

Testimony

of

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Chairman Thibault, Chairman Shays, and members of the Commission, thank you for the opportunity to appear before you today; I am pleased to be here. As requested, I will describe the audit effort performed by the Defense Contract Audit Agency (DCAA) on contractor business systems for contractors performing effort in-theatre.

Background

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 contract audits for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA also provides contract audit services to about 35 civilian Government organizations.

In FY 2008, DCAA performed 30,352 audits covering \$501 billion in proposed or claimed contractor costs. These audits recommended reductions in proposed or billed costs of \$17.9 billion (referred to as questioned costs), and \$7.2 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). In total, the DCAA has about 4,200 employees and 104 field audit offices.

DoD Contract Performance Oversight Responsibility In-Theatre

DCAA has been an integral part of the oversight and management controls instituted by DoD to ensure integrity and regulatory compliance by contractors performing services in-theatre. DCAA's services include audits and professional advice to acquisition officials on accounting and financial matters to assist them in the negotiation, award, administration, and settlement of contracts.

Decision-making authority on DCAA recommendations resides with contracting officers within the procurement organizations who work closely with DCAA throughout the contracting process.

DCAA Staffing and Actions

Since April 2003, DCAA has worked with all U.S. procurement organizations supporting Iraq/Afghanistan Reconstruction to establish the resources and planning information needed to carry out required audits of contract costs as they are incurred and billed. These organizations include the Joint Contracting Command – Iraq/Afghanistan, the Army Sustainment Command, the U.S. Army Corps of Engineers, the Defense Contract Management Agency in Iraq and Kuwait, USAID, and the State Department.

DCAA is responsible for providing Iraq/Afghanistan related contract audit services to both DoD and other Government organizations at about 111 contractors. These contractors hold more than 261 prime contracts with contract ceiling amounts of \$75.7 billion and funding to date under those contracts of about \$62.0 billion. DCAA audits of cost-reimbursable contracts represent a continuous effort from contract award to final closeout and payment. Initial audits of contractor business system internal controls and preliminary testing of contract costs are carried out to provide a basis for provisional approval of contractor interim payments and early detection of deficiencies. Early detection is important to reduce the risk of overcharging on Government contracts and cost issues becoming an impediment to contract performance. Comprehensive contract cost audits are performed annually throughout the life of the contract and are used by the contracting activity to negotiate final payment to the contractor.

To carry out the extensive and time-sensitive audit requirements, DCAA has implemented planning and coordination procedures to effectively integrate audit work between the Iraq Branch Office, opened in May 2003, and more than 60 DCAA CONUS Audit Offices with cognizance of companies performing contracts in-theatre.

Just recently, I approved the opening of a second audit office in-theatre with a home base in Afghanistan. We are in the process of coordinating the logistics with CENTCOM and anticipate the office will be operational shortly. In the meantime, we are proceeding with adding a second manager and ramping up the audit staff in Afghanistan in anticipation of the increased workload.

Results of Audits

Through June 2009, DCAA has completed over 200 business system audits and has cited deficiencies in more than half of the audits. We have recommended withholds in 12 of the audits and 4 withholds have been implemented to date. Examples of system deficiencies will be discussed throughout the remainder of the testimony. We also provide for the Commission's consideration, our top five lessons learned with recommendations from auditing contractor business systems in a war environment.

Contractor Business Systems

General Overview

Business systems and related internal controls are an essential part of any organization and provide reasonable assurance for preventing loss of resources, maintaining reliable financial reporting and complying with laws and regulations. In the Government contracting environment, adequate

contractor business systems and related internal controls are essential in protecting the Government's interest and preventing contractor overpayment.

In 1977, the Foreign Corrupt Practices Act was enacted and required corporate management to maintain books, records and accounts that accurately and fairly reflect the transactions and dispositions of the corporation's assets and to devise and maintain a system of internal accounting control adequate to accomplish certain objectives. The key theme underlying the passage of this act was that sound internal control should provide an effective deterrent to fraudulent and improper payments.

In 1985, the National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, was created. The Commission made a number of recommendations that directly addressed internal controls. Based on those recommendations a task force under the auspices of the Committee of Sponsoring Organizations of the Treadway Commission conducted a review of internal controls and provided an Internal Control Integrated Framework that is widely accepted by legislators, regulators, governmental agencies, and corporations. The Framework defined internal control as a process, affected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Requirements for Adequate Business Systems – Government Contracts

The overarching requirement for Government contractors with systems audited by DCAA is Defense Federal Acquisition Regulation Supplement 242.75, *Contractor Accounting Systems and Related Controls*, which states in part:

Contractors receiving cost-reimbursement or incentive type contracts, or contracts which provide for progress payments based on costs or on a percentage or stage of completion, shall maintain an accounting system and related internal controls throughout contract performance which provide reasonable assurance that—

- (a) Applicable laws and regulations are complied with;*
- (b) The accounting system and cost data are reliable;*
- (c) Risk of misallocations and mischarges are minimized; and*
- (d) Contract allocations and charges are consistent with invoice procedures.*

Federal Acquisition Regulation Subpart 16.1, *Selecting Contract Types*, requires contracting officers to ensure the adequacy of the contractor's accounting system before agreeing on a contract type other than firm-fixed-price type contract. The contractor's accounting system shall permit timely development of all necessary cost data in the form required by the proposed contract type.

In addition to the overarching requirements for adequate business systems, the regulations specifically address certain business systems in more detail. Examples of the purchasing system and estimating system follow.

Purchasing System

Federal Acquisition Regulations 44.3, *Contractors' Purchasing Systems Reviews*, requires the contracting officer to evaluate the efficiency and effectiveness of a contractor's purchasing system including policies, procedures, and practices related to subcontracting. The regulations stipulated that the contracting officer shall approve a purchasing system only after determining that the

contractor's purchasing policies and practices are efficient and effective and provide adequate protection of the Government's interests.

Cost Estimating System

Defense Federal Acquisition Regulation Supplement 252.215-7002, *Cost Estimating System*

Requirements, requires contractors to have an "acceptable estimating system" that:

- (1) Is maintained, reliable, and consistently applied;
- (2) Produces verifiable, supportable, and documented cost estimates that are an acceptable basis for negotiation of fair and reasonable prices;
- (3) Is consistent with and integrated with the Contractor's related management systems; and
- (4) Is subject to applicable financial control systems.

Cost Accounting Standards

Public Law 100-679 (41 USC 422), as implemented in the acquisition regulations, requires contractors and subcontractors meeting certain criteria to disclose in writing their cost accounting practices in a document referred to as the Cost Accounting Standards Board Disclosure Statement in addition to meeting the requirements of a number of specific accounting standards. This disclosure provides an authoritative description of the contractor's cost accounting practices to be used on Federal contracts. When contractors deviate from the disclosed practices, they may be liable for increased costs paid by the Government as a result of the change/deviation. Further, when a contractor fails to submit the required Disclosure Statement or to comply with its disclosure practices or the applicable Standards, DCAA will cite the contractor for a noncompliance. Such failure may also be considered a significant deficiency/material weakness in the contractor's accounting system and related internal controls.

