

Testimony

of

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before the

Commission on Wartime Contracting

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Chairman Thibault, Chairman Shays, and members of the Commission, thank you for the opportunity to appear before you today. As requested, I will discuss the status of our effort with the Defense Contract Management Agency (DCMA) and Mr. Shay Assad, Director, Defense Procurement and Acquisition Policy, related to the oversight of contractor business systems. Along these lines, I will provide an update on our actions for assessing the appropriate opinion to provide when auditing contractor business systems. Lastly, I will provide an update on several issues discussed at prior hearings with the Commission.

Background

The Defense Contract Audit Agency (DCAA) is a distinct agency of the Department of Defense (DoD) that reports to the Under Secretary of Defense (Comptroller). The DCAA mission is to perform all necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting thereby protecting the taxpayer's interest. In total, DCAA has about 4,400 employees and 105 field audit offices around the world.

In FY 2009, DCAA performed 21,276 audits covering \$330 billion in proposed or claimed contractor costs. These audits recommended reductions in proposed or billed costs of \$20.4 billion (referred to as questioned costs), and \$12.1 billion in estimated costs where the contractor did not provide sufficient information to explain the basis of the estimated amounts (referred to as unsupported costs).

DCAA Audit Effort Update: In-Theatre Contracts

DCAA is responsible for providing Iraq/Afghanistan related contract audit services to both DoD and other Government organizations with about 114 contractors. These contractors hold more than 271 prime contracts with contract ceiling amounts of \$81.7 billion and funding to date of about \$65.9 billion.

Through FY 2009, DCAA has issued 3,036 reports in support of in-theatre contracts. We estimate issuing another 400 reports in FY 2010. As reported to you in May and August 2009, DCAA oversight of in-theatre contracts has found a number of problems. Our resulting action has ranged from recommending changes in processes to collection of overcharges to referral of our findings to the Inspector General for possible legal action against a contractor. Through FY 2009, DCAA has reported total exceptions of \$16.3 billion consisting of recommended reductions in proposed and billed contract costs of \$8.8 billion and \$7.5 billion of estimated costs where the contractor has not provided sufficient rationale for the estimate.

In May and August 2009, I reported that DCAA discovered numerous instances of inflated prices for dining facilities, living units, and various other logistical support items related to the war effort. Currently, DCAA has issued over 140 Forms 1 under the Logistics Civil Augmentation Program (LOGCAP) III program that suspended or disapproved over \$655 million. Of this amount, \$439 million has been resolved. Unresolved amounts have generally been temporarily recovered from the contractor pending contracting officer final determinations.

I would like to provide an update on two issues: disapproval of \$103 million in private security costs in August 2009 and ineffective drawdown by Kellogg Brown & Root (KBR) in Iraq costing the Government at least \$193 million.

Private Security Costs

In May 2009, I briefed the Commission that KBR incurred private security costs that were prohibited under the LOGCAP III contract. In February 2007, DCAA issued a Form 1 suspending \$19.7 million of private security costs and recouped the money from KBR shortly thereafter. In August 2007 we completed our audit of KBR's security cost submission and concluded that the information provided by KBR was not adequate for determining the amount and extent of prohibited private security costs billed to the government on LOGCAP III, but we estimated that the private security costs could be at least \$100 million. In April 2008, KBR filed a claim with the Armed Services Board of Contract Appeals to recover the \$19.7 million suspended by DCAA.

Although the Board has yet to make a decision, we determined that KBR had previously been paid in excess of the \$19.7 million and had not yet repaid the Government. As a result, in August 2009, we issued a Form 1 disapproving \$103 million (the \$19.7 million suspended in February 2007 is part of the \$103 million) in hopes of recouping previously paid private security costs while we await a decision from the Board. In August 2009, we recouped \$22.3 million resulting in a total repayment from KBR of \$42 million (19.7 million + \$23 million). We understand that the Army is assessing the disapproval by DCAA and is in the process of initiating action to recoup the remaining costs.

We believe the \$103 million is a very conservative estimate, but due to the lack of visibility in KBR's accounting records for private security costs incurred by subcontractors, it is the most supportable estimate we have at this time. However, KBR made the following disclosure in the footnotes of their 2008 Annual Financial Statements:

“If we are unable to demonstrate that such action by the Army is not necessary, a 6 percent suspension of all subcontract costs incurred to date could result in suspended costs of approximate \$400 million.”

