAA system reviews and follow-ups are not always timely; therefore, the real-time status of contractor business systems cannot always be determined. As noted in our Interim Report to Congress, DCAA has not performed timely reviews of many contractor business systems. For example, the last full billing and estimating system reviews of KBR were completed in 2004; current reviews are scheduled for completion in late 2009 or early 2010.

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7. Ibid., 17.

8. Testimony of Msrs. Methot, Ballhaus, and Walters, representing Fluor, DynCorp, and KBR, August 11, 2009, 106.

9. Ibid.

10. Testimony by David Ricci, 26 and 36.

11. Ibid., 62.

Top: 8/11 CWC Panel 1, l-r: Jeff Parsons, Army; April Stephenson, DCAA; David Ricci, DCMA.  
Bottom: 8/11 CWC Panel 2, l-r: David Methot, Fluor; William Ballhaus, DynCorp; William Walter, KBR.

Corrective actions taken by contractors sometimes remain unvalidated for extended periods of time. Consequently, contracting officers may not have current and accurate information to determine if the corrective actions that were implemented actually resolved system deficiencies. This may also give contractors the impression that the government does not consider business system reviews to be important. DCAA's practice is to conduct follow-up assessments on contractors' corrective actions within 6 to 12 months.<sup>12</sup> In some cases, however, these assessments take more than a year to complete. For instance, DCAA's April 2009 report on KBR's purchasing system was the culmination of a review that started in January 2008.<sup>13</sup>

Another indication of personnel shortages is the small number of DCMA personnel devoted to contractor purchasing system reviews (CPSR). The number of personnel assigned to perform CPSR reviews has decreased from 102 in 1994 to 70 in 2002, to 14 in 2009. Contract transactions, on the other hand,

have increased by 328 percent since fiscal year 2000.<sup>14</sup> This steep decline in personnel, combined with the exponential increase in contracting activity, demonstrates a diminishing level of DCMA critical analysis of contractor purchasing systems.

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The Commission believes that many of the untimely reviews are due to the failure of both DCAA and DCMA to prioritize their business-system workload in a wartime environment. DCAA does review outputs generated by contractor business systems, such as proposals that reflect contractors' estimating systems. In fact, the DCAA Director testified that the agency found \$6.1 billion in unsupported estimating costs in Iraq and

Afghanistan.<sup>15</sup> But DCAA is under-resourced for comprehensively reviewing all contingency contractors' business systems on a timely basis.

The Commission recognizes that both DCAA and DCMA have recently requested additional resources to effectively accomplish their full missions. Nevertheless, the wars in Iraq and Afghanistan have been going on for many years and the Commission is at a loss to understand why leadership has not aggressively pursued additional staffing until recently. In addition, it is the job of DCMA and DCAA leadership to reallocate existing, albeit limited resources in accordance with mission priorities. Timely oversight of contingency contractors' business systems should be a priority for both agencies during wartime.

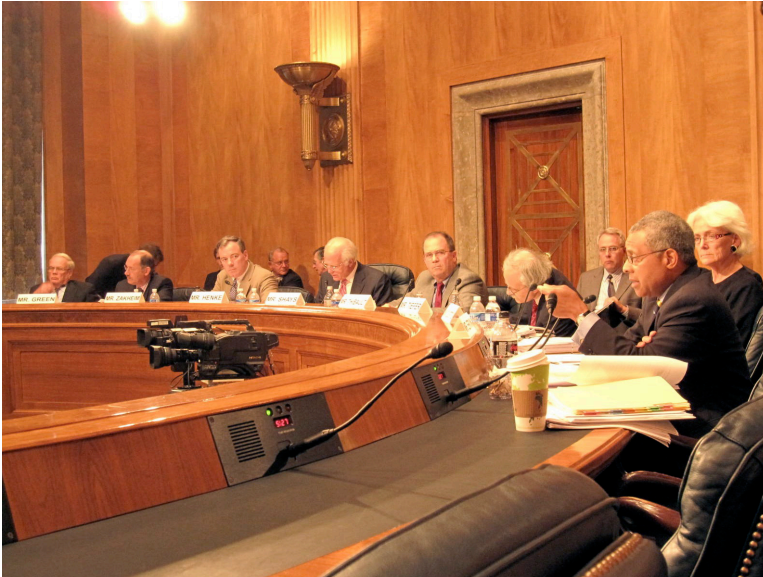
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12. Testimony of April Stephenson, August 11, 2009, 50.

13. Information provided to the Commission by DCAA in July 2009.

14. Information provided to the Commission by DCMA on August 4, 2009.

15. Testimony by April Stephenson, May 4, 2009, 4.



Commissioners pose questions to witnesses at August 11, 2009, hearing on Capitol Hill.

## FINDINGS SUMMARY

Opinions rendered and actions taken on contingency-contractor business systems have not received the attention necessary to monitor the billions of dollars of costs that flow through these systems. The five findings of this report indicate that the oversight process, as well as the communication between agencies must improve if we are to effectively mitigate the risk of waste, fraud, and abuse.

These findings would be important in peacetime; in wartime they are critical.

Because the United States relies on contractors as a primary source of in-theater support, it is imperative that the government correct the flaws in this process. The Commission offers the following recommendations for improvement.