DCAA Internal Control Audits

DCAA relied on the work of the Treadway Commission, the Standards established by the American Institute of Certified Public Accountants, and the acquisition regulations in designing audit procedures to assess the contractors' systems of internal controls. Using the framework of the Committee of Sponsoring Organizations, DCAA established audit procedures for audits of the ten contractor business systems listed below:

1. Control Environment and Overall Accounting System
2. General Information Technology System
3. Budget and Planning System
4. Purchasing System
5. Material System
6. Compensation System
7. Labor System
8. Indirect and Other Direct Cost System
9. Billing System
10. Estimating System

DCAA audit procedures include tests of key contractor internal controls that we believe a contractor business system should possess to be adequate and to ensure the Government's interests are protected and the risk of contractor overpayments is minimized. DCAA performs these audits at contractor locations that charge significant contract costs to the Government.

The acquisition regulations stipulate that the contracting officer obtain from DCAA the status of contractor business systems and related internal controls for various actions. For example, Federal Acquisition Regulation 9.105.1(b)(2)(i)(B) requires the administrative contracting officer to obtain from the auditor any information required concerning the adequacy of prospective contractors' accounting systems and the Defense Supplement 253.209-1(a)(i)(E) requires an assessment by the

auditor of the adequacy of the prospective contractor's accounting system and related internal controls.

Effect of Inadequate Business Systems

When a contractor's business system and related internal controls are inadequate, the data generated by the contractor's system is unreliable, which, in turn, results in the risk of noncompliances with Government laws and regulations, mischarging, fraudulent acts and contract overpayments.

Since an inadequate business system is considered a critical breakdown in the contractor's processes, the acquisition regulations require contracting officers take certain actions when deficiencies are found and reported. Specifically, the overarching provision at Defense Federal Acquisition Regulation Supplement 242.75, *Contractor Accounting Systems and Related Controls*, requires contracting officers to consider whether it is appropriate to suspend a percentage of progress payments or reimbursement of costs proportionate to the estimated risk to the Government when significant accounting system or related internal control deficiencies are identified. The costs may be suspended until an acceptable corrective action plan is submitted and the deficiencies are corrected.

In addition to the overarching acquisition requirements, actions related to specific systems are mentioned throughout the acquisition regulations. For examples, Federal Acquisition Regulation 44.305 covers the purchasing system and stipulates that the contracting officer may withdraw approval of the contractor purchasing system at any time based on the determination that there has been a deterioration of the contractors system or to protect the Government's interest. Approval

shall also be withdrawn when there are recurring noncompliances with requirements such as the Cost Accounting Standards or subcontract administration.

Examples of Inadequate Business Systems for In-Theatre Contracts

During our audits of contracts and contractor business systems for contracts performed in-theatre, we have reported a number of system deficiencies. This section provides several examples of system deficiencies involving three contractors performing significant effort in-theatre – DynCorp, KBR, and Fluor. This list is not meant to be all-inclusive and we would be pleased to provide a more comprehensive briefing to the Commission at another time.

DynCorp

Since March 2009, we have reported three business systems at DynCorp to be inadequate. These inadequacies have resulted in billings to the Government that significantly exceed allowable amounts. In the last few months, 15 of 29 billings sampled prior to payment (for \$8.7 million of the sampled \$20.6 million) have been rejected for various reasons. For example, on the LOGCAP IV contract task orders in Kuwait, we have rejected three vouchers to date, totaling \$2.1 million. DynCorp billed labor rates and fringe costs were significantly higher than those proposed (more than 10 percent greater than proposed). The LOGCAP IV contract includes a specific provision requiring all compensation increases of greater than 10 percent from those proposed be approved by the Contracting Officer [prior to charging the Government]. However, DynCorp did not obtain the required approval prior to billing these costs.

As a result of what could be described as “buying-in” to the LOGCAP IV task orders, shortly after DynCorp was awarded the LOGCAP IV task orders for Kuwait, it submitted change order proposals requesting an increase in price of about 51 percent or a \$49.9 million increase. The increase is primarily due to increased labor costs DynCorp stated it incurred to hire employees in-theatre. Pending contracting officer evaluation of the change order proposals and modification of the contract task orders, DynCorp has agreed to voluntarily decrement its billings for labor on this contract by 32 percent and to defer billing of indirect costs completely to obtain DCAA approval for provisional payment.

Unfortunately, DynCorp’s billing issues are not unique to LOGCAP. We identified a number of other billing deficiencies through our audits of the Department of State Civilian Police Contract Task Orders. The audits to date have resulted in \$13.3 million of identified overbillings refunded by DynCorp to the Department of State as follows:

- Camp Outer Wall, Rifle Scopes, Generators Paid but Not Provided - \$5.1million
- Generator fuel and body armor billed but not delivered - \$3.8 million
- Duplicated Other Direct Costs billed - \$2.9 million
- Water Purification Systems Paid but Not Delivered - \$528K
- Duplicated freight costs billed - \$307K
- Body Armor Double Billed - \$225K
- Body Armor Paid but Not Delivered - \$176K
- Immunizations Double Billed - \$161K
- Billed fuel costs not applicable to task order - \$101K

The Department of Defense has also received credits from DynCorp totaling \$6.89 million on the Global Linguist Solutions Contract for costs DynCorp states it unintentionally misclassified.

KBR

As stated in our testimony to the Commission on May 4, 2009, we have reported a number of issues related to system deficiencies at KBR. Rather than repeating the extensive list of issues in this testimony, we refer the Commission to the May 4th written testimony. However, it is worth noting in this testimony that the effects of inadequacies related to KBR's purchasing system resulted in significant unreasonable subcontract prices on the LOGCAP III contract. We issued a number of DCAA Forms 1 suspending hundreds of millions of dollars due to unreasonable and unsupported costs, many of which stem from deficient systems.

In April 2009, DCAA issued an audit report on KBR's purchasing system reporting that KBR failed to (i) perform adequate cost/price analysis of subcontractor proposals, (ii) conduct sufficient market research of suppliers prior to solicitation, (iii) obtain the Contracting Officers' consent to subcontract in a timely manner, and (iv) justify the reasonableness of prices and costs billed to the Government.

For instance, without adequate rationale or documentation, KBR awarded a subcontract for trucking services for \$7.2 million which was 41 percent higher than the lowest bidder. We also cited a number of examples involving unreasonable dining facilities costs. Although improvements have been made over time, we are still discovering instances of unreasonable subcontract prices and instances where KBR has failed to conduct adequate price analysis of subcontract costs.

