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CAN THE DEPARTMENT OF DEFENSE PROTECT TAXPAYERS WHEN IT PAYS ITS CONTRACTORS?

HEARING

BEFORE THE

PANEL ON DEFENSE ACQUISITION REFORM

OF THE

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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PANEL ON DEFENSE ACQUISITION REFORM

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[There were no Questions submitted post hearing.]

CAN THE DEPARTMENT OF DEFENSE PROTECT TAXPAYERS WHEN IT PAYS ITS CONTRACTORS?

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
DEFENSE ACQUISITION REFORM PANEL,
Washington, DC, Thursday, October 15, 2009.

The panel met, pursuant to call, at 8:02 a.m., in room 1310, Longworth House Office Building, Hon. Robert Andrews (chairman of the panel) presiding.

OPENING STATEMENT OF HON. ROBERT ANDREWS, A REPRESENTATIVE FROM NEW JERSEY, CHAIRMAN, PANEL ON DEFENSE ACQUISITION REFORM

Mr. ANDREWS. Ladies and gentlemen, good morning. We appreciate your attendance this morning. Welcome, my colleagues on the panel.

The panel has been engaged in an investigation of hypotheses as to the reasons why there is a difference between the price that the taxpayers pay and the value that those who wear the uniform of our country and serve our country receive when we buy goods and services. We start from the proposition that there is not always a gap between those. There are many instances where, in fact, we get full value for what we pay. And we are very grateful for that.

Last week we had an example of that when we looked at the excellence that occurred in the Mine Resistant Ambush Protected vehicle (MRAP) program. Good things have happened there.

Suffice it to say, though, that we are concerned that, whether it is major weapons systems, services, or other kinds of goods and supplies, that there are too many instances where we pay a dollar and get 75 or 80 cents worth of value. There is unanimity on Republicans and Democrats, House and Senate, executive branch and legislative branch, certainly among the American people, that we want to do a lot better than that. So we have engaged in a series of hearings where we have looked at various hypotheses as to why that gap exists.

For instance, we have looked at the way that we don't, I think, quite understand the right way to buy information technology. By using a paradigm that tracks the paradigm we use for hardware, we make some mistakes in that area.

We have looked at the issue of whether our workforce is not right-sized and not correctly trained to deal with these issues. We have looked at questions concerning the supply chain, whether it is properly organized, properly managed and so forth.

This morning we are going to look at a question that is a little narrower than what I just talked about, but certainly not any less

important. And that is, how well are we doing at auditing the contracts that we let? In other words, if we were to ask this morning on a contract for a certain communications system, are we behind in our payments or ahead in our payments? Have we paid what we should have or not? Has the work that is supposed to be done for what we have been paid been done or not?

The Department of Defense (DOD) is charged with an enormous responsibility in monitoring huge amounts of money and literally hundreds of thousands of contracts at any given time. So it is a very important job. But, frankly, work in recent times by the Government Accountability Office has raised some serious concerns as to whether we are properly organizing ourselves to do the auditing and monitoring of contracts.

This morning we are going to hear about the nature of those concerns, some efforts to address those concerns which are going on at the Defense Contract Audit Agency (DCAA) and other instruments of the Department of Defense, and then help the panel make an assessment of how we can do this whole process better.

And I want to begin with two cultural snapshots of issues within the DCAA, which are elucidated in a report done by the Government Accountability Office last month that I believe was at the request of Senators Lieberman and Collins, but are certainly important for the entire Congress.

And I do use the phrase "cultural snapshot," because I understand that the two instances about which I am going to refer, or to which I am going to refer, may or may not be representative of the systemic situation. But whether they are representative of the systemic situation or unrepresentative, they are troubling.

The first cultural snapshot is a problem of, I would say, too much engagement with a contractor. In May of 2005, according to the Government Accountability Office (GAO), in the eastern region of DCAA, there was an issue with a billing system contract. The DCAA reported an inadequate in part opinion of the billing system internal controls of one of the five largest DOD contractors.

After issuing the report, DCAA auditors helped the contractor develop policies and procedures related to the accounts receivable, overpayments and system monitoring before performing a required follow-up audit, which is a significant impairment to the independence of the auditors. So we sort of have a joint venture, if you will, between the auditors and the people being audited before there is a follow-up audit.