# RECOMMENDATIONS FOR IMPROVEMENT

## **DoD needs to ensure that government speaks with one voice to contractors**

DCMA and DCAA must work closely together to protect the government's interests. The Commission believes it is possible to achieve this while maintaining the auditing independence desired by DCAA and respecting the decision-making authority of the contracting officer. Audits and assessments that are conducted using a well-defined evaluation methodology will provide a consistent government position that is clear to the contractor. DCAA and DCMA must work together to develop agreed-upon standards and processes that communicate the same message to both the individual contractor and the contracting community and help contractors achieve "adequate" systems. Ideally, the process should be defined in the FAR (in a way similar to the material-management and accounting-system standards called out in the DFARS 252.242.7004) so they are visible to all stakeholders.

## **DoD needs to improve government accountability by rapidly resolving agency conflicts on business systems**

The Department of Defense needs to re-establish control of the oversight process to the government by developing better internal-resolution processes. The DoD process should ensure that disagreements between DCAA and DCMA are rapidly resolved, with consideration for DCAA's independent audit expertise as well as for the DCMA contracting officer's decision-making authority and the operational mission.

## **DCAA needs to expand its audit reports beyond rendering a pass/fail opinion**

DCAA should revisit its policy with respect to its binary "adequate/inadequate" opinions for business-system reports and provide a mechanism for reporting any deficiency that warrants formal notification and tracking. Also, whenever possible, audit reports should include an assessment of audit risk and cost impact associated with reported deficiencies. Further, DCAA should re-examine the need to express opinions on the overall adequacy of business system audits beyond those explicitly required by the FAR.

## **DCMA needs to develop an effective process that includes aggressive compliance enforcement**

DCMA, with DCAA advice, should develop a reliable and aggressive process for reaching consistent decisions on business systems and any corrective action needed. The process should recognize the contracting officer as the final authority but also acknowledge DCAA auditors as the business-system experts chartered to advise government contracting organizations, as noted in the DCAA mission statement.<sup>16</sup> Disagreements with audit recommendations should be discussed at appropriate leadership levels within DCMA and DCAA and documented accordingly. As part of their decision process, DCMA contracting officers should also consider any risk analysis provided by DCAA and thoroughly address it in documenting their decisions. Finally, DCMA should ensure timely follow-up on contractor corrective-action plans and validate that the contractor actions actually correct the deficient business system. If not, the contracting officer should pursue such contractual remedies as withholds, and DCMA leadership should ensure that this occurs. If DCMA leaders believe there is ambiguity about their ability to impose withholds, they should seek clarification and resolution from the Undersecretary of Defense for Acquisition, Technology, and Logistics.

## **DCAA and DCMA need to request additional resources and prioritize contingency-contractor oversight workload**

The Commission believes that much of the delay in delivering audit opinions and enforcing corrective action is caused by the failure of both DCAA and DCMA to obtain enough resources and to effectively prioritize the wartime workload. These agencies need to give contractor business systems the appropriate priority and allocate resources accordingly. Both DCAA and DCMA have requested increases to their workforce in order to fulfill their assigned missions. The Commission strongly encourages each organization to aggressively pursue additional staff, but also to immediately prioritize its current workload to meet government oversight needs in the contingency-contracting arena. This is imperative to address the risks of waste, fraud, and abuse.

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16. .See "The DCAA Organization," <http://www.dcaa.mil>.

## CONCLUSION

At the August 11, 2009 hearing, the Commissioners asked DCMA and DCAA to work together to improve the state of affairs outlined in this Special Report. A resolution is necessary sooner rather than later, and both agencies have been invited back to testify on their progress. The Commission hopes to learn that they have indeed made significant progress in developing an effective oversight program that capitalizes on the strengths of each organization. The Commission hopes to hear the agencies propose a plan that positively addresses each of the above findings and recommendations and we recommend that this plan subsequently be fully coordinated within the Department of Defense.

Both agency directors have made a commitment to implementing improvements. DCMA Director Charlie Williams sent a post-hearing letter for the record to the Commission committing to identify opportunities for improvement and to implement solutions. DCAA Director April Stephenson gave a similar commitment during her testimony.

Making sure that contractor business systems are reliable will have far-reaching consequences for all contracts executed to support contingency operations. Government regulations need to ensure that audit follow-up and resolution is effective and timely for all government contracts. In the coming months, the Commission intends to expand its research to contractor business systems supporting Department of State and U.S. Agency for International Development contingency contracts. The Commission's Final Report to Congress will reflect the results of all Commission work in this area. It will include lessons learned and recommendations for permanent improvement of oversight of wartime-contractor business systems.

Despite the difficulty of providing critical support for U.S. contingency operations in Iraq and Afghanistan, DCAA and DCMA military personnel, civilian employees, and private contractors have performed diligently and at the cost of great personal sacrifice. The Commission's recognition of opportunities for improvement and suggestions for reform in no way diminish their contributions.



The Commission on Wartime Contracting is an independent, bipartisan legislative commission established in Section 841 of the National Defense Authorization Act for Fiscal Year 2008 (Public Law 110-181) to study federal agency contracting for reconstruction, logistical support, and security functions in Iraq and Afghanistan.

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