Subsequent to the over-haul of the dining facility contract terms and procedures by the Army in April 2005, DCAA has issued five DCAA Forms 1 suspending an additional \$64.7 million which remain unresolved as of today. DCAA has also recommended the Army pursue additional recoveries as a result of potential false claims allegedly perpetrated by former KBR employees involving dining facility subcontracts.

As another example of unreasonable subcontract prices as a result of an inadequate purchasing system, KBR purchased about 4,100 living units at an average unit price of \$38 thousand when a lower priced vendor proposed \$18 thousand each for containers having similar amenities. The \$20 thousand unit price difference equates to questioned costs of about \$82 million.

Many of these deficiencies reported in our April 2009 report were contained in a report issued in 2006 and although KBR submitted a corrective action plan, many of the corrections were not implemented.

Fluor Federal Services

Shortly after receipt of the task orders under LOGCAP IV, DCAA determined that Fluor billed direct labor and indirect costs for a new Fluor business segment, Fluor Federal Global Projects, that had not been disclosed to the Government under the Statutory requirement (as implemented in the regulations) to disclose its accounting practices in the Cost Accounting Standards Disclosure Statement. In June 2009, DCAA rejected interim billings and instructed Fluor to comply with the Statutory disclosure requirements. Fortunately, the contracting officer responsible for Fluor has been very supportive of DCAA's findings and immediately instructed Fluor to bill only direct

contract costs and associated fee until the indirect rate issues are resolved. We appreciate the prompt actions of the contracting officer responsible for Fluor.

Government Adequacy Determination and Contract Audit Follow-up

Under the acquisition regulations, DCAA audit reports, including reports on contractor business systems, are considered advisory. In the case of business systems, the administrative contracting officer is responsible for the final determination of system approval. In most instances, the Defense Contract Management Agency (DCMA) is responsible for system approval. Tracking of DoD administrative contracting officers' final disposition of inadequate systems is handled through the DoD Contract Audit Follow-up System. Under the follow-up system, DCAA provides DCMA a listing of audit reports in the Contract Audit Follow-up system awaiting contracting officer actions as annotated in the DCAA management information system. The Contract Audit Follow-up System is only used by DoD. When the contracting officer is other than DoD, outstanding audit reports with system deficiencies is not as easily accomplished by the contracting officer community.

For example, the administrative contracting officer responsible for the final approval/disapproval of business systems for Fluor Federal Services changed from the Department of Energy to the Defense Contract Management Agency in January 2009. Without a Federal-wide Contract Audit Follow-up System, some of the unresolved DCAA audit reports could have gone unaddressed. However, when it came to our attention that the DCMA contracting officer was not aware of the reports we previously issued to the Department of Energy, we obtained the outstanding audit reports from the DCAA Management Information System and provided a briefing along with the reports to the DCMA contracting officer.

Contractor Corrective Action Plans

When the contracting officer agrees with DCAA's reported deficiencies, it will request a corrective action plan from the contractor. After DCAA is notified that the contractor has implemented actions to correct the deficiencies in its system, DCAA will perform an audit to verify that the contractor's corrective actions have been implemented effectively. Auditing standards require DCAA to have sufficient evidence as a basis for our audit opinions and as a result, we must test the effectiveness of the contractor's implementation of the corrected deficiencies. This will generally require the auditor to test transactions processed through the "corrected" system over several cycles. DCAA cannot revise its opinion on the system deficiencies merely based on the submission of a corrective action plan. Once DCAA determines that the corrective actions have been implemented effectively and that other parts of the system continue to operate as required, DCAA will issue an audit opinion that the system is adequate.

When contractor systems are found to be inadequate regardless of whether a corrective action plan has been submitted, DCAA recommends withholding a portion of the interim payments impacted by the deficiency until DCAA has verified that the system is adequate. The acquisition regulations support this process and Defense Federal Acquisition Regulation Supplement 242.7502 stipulates that the contracting officer consider whether it is appropriate to suspend reimbursement of costs proportionate to the estimated risk until the contractor submits a corrective action plan **and** corrects the deficiencies. Until the contractor has implemented the necessary corrective action and DCAA has verified the effective implementation, the Government is at a greater risk for contractor overpayments.

We have experienced hesitation by some contracting officers to implement a contractor withhold either because (1) the contractor has submitted a corrective action plan or (2) an actual cost impact related to the deficiency cannot be demonstrated. We do not agree.

We do not agree that submission of a corrective action plan should automatically negate the need for a percentage withhold because the Government is at a greater risk of contractor overpayments until the system is corrected. Even when the contractor has proposed an apparently adequate corrective action plan, until that plan is effectively implemented, the contractor is still processing transactions with an inadequate system of internal controls. As a result, there is a greater risk of overpayment.

Regarding the lack of a readily demonstrated actual cost impact, some deficiencies may not have a direct relationship to charging costs to Government contracts. For example, the control objective related to ethics and integrity is not directly related to charging costs to Government contracts, but weaknesses in its ethics program equates to a weakness in the underlying fundamentals of the contractor and creates an environment that could ultimately result in overcharging to Government contracts.

In general, DCAA has found contractors do not always follow through to correct deficiencies in internal controls related to business systems. In some instances, corrective action plans are developed, but implementation is delayed. For example, at DynCorp, we reported four significant conditions related to the General Internal Controls/Electronic Data Processing Controls on April 17, 2007. Two significant deficiencies related to the lack of a Business Continuity/Disaster Recovery Plan and lack of a Formal IT Security Awareness Program. DynCorp submitted a corrective action plan April 30, 2007 stating all conditions would be corrected and provided a tentative schedule for

its actions, but subsequently it deferred implementation of the corrective actions and to date, the corrections have not been implemented.

Since DCMA recognized the existence of a corrective action plan alone as sufficient to render the system adequate, DynCorp has not been incentivized to give serious attention to implement the corrections for these significant deficiencies. An adequate disaster recovery plan is an essential part of any system, especially one located in a single geographical area. A single tornado, common in the Dallas Fort Worth area, could destroy the accounting data for all DynCorp contracts. Currently, DynCorp states they have received internal funding to take corrective action in the current year, although we remain uncertain as to whether DynCorp is now placing the emphasis required on these corrections to ensure Government risk is mitigated.

In June 2006, DCAA reported significant deficiencies with KBR's purchasing system. KBR initiated a corrective action plan in 2006 to resolve the identified deficiencies. Although DCAA participated in a DCMA's sponsored Purchasing and Property Issue Council (a group established by the Government) to facilitate a resolution of the deficiencies, little substantive progress was made during monthly meetings. In the latter part of 2008, DCAA initiated a new purchasing system audit and issued a report on April 28, 2009. This second audit identified similar deficiencies as well as two new deficiencies which led to DCAA issuing an overall inadequate opinion of KBR's purchasing system. Based on these events, it is clear that KBR did not take the correction of the reported deficiencies seriously. We believe a contributing factor is DCMA's practice of recognizing the existence of a contractor's corrective action plan as a basis to render a system adequate.