Ineffective Drawdown by KBR in Iraq

As mentioned during the Commission hearing in August, in light of the military drawdown in Iraq, DCAA had initiated several audits of KBR's labor operations in Iraq. In October 2009, we issued a report concluding that KBR's drawdown was ineffective and KBR could save the Government at least \$193 million by improving the staff management and aligning their labor drawdown with the military drawdown. When the military reduced its troop levels from 160,000 to 130,000, a 19 percent reduction, KBR's staffing levels remained constant. At the 160,000 troop level, the ratio of KBR staff to troops was 1:9.4. The ratio is 1:7.6 with a troop level at 130,000. At the time of our audit, KBR did not have a detailed, written plan to reduce staffing levels in consonance with the military drawdown.

In addition, KBR's system and procedures for staff management were not sufficiently detailed to identify and prevent overstaffing. We estimate that without significant action, KBR would have 1 employee for each 3.6 in military troops by August 2010. Even if KBR achieves its projected quarterly 5 percent staffing reduction, we estimated KBR will be overstaffed by an average of 2,857 from January 2010 to August 2010. The average payroll for this 8 month

period for these employees is \$193 million. The \$193 million is a very conservative amount and KBR could achieve increased savings if more aggressive staff management techniques were used. The \$193 million represents excessive costs to be paid by the Government if KBR does not take immediate action to reduce its staffing levels commensurate with the military drawdown.

Oversight Update: Actions Related to Contractor Business Systems

DCAA Actions

Last year, we recognized the need to reassess the current process for auditing contractor business systems and established a project for that purpose. This project includes assessing the DCAA process for evaluating and reporting on contractor internal controls considering the requirements of the Generally Accepted Government Auditing Standards and the need to provide contracting officials with the necessary information to meet their responsibilities related to contractor systems under the Federal Acquisition Regulations.

Based on our analysis of the relevant auditing standards, we determined that DCAA is not required to audit and report on the overall adequacy of the contractor's system and related internal controls. We believe reporting significant deficiencies/material weaknesses on contractors' various subsystems comprising the overall accounting system (e.g., billing, purchasing), as opposed to an overall audit opinion on the adequacy of each of those systems, may be a better approach because it would place the focus on the significant deficiencies/material weaknesses instead of the contractor's system as a whole. This revised audit approach would eliminate the concerns of a pass/fail rating as was raised at the hearing in

August. We believe this audit approach would help DCMA and DCAA work together to ensure the contractor takes the appropriate corrective actions.

We have recently completed our preliminary assessment of the revised audit process for evaluating contractor billings and I briefed the DoD Inspector General on the revised audit process. We plan to begin field testing the revised audit approach this month. The revised audit approach focuses resources where the risk is, by performing real-time testing of contractor billings and evaluating key aspects of the contractor's billing process. The revised process calls for DCAA to report significant deficiencies/material weaknesses identified during the audit, but not issue an overall opinion on the system. We anticipate that our reassessment will be complete by the end of December 2009.

Consequently, until we have completed this assessment, we will continue to issue audit reports on internal controls with two opinions – adequate and inadequate. We believe it would be counter-productive to revise the process for a month or two and then revise it again at the end of the calendar year when we complete our analysis of the revised auditing process and procedures.

To ensure our FY 2010 audits of contractor business systems reflects the revised audit process, no new internal control audits will be started until the revised audit process is tested and distributed to the field audit offices.

Joint DCAA, DCMA, and AT&L Actions

On August 27, 2009, Mr. Shay Assad, Director, Defense Procurement and Acquisition Policy announced the establishment of a new subcommittee under the Panel on Contracting Integrity to perform a comprehensive review of current policy, processes and practices within the DoD regarding the evaluation of contractor business systems. The DCAA Director is a member of this subcommittee along with DCMA representatives. The first meeting was held on October 23, 2009 with actions items established. We believe this subcommittee will meet the intent of the Commission's tasking as part of the subcommittee's objectives will be to define the criteria for what constitutes an adequate business system. In addition, the subcommittee will determine the necessity for mandatory contractor suspensions pending implementation of contractor corrective action to address internal control deficiencies.

Closing

In closing, DCAA will continue to work closely with all acquisition organizations to promote an integrated, well-managed contract audit process in-theatre. I believe Mr. Assad's establishment of the new subcommittee is a positive step to improving the oversight of contractor systems.