DCAA has experienced several instances where a percentage withhold on interim billings has been a positive incentive for contractors to correct deficiencies. In 2004, we issued an audit report on Titan Corporation's labor system with an opinion of inadequate (Titan performed linguist services in-theatre). The withhold lasted several years and over \$40 million of labor costs were withheld at one point, but Titan Corporation made significant effort to correct the deficiencies including adequately staffing the Government accounting and billing departments. Titan eventually corrected the system deficiencies and a portion of the withhold was returned as each section of the system was corrected.

Challenges in Auditing Business Systems

General

Auditing contracts for contractor's performing effort in-theatre has been challenging in many arenas. These challenges may delay the timely completion of system audits. For the purposes of the hearing today, we have listed five challenges.

- Rapid changes in business organizations and related systems
- Lack of contractor management attention and correction of deficiencies
- Determination of the administrative contracting officer
- Requirement for DCAA's compliance with the auditing standards versus the contracting officer's "need for speed"
- Timely access to contractor information and data in a contingency environment

1. Rapid Changes In Business Organizations and Related Systems

Frequent changes to contractor business organizations and systems impose significant challenges to conducting audits. While changes are a normal part of the business cycle, organizational changes and corresponding changes in business systems and cost accounting practices at contingency contractors seem to be more frequent than are experienced under normal conditions.

We believe most of these changes are the result of the rapid growth in business volume

contingency contractors have experienced since they began supporting efforts in Iraq and Afghanistan.

The frequency and the scope of these changes have created significant challenges for DCAA auditors responsible for auditing the contractor's business systems. For instance, KBR has experienced tremendous growth since being awarded the LOGCAP III contract; increasing its sales over the last several years by 10 fold. In our opinion, the business systems KBR had in place at the onset of the LOGCAP III contract could not adequately account for its Government contract costs and allow the KBR management team sufficient information from which to manage the company's effort on its Government contracts. As a result, since the beginning of its efforts in-theatre, it implemented new systems, revised its various disclosure statements under the Cost Accounting Standards and was "spun-off" from Halliburton into the autonomous business unit it is today.

DynCorp also has experienced significant change. Just in the last three years sales have increased more than 200 percent. A large part of its recent growth is related to contingency contracts issued to support the Army and/or Department of State. DynCorp, like many other contractors, implemented new business systems. The implementation of major automated (electronic) business systems presents challenges for auditors performing internal control reviews. Since implementation takes many months for contractors to complete, DCAA's plan for evaluating related internal controls are often delayed until the system implementation is complete. DynCorp also re-organized or re-aligned business activities and business segments each year for the last three years. As a result, related Cost Accounting Standards Disclosure

Statements were revised to disclose the new structure and the rearrangement of functions and changed accounting practices within the business segments and utilized on Government contracts.

DynCorp submitted 9 new or revised Disclosure Statements for 2009 and an additional 18 new or revised Disclosure Statements for 2010. The changes require submission of cost impact statements identifying the cost impact on existing Government contracts. We have found instances where DynCorp did not disclose all applicable changes nor were all required cost impacts provided, shifting responsibility for cost impact statements from itself to the Government (often the auditor).

Frequent changes in contractor organizational structure and cost accounting practices present significant challenges to auditors responsible for systems audits. DynCorp's rapid changes in organizational structure and its decentralized style of managing business activities has resulted in inconsistent business processes applied across the organization. For instance, recent interim vouchers submitted by one business segment were rejected by the DCAA office because they lacked adequate documentation to support the incurred costs claimed for reimbursement. However, interim vouchers prepared by another segment within DynCorp were approved for provisional payment without exception. Both units use the same "billing system", but DynCorp does not require or implement standardized business procedures and practices throughout the company which results in inconsistent application of a single common system. Auditing in such a changing environment presents significant risk and requires extensive testing to obtain adequate audit coverage, which is not only challenging, but quite time consuming.

Fluor Federal Systems is yet another example of a contractor that has experienced rapid change in recent months. Fluor's geographically dispersed business units contribute to challenges in conducting audits of business systems. Fluor places responsibility for the various business systems at various business unit locations, so that some business systems are examined in Washington, some in California, and some in South Carolina. The creation of new business units presents a challenge for auditors on occasion.

Recently, the audit office responsible for approving interim vouchers on the LOGCAP IV contract discovered that Fluor had submitted vouchers for reimbursement that included indirect cost rates that had not been previously disclosed to the audit office. The audit office is currently disapproving indirect costs associated with this business unit until the rates are adequately disclosed.

Public Warehousing Company (PWC) is another example of a contractor whose business systems have been overcome by considerable increases in the volume of accounting transactions. PWC has either lost or cannot locate a significant number of accounting records supporting its incurred costs proposals. Although DCAA will typically question costs not supported, contracting officers or the courts will likely feel compelled to determine how much to reimburse PWC for claimed costs that are not supported as required by the underlying contractual terms. Simply questioning costs makes it very difficult to equitably resolve amounts to be reimbursed for services rendered.

DCAA has implemented a number of initiatives to mitigate the impact of contractor changes on our efforts to audit and report on business systems. A significant change is in the process for

real-time reporting of systems deficiencies disclosed during the course of normal audit assignments. If an auditor performing an audit of a contractor proposal identifies an apparent deficiency in the estimating system, then the auditor will immediately issue a “flash” report on the estimating system in which the specific deficiency will be described in sufficient detail for the contractor and ACO to understand the issue. This ensures the procurement community, including the contractor, is aware of a potential estimating system deficiency and can conduct business accordingly. Subsequent to issuing a flash report, the auditor will commence an audit of the specific control activities identified in the flash report to determine if the deficiency is pervasive or simply an isolated incidence. If the audit discloses it is a systemic deficiency that is the result of poorly designed or implemented internal controls or consistent failure of employees to follow policies or procedures, the auditor will issue an internal control system audit report which will cite the significant deficiency and identify it as a material weakness, if appropriate.

2. Management Attention and Correction of Inadequacies

The Government Auditing Standards require DCAA to report on all significant deficiencies identified during its review of contractor internal control systems and to determine whether the deficiencies are considered material weaknesses. Those deficiencies are communicated to the contractor via a written description of each deficiency and the contractor is asked to respond to the conditions cited by the auditor. DCAA faces significant challenges in obtaining a contractor’s commitment to correct the inadequacies because historically there has been little, if any, negative consequence related to inadequate internal control systems. As a result, in many instances the contractors have failed to give the cited deficiencies the level of attention they require to be corrected. Contractor’s sometimes agree in principle with our findings but do little if anything to

actually implement a corrective action plan that results in changes to the existing policies, procedures, and/or practices to correct the deficiencies.

One area of frustration to DCAA in obtaining management corrective actions is that it appears DCAA and the contracting officers may apply different criteria when assessing the adequacy of systems. DCAA complies with Government Auditing Standards (GAO's "Yellow Book") and must follow general, fieldwork, and reporting standards when conducting audits. These standards require DCAA to audit contractor systems based on an established criteria that can be applied consistently – that criteria in audits of DoD Government contracts is the Federal Acquisition Regulations, Defense Federal Acquisition Regulation Supplement, and the Cost Accounting Standards. The standards also require DCAA to be independent, which means the auditor must be unbiased; not favoring one position over another. Contracting officers, on the other hand, appear to have significantly more flexibility in evaluating the adequacy of business systems. The contracting officer generally assesses the adequacy of business systems based on his/her limited personal knowledge of the contractor systems, consideration of regulations and Cost Accounting Standards, DCAA audit reports, contractor input, and other undefined criteria.

For instance, in DCAA's opinion, the KBR purchasing system internal controls are inadequate. The auditors have cited deficiencies including the contractor's failure to adequately document the reasonableness of subcontract awards and failure to adequately perform cost or price analyses that DCAA believes is necessary to demonstrate the subcontract price reasonableness. DCAA has provided numerous examples of unreasonable costs paid by the Government as a result of the system deficiencies.

However, in June 2009, the DCMA Contractor Purchasing System Review (CPSR) team performed its review of the KBR purchasing system. The local DCAA office provided the CPSR team the system deficiencies along with an extensive list of subcontracts it had identified during a proposal audit that DCAA believed may not have been adequately evaluated during the procurement process and asked the CPSR team to include those subcontracts in its review. The CPSR team conducted its review in less than one week. The entire breadth of the testing, which encompassed between 200 and 300 separate procurements, was completed during a three day period. By weeks end, the CPSR team informed KBR that its purchasing system is adequate and that KBR had obtained adequate competition on approximately 95 percent of the subcontracts the CPSR team reviewed and since the contractor obtained adequate competition no cost or price analyses were required.

Clearly, DCMA and DCAA have a different opinion on what the regulations require with respect to prime contractor responsibilities of conducting and documenting cost or price analyses. It also appears the DCMA interpretation of cost or price analyses is significantly different than that of the Army Contracting Command. In its *Cost & Price Analysis Handbook*, dated February 2004, the Army Contracting Command states “Some form of cost or price analysis is required for every procurement.Even in sealed bidding; we perform price analysis in determining the low acceptable bid.”

In order to mitigate the challenges related to obtaining adequate contractor corrective action plans and resolving the deficiencies reported by audit offices, DCAA has instructed auditors to ensure they are holding exit Conferences with the appropriate level of contractor management. Auditors are instructed to make every attempt to hold the Exit Conference with an executive at the Vice President or CFO level, at least. The auditors are instructed to clearly communicate the issues related to the

internal control deficiencies to the contractor executive and seek the contractor's commitment to provide a response within a specific timeframe.

Where an audit office has determined a contractor's system of internal controls over the accounting system and/or the billing system is inadequate or the contractor's system for preparing final incurred cost proposals is inadequate (as demonstrated by the contractor not preparing and submitting adequate and timely proposals), the audit office has been instructed to rescind the contractor's authority to participate in the direct billing program. The removal from this program provides an incentive to many contractors to implement corrective actions.

In addition, when the auditor issues a report to the contracting officer identifying significant deficiencies that are considered material weaknesses, the auditor will also recommend the contracting officer apply a decrement to contractor billings until the cited deficiencies are corrected and the effectiveness of the corrections can be verified. A billing decrement is a valuable tool that can be used by the contracting officer to incentivize the contractor to make timely corrective actions.

3. Determination of administrative contracting officer

In contingency environments there are multiple agencies conducting business in the area of operations and in many cases each entering into contracts with the same contractors. In some instances a single Cognizant Federal Contracting Official has not been identified and this represents a significant challenge to obtaining resolution to various systems issues. Without a single Cognizant Federal Contracting Official identified, individual Procuring Contracting Officers may feel the necessity to attempt to resolve deficiencies with respect to their own

contracts or task orders. Attempting to resolve system deficiencies, e.g., internal control deficiencies, on a contract by contract basis generally does not work well and may favor a single Government agency or group of contracts. A single Cognizant Federal Contracting Official can settle issues globally with respect to administering systems decisions that impact all Government contracts, and work toward adequately resolving issues in the best interest of the Government.

For instance, initially an administrative contracting officer was not assigned responsibility for resolving issues that were disclosed during certain audits at the Parson Iraq Joint Venture.

Fortunately, the joint venture was only awarded a single contract. However, having the only contracting officer with responsibility for a contractor located thousands of miles away from where the books and records are located makes resolution of issues a challenge.

Additionally, DynCorp's approximately \$3 billion in annual revenue consists of about \$1.5 billion in Department of State contracts and another \$1.5 billion in DOD contracts for the Army, Navy, Air Force and other Government customers. Even within each Agency, DynCorp has contracts for various buying commands, e.g. for the Department of State, DynCorp has contracts with four different Bureaus in-theater. In order to retain flexibility in administration of the contracts, most buying commands retain Administrative control of their post-award contract efforts rather than delegating them to a common entity like DCMA. This provides a challenge to our Agency as we approach DynCorp as a whole. Systems issues, accounting practices changes, timekeeping deficiencies, tax issues, etc. affect the contractor and all its contracts whereas some issues affect only certain groups of contracts. It is an ongoing and extensive challenge for the audit office to identify all affected contracts and appropriate points of contact and to notify them of issues and to facilitate a coordinated approach to these issues across multiple buying

commands. Further it is not possible in the initially competitive environment DynCorp operated in to ensure that prospective buying commands are aware of current issues that may impact their awards.

Although Public Warehousing Company has been providing logistical support on the LOGCAP contract for several years, no administrative contracting officer has been appointed. We have requested the appointment of a contracting officer from the major organizations awarding contracts to Public Warehousing Company. However, no action has taken place. We believe the lack of an assigned contracting officer has hampered the Government's ability to successfully resolve DCAA's reported deficiencies. Due to the lack of a contracting officer to address reported system deficiencies, DCAA has taken the matter into their own hands and Public Warehousing Company has withheld significant amounts of indirect costs from interim billings until the deficiencies are corrected.

4. DCAA's Requirement to Comply with Auditing Standards versus the Contracting Officer's "Need for Speed"

A significant challenge for DCAA is balancing the contracting officer's need for audit reports quickly in order to get contingency contracts awarded while complying with the Government Auditing Standards. During contingency operations, contracting officers are called upon to award contracts quickly in order to get needed goods and services to the war fighters.

Frequently, contracting officers have been able to make use of letter contracts in order to start the delivery of goods and services before the final price is negotiated.

DCAA is sensitive to the contracting officer's need for rapid turn around of audits, but is constrained by Government Auditing Standards with respect to "short cutting" or "streamlining" the audit process. DCAA has little flexibility; it must comply with the Government Auditing Standards. Those standards require that DCAA (i) adequately plan the audit, (ii) gain an understanding of the system of internal controls, and (iii) obtain sufficient evidence as a basis for any opinion the auditors will render. DCAA is required by the auditing standards to perform extensive testing. DCAA auditors obtain the evidence through various methodologies, almost all of which require data be provided from the contractor. Unfortunately, DCAA auditors are often faced with delays in obtaining data. These delays in obtaining contractor data or access to contractor personnel that prepared accounting records or estimates has resulted in audits being issued much later than the contracting officers would desire. Nevertheless, DCAA makes every effort to perform the audits of systems, e.g., internal controls, in a timely manner.

As discussed earlier, to mitigate this challenge to the extent possible, DCAA has initiated some policy changes that allow it to provide more timely information on business systems when a deficiency is noted during another audit. The process under which the auditor issues a "flash" report and immediately follows-up with an audit of a specific set of internal control activities to determine whether a systemic deficiency exists does allow the auditors to issue some reports quicker, by focusing the scope of the audit on a specific area where the auditor already has an indication that a weakness may exist. However, in the case where it is determined the contractor has a material weakness in its system of internal controls, the standards still require the auditor to perform a complete audit of the system of internal controls during the follow-up audit, again which could take a significant amount of time to complete.

5. Timely access to contractor information and data in a contingency environment

Timely access to contractor information and data and personnel is an on-going challenge in a contingency environment. As mentioned earlier, DCAA must obtain sufficient information or data and perform extensive testing in order to form an opinion on the adequacy of a contractor's system of internal controls. In a contingency environment obtaining the information and/or access to the personnel responsible for preparing data is often difficult for various reasons.

For instance, much of the data is originated in Iraq or Afghanistan and later transferred to a contractor facility in the U.S. or some other foreign location. Often times it is a challenge to determine the location of the data. Once it has been located, then retrieving the data for review purposes is another challenge. Additionally, gaining access to the individuals that prepare information or that have responsibility for certain internal control activities is often difficult because they are located in remote areas not easily accessed by DCAA auditors. For instance, we were recently requested to perform an audit of a claim prepared in Denver, Colorado, while the records supporting the claim were located in two different foreign countries (one of which DCAA had been unable to obtain country clearance to enter). The auditors were able to gain access to the person that prepared the claim, but were unable to gain access to all of the records stored in other countries or the people that originally prepared the documentation in Afghanistan and Pakistan.

Since gaining access to needed data and contractor personnel has been a long standing challenge while auditing contingency contracts, DCAA has implemented the following initiatives to mitigate this challenge. First, DCAA believes there is a greater benefit to performing more

“real-time” testing of contractor records. Accordingly, for contingency contracts, DCAA offices perform a significant amount of direct cost transaction testing concurrent with the performance of the contract. This allows deficiencies in contract records and/or performance to be identified early. Second, DCAA provided guidance to the auditors explaining the Agency’s policy and processes for gaining access to records. The guidance explains that supporting data must be provided within a short period of time (depending on circumstances) and that data not provided within those timeframes will be considered a denial of access to records. The guidance further explains the process for elevating the access to records within the Agency and contractor management. Finally, DCAA issued guidance to the auditors explaining that in certain instances when the contractor does not provide adequate supporting data, the audit office should issue DCAA Forms 1 suspending or disapproving billed costs.

Business Systems Lessons Learned

General

DCAA’s primary involvement in auditing contingency contracts began in 2003, in support of the military’s operations in Kuwait, Iraq, and Afghanistan. Since that time, we have identified numerous procurement processes and/or misconceptions that if adequately addressed would better protect the taxpayer’s interest in the goods and services purchased in support of the U. S. military and Government civilian employees during the execution of a war or other type of contingency operation. We have consolidated these observations into “Lessons Learned” which have been shared with various Government and industry organizations. We have five areas of lessons learned that we will discuss today in the area of contractor business systems. We have shared the lessons learned and recommendations with the Director, Defense Procurement and Acquisition Policy (DPAP) and

we have agreed to establish a working group to further assess the recommendations. It is anticipated that the working group will be co-chaired by the DCAA and DPAP Directors.

1. Lack of Contractor Incentive to Address System Deficiencies.

As discussed earlier in the testimony, currently there is little, if any, negative consequence for contractors with reported material weaknesses. DCAA audit reports alone do little to motivate contractors to make timely corrective actions. Generally, administrative contracting officers are responsible for determining an overall systems “adequacy” and frequently determine the contractor’s system to be adequate based merely on the receipt of a corrective action plan. The current process for resolving significant deficiencies in internal controls provides little motivation to the contractors to implement corrective action.

In recent months DCAA has commenced a process of clearly identifying serious weaknesses in internal control (i.e., material weaknesses in Government Auditing Standards terminology) in reports to the cognizant administrative contracting officer and recommending the contracting officer withhold partial payments on contractor interim payments until a corrective action plan has been implemented and demonstrated to be working effectively. In some instances, administrative contracting officers have aggressively pursued withholds based on DCAA’s advice, while in others the administrative contracting officers are reluctant to pursue withholds.

Recommendations:

- a) Explore revisions to the regulations to provide that flexibly priced prime contracts (any contract type with a variable element that impacts the billed costs), must be awarded only to contractors that (i) have adequate Cost Accounting Standards Board

Disclosure Statements, and (ii) have adequate business systems, including business ethics and compliance programs and internal controls.

- b) Explore whether the regulations and DoD's policies, guidance, and instructions (PGI) should be revised to specifically require a withhold of a certain percentage (i.e., 10%) on interim payments when DCAA determines a contractor's internal controls related to accounting and management systems are not adequate. The mandatory withhold on interim payments should be significant enough to motivate the contractor to implement corrective action promptly and remain effective until the corrective action is completed and validated.

2. Resolution of Business System Deficiencies

Internal control deficiencies are generally not resolved in an expeditious manner and in many instances not considered resolved by both DCAA and DCMA (or the agency with responsibility for the administration of Government contracts). As discussed earlier, DCAA is required to report all significant deficiencies in internal control it identifies in its audits, identifying those that are considered material weaknesses. DCAA's opinion on the internal controls is based on performing an evaluation as required by the Government Auditing Standards. Those same standards require DCAA to perform a "follow-up" review of the internal control system once the contractor has implemented any corrective action plan. DCAA performs additional testing of the internal controls during the follow-up review and therefore is prohibited from changing its opinion on internal control deficiencies without performing additional testing (which requires adequately planning the audit and performing extensive testing from which it can form an opinion).

The administrative contracting officer, on the other hand, is made responsible for determining the overall adequacy of systems and consequently is responsible for resolving DCAA findings of material weaknesses in the contractor's system of internal controls. In certain situations, the acquisition regulations contain established criteria, characteristics, or standards that should be embodied in "systems" such as the contractor estimating system and/or the material management and accounting system. However, the regulations do not provide specific criteria for evaluating and/or approving all systems.

For example, the accounting system is "approved" by a contracting officer and DCAA evaluates the internal controls over the accounting system. There is no concise listing of accounting system characteristics that can be used to determine the accounting system adequacy. Instead, the accounting system is a very complicated system involving the contractor's overall control environment, its cost accounting practices (and consequently its Disclosure Statement), and its practices for accounting for labor, material, other direct costs, and indirect expenses. DCAA's evaluation is based on criteria established in law (Cost Accounting Standards), regulation (cost principles and other relevant regulations identified in the Federal Acquisition Regulations), contractor policies and procedures, and common/appropriate internal control activities necessary to achieve certain accounting system objectives related to initiating, authorizing, recording, processing, and reporting accounting data. It is unlikely the contracting officer has or can consider all of the criteria DCAA considers in performing its review of the accounting system when a system determination is made and cited business system internal control deficiencies are determined approved by the contracting officer. Establishing a common set of criteria upon which DCAA and

contracting officers base their evaluation of business internal controls would result in a more expeditious resolution of system deficiencies.

Recommendations:

- a) Consider assessing whether the regulations need to define minimal internal control criteria, characteristics, or standards for mandatory implementation of internal controls over Government contract cost reporting. Clearly defined internal control criteria establishing the minimal requirements would result in fewer system deficiencies.
- b) Consider assessing whether the regulations and/or DoD policies, guidance, and instructions (PGI) need to prohibit contractor overall business systems from being deemed “adequate” or “approved” when serious internal control deficiencies are reported and a follow-up review has not yet been performed by DCAA to ensure corrective actions have been implemented and the internal controls are working effectively.

3. Business Systems in Competitive Award Processes

Under ideal circumstances (perfect competition) the Government would be one of many purchasers of identical goods and services offered by many vendors competing in the market place. Under ideal circumstances the Government would not need to be concerned with the adequacy of business systems because market forces would drive a seller’s business behavior to maintain the most efficient business processes possible. However, the Government rarely purchases goods and services in a situation that could be considered ideal. Generally speaking, there are not many buyers like the Government. In fact, in a contingency situation the Government may be the only buyer of

certain goods and services and those goods and services may be of such a complex or specialized nature or the amount required is so large that there are very few sellers capable of satisfying the Government's requirement.

It is important to realize that in most instances, the Government's requirement for goods and services are of such a magnitude or complexity that there is generally no easy entry into the market so an expansion of the vendor base is difficult. That is, during a contingency operation only established contractors with certain capability and capacity are going to have the ability to provide goods and services at either the prime or subcontract level. In these circumstances, we do not believe adequate competition can be achieved.

The LOGCAP IV program envisions awarding individual Task Orders to one of three contractors through competition among the three (KBR, Fluor, and DynCorp). Generally, FAR would consider this to be a contracting model using "adequate competition" as described at FAR 15.403-1(c)(1). For contracts awarded under normal conditions, we would agree this model would result in adequate competition. However, in a contingency environment such as Iraq and/or Afghanistan there are limited resources available to satisfy the U.S. Government and/or coalition forces requirements. As such, normal market conditions do not exist. When the Government's demand exceeds the capacity for urgently needed goods or services, the ability of the LOGCAP IV prime contractors to secure goods and services at lower prices based on competitive forces is diminished at best. Consequently, we do not believe substantially lower prices or costs result from the "competition" in the area of a contingency. In at least one instance, we noticed a situation where it appeared truck drivers in-theatre joined together to set rates that were required to be paid on a contingency contract. In our

opinion, this demonstrates the potential for suppliers of limited resources to band together to effectively increase prices when prices are not based on cost or pricing data.

Most of the task orders, if not all, issued under LOGCAP IV to-date are cost reimbursable contracts and in at least one instance costs changed significantly on a task order issued to DynCorp almost before work even started. In this case, DynCorp “won” the competition for a task order that has been transitioned from KBR and the LOGCAP III contract to DynCorp. As usually happens with follow-on service contracts that are not awarded to the incumbent, DynCorp hired many, if not most, of the incumbent’s employees already performing the work under the LOGCAP III contract. However, the salaries negotiated between DynCorp and some of its new employees were substantially higher than the salaries included in the proposal upon which DynCorp “won” the task order. Those higher salaries were reflected in invoices submitted to the Government for reimbursement – resulting in higher costs than contemplated as a result of the competition.

In situations where there is a limited pool of personnel and/or subcontractors available or capable of performing the work on the LOGCAP IV task orders, any competition among the three prime contractors may only result in minor cost reductions, if any. In our opinion, significant cost/price reductions will only occur if the pool of qualified subcontractors and sources of labor available in theater is increased significantly.

Recommendations:

- a) Consider whether the regulations should provide that flexibly priced prime contracts (any contract type with a variable element that impacts the billed costs), be

awarded only to contractors that (i) have adequate Cost Accounting Standards Board Disclosure Statements, and (ii) have adequate business systems, including business ethics and compliance programs and internal controls.

b) Consider whether the regulations should mandate the use of negotiated contracts requiring the submission of certified cost or pricing data when a cost reimbursable contract award is contemplated and the contract is to be performed in the area of contingency operations where substantial portions of the contract will be performed by subcontractors and (i) the Government will be the largest consumer of the subcontractor's goods or services, and (ii) there are limited subcontractor resources available to satisfy the Governments requirements.

4. Issues Related to Requests for Proposals (RFPs)

Contractors establish and maintain business systems with certain internal controls that ensure among other things consistent application of estimating techniques and accounting practices. Contractors also establish internal controls to ensure they (and its employees) comply with a variety of laws and regulations. During our reviews of contingency contracts, we have noted instances where the procurement processes have resulted in contractors preparing proposals and/or accounting for and billing costs in a manner that is not compliant with the Cost Accounting Standards, acquisition regulations, or consistent with their normal disclosed practices. In many of these cases it seems the Government has some responsibility for these deviations from normal practices or regulation.

During our reviews of contingency contracts we have found instances of "competitions" for cost reimbursable type contracts in which the contractor was required to prepare a proposal in accordance

with specific instructions accompanying the Request for Proposal (RFP). In some instances, the instructions dictated specific assumptions the competitors needed to follow when estimating costs, but did not include the actual statement of work to which the contractor would be proposing specific costs or prices. These proposals yielded what we would refer to as a “notional” proposal that the contracting officer or Source Selection Evaluation Board used to select a contract winner or multiple awardees. While this may be an acceptable process for distinguishing between contractors, it does not in our opinion, result in a realistic proposed cost or price because the contractor should actually account for costs in accordance with its established practices as implemented by its business systems or it risks being in violation of the law (that is, non-compliant with the Cost Accounting Practices) or regulation.

We also noted that contracts awarded under this type of procurement process had the proposal incorporated into the contract. Based on the proposal in totality being included in a contract (either attached or included by reference), contracting officers and contractor personnel considered the assumptions the contractor used in preparing its proposal to be a contract terms and conditions. Therefore, any assumption included in the notional proposal that is contrary to a contractors established practices would potentially result in a noncompliance. In one case, the RFP instructed the contractor to submit a lump-sum price for generic projects developed using a specified set of criteria as to size, duration, and certain cost parameters. The contracting officer used a streamlined approach to obtaining pricing information and limited the amount of cost or pricing data a contractor was allowed to submit. The contractors bidding on the contract were known to make significant changes to cost accounting practices from year to year and consequently would most likely be required over the contract performance period to prepare impact statements associated with cost

accounting changes. However, since the RFP required, and presumably the contract was negotiated using, the lump-sum project prices, there was no proposal information provided to the Government to establish a proposal baseline to measure any increased costs that might result from contractor accounting changes. Further, since the contract negotiated is a cost reimbursable type contract, the actual costs incurred and that will ultimately be billed to the Government, will be more than was included in the notional individual project prices or will in all likelihood result in change orders and/or requests for equitable adjustments once the specific details of each individual project becomes known.

Recommendations:

- a) Assess whether the regulations and/or DoD policies, guidance, and instructions (PGI) should limit the use of competitive awards for cost reimbursable contracts. Cost reimbursable contracts should be procured as sole source or negotiated contracts requiring the submission of certified cost or pricing data.
- b) Vague statements of work and/or RFPs requiring estimates based on assumptions that differ from expected conditions or circumstances may not result in realistic pricing by potential contractors. Awards made based under these conditions will probably be subject to numerous change orders or requests for equitable adjustments. We recommend assessing whether the regulations and/or DoD policies, guidance, and instructions (PGI) should be revised to require Government statements of work be prepared for each contemplated contract award with sufficient detail for contractors to prepare realistic estimates that consider expected conditions/circumstances under which the contract will be performed.

c) Explore revisions under the regulations and/or DoD policies, guidance, and instructions (PGI) for incorporation of a contractor proposal prepared in response to a notional scenario for purposes of conducting a competition for a cost reimbursable contract into a contract. Assumptions/practices included in the contractor's notional proposal that are contrary to the FAR cost principles, other FAR contract requirements, and/or Cost Accounting Standards requirements should not be considered a contract term or condition.

5. Issues Related to Management Reviews and Results of Self-Monitoring Activities

Monitoring is an extremely important aspect of the contractor's system of internal controls impacting every business system. Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Effective monitoring should result in (i) minimizing internal control failures and their errors/defects that require correction, and (ii) improving the quality and reliability of information used for decision making.

Generally, contractors provide DCAA access to sufficient information to form opinions on the business systems internal controls, except for information relative to its monitoring activities.

Contractors by and large deny DCAA access to their-own monitoring activities. Self-monitoring activities would include contractor management reviews, internal investigations, internal audits, and its evaluation of its own internal controls. Without access to this information DCAA can not assess the effectiveness of the contractor's internal controls relative to monitoring. The lack of monitoring activities would certainly be considered a material weakness in the design and/or operation of any

system of internal controls (whether discussing internal controls over financial reporting under Sarbanes-Oxley requirements or internal controls over Government contract cost reporting). More importantly, without access to this information the procurement community can not determine whether the company is adequately implementing processes for (i) identifying risks to Government contracts for inefficient or ineffective operations or controls, and/or (ii) identifying illegal or unethical activities of employees and subcontractors, and/or (iii) identifying the impact on Government contract costs, and (iv) taking timely action to correct errors and/or mischarging that may occur as a result of poor internal control design or operation that has become known to the contractor.

The procurement community has a vested interest in ensuring the contractor's monitoring activities are adequate and result in the contractor's systems producing and maintaining the most reliable data possible because the Government's reliance on contingency contractors is extremely large. In most cases, the contingency contracts are cost reimbursable and as such the Government will take ownership of materials procured under the contract. In our opinion, the Government (procurement and oversight communities) has an obligation to ensure the contractor is using the data it obtains through the monitoring processes to protect the tax-payers investment in the significant contracts awarded to the contractors. In order to fulfill its obligations, we believe the Government needs access to the results of contractor monitoring activities, including management reviews and applicable internal audits in order to ensure tax-payer interests are adequately being protected by the prime contractors.

For example, there have been numerous instances where contractor employees have been convicted of fraudulent activities that would have resulted in increased costs on Government contracts. In those instances where the contractor discovered these fraudulent activities, its management review process should have included an assessment of the impact of those fraudulent activities on Government contracts and should have resulted in a credit to the contract costs. That analysis and the contractor's decision on adjusting contract costs should be disclosed to the Government in a timely manner.

On occasion contractors have established special teams or task forces to conduct internal reviews or investigations into various activities or business practices; they are not necessarily investigating accusations of wrong doing. This occurred during the earlier years of the contingency operations in Iraq when KBR established a Tiger Team to conduct a review of its subcontracting practices as implemented in theater under the LOGCAP III contract. If the Tiger Team identified subcontract awards that were ultimately determined to involve fraud, we believe the contractor should have adjusted contract costs billed to the Government to reflect an estimate of any inflated subcontract costs or at least suspended the costs from billings until the case was finally adjudicated. DCAA has requested access to the results of the Tiger Team's review repeatedly, however, it has never been provided.

Recommendations:

- a) Consider assessing whether the regulations should be revised so that in order for a contractor to be awarded a contract other than a firm fixed price contract, a contractor must provide an annual assertion that its internal controls over Government contract cost reporting have been reviewed and are operating

effectively at a point in time or during a particular period. The contractor should be required to demonstrate its evaluation of the internal control system to support its certification and maintain documentation of its evaluation.

- b) Consider assessing whether the regulations should require contractors to provide DCAA access to its self-monitoring activities (including but not limited to evaluations of contractor's internal audits, management reviews, and internal investigations) annually to allow the Government to assess the effectiveness of the contractors' monitoring activities and to provide assurance that contractor management is taking appropriate corrective action, such as adjusting contract costs for unreasonable costs recorded on Government contracts as a result of contractor employee fraudulent activities.

Closing

In closing, I want to underscore that DCAA has worked closely with all acquisition organizations to promote an integrated, well-managed contract audit process in-theatre. We have had a continuous presence in Iraq and the Middle East Theatre of Operations since May 2003, staffing our office entirely with civilian volunteers. The challenges in applying sound and reliable business practices and auditing in Iraq and Afghanistan are daunting and have required our auditors to be flexible while insisting that the Department will not tolerate the billing of costs that do not comply with contract terms or are not appropriately documented and supported. DCAA has been and will continue to be vigilant about contract audit oversight and protecting the taxpayers' interests.