In June 2006, the DCAA reported an adequate opinion on the contractor's billing system, internal controls, including the price, policies and procedures DCAA helped the contractor develop. So the problem here obviously was the auditor was auditing in part its own work product. As a result of GAO's review, the DCAA rescinded the follow-up audit report on March the 6th of this year of 2009. So there is an instance where the line between the auditor and the audited was unfortunately blurred.

The second instance is kind of the opposite problem. This was in the central region of DCAA, 2006, again involving a billing system case. A fraud investigation by the Army's Criminal Investigation Division was under way at the time the DCAA performed a given contractor's billing system audit. So the facts are that the con-

tractor is under criminal investigation at the time, and there is an audit of the contractor's billing system.

The auditors were aware of the substance of the Army's investigation. So there is knowledge of the auditors what is going on. The auditor requested increases in budget audit hours to perform increased testing because of the fraud risk and the contractor's use of temporary accounts for charging costs that had not yet been authorized by the contracting officer. So the person that DCAA puts in blows the whistle and says, "I need more help because there are some things that raise a red flag here."

The auditor then drafts an inadequate opinion on the contractor's billing system, which was overturned by the supervisor and Field Audit Office (FAO) manager. So the person who is on site reaches the conclusion that an inadequate report is the right result. Her opinion is overturned.

Despite a reported $2.8 million in fraud for the contractor in question, the DCAA reported an inadequate in part opinion related to three significant deficiencies in the contractor's billing system on August 31, 2005 and an adequate opinion then on September 11, 2006, regarding a follow-up audit. The auditor on the ground, the initial auditor, whose performance appraisal was lowered for performing too much testing and exceeding budgeted hours, was assigned to and then removed from the follow-up audit. This auditor then left the agency in March of 2007.

So then to briefly review the facts, the person who is on the ground sees the red flag, asks for more help, renders an opinion that is, frankly, a negative opinion of the contractor. That opinion is essentially reversed in a follow-up audit. And the person who is on the ground is excluded from the follow-up audit and, in effect, disciplined and sanctioned because she put too much time into the first audit and asked for too much help.

Following the GAO's review of this matter, the DCAA rescinded both audit reports on November 20th of 2008. Now, again, I am not claiming that these are systemic examples. I think that is research that is yet to be done and an analysis that is yet to be done.

But I think the members of the panel would agree that they are disturbing examples because on the one hand, there is an example of blurring the line between the auditor and the audited. The other case there is an example of someone who is quite aggressive as an auditor, who it appears was sanctioned for her appropriate behavior, and that an unfortunate and incorrect result was reached in the end.

The importance of these examples is self-evident for the facts of the example. But the importance goes beyond that. It is sort of the fruit of the poisonous tree doctrine because once there is a finding, that finding then spreads through the system.

For example, once a contractor is put into the green light list, the good guy list, the level of attention and auditing that is paid to that contractor diminishes. There is sort of a presumption that the contractor is okay. So a mistake that is made in one audit has potentially negative consequences for many, many contracting decisions down the road. This is not simply a contract-by-contract decision.

It is a big job that the DCAA has. But what we are interested in hearing this morning is its reaction to and improvements as a result of the work of the GAO and suggestions that each of our three witnesses would have on how this panel can aid that effort so that we can reach a point where we have a high confidence with good reason in our auditing system.

At this time, I am going to ask my friend, the senior Republican on the panel, Mr. Conaway, for his opening statement.

[The prepared statement of Mr. Andrews can be found in the Appendix on page 33.]

STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE FROM TEXAS, RANKING MEMBER, PANEL ON DEFENSE ACQUISITION REFORM

Mr. CONAWAY. Well, thank you, Mr. Chairman.

And, witnesses, thank you all for being here this morning. Today's hearing examines an area of acquisition that is near and dear to my heart: auditing. I am a Certified Public Accountant (CPA). And I spent my early part of my career doing that often thankless task.

The basic question is how vulnerable is the Department to overpaying its contractors on acquisition programs and how robust are its systems for preventing overpayments. The Defense Contracting Audit Agency provides the department's primary internal means of detecting, preventing or correcting the majority of potential contractor overpayments.

There have been recent articles based on GAO findings regarding the DCAA. Based on written testimony, there are major disagreements between the Department and the GAO. And I would only add that we are here today to learn all points of view. We have a group of very qualified witnesses. And we are glad that you are here to help us understand these issues.

Finally, I would say that once again a recurring theme has been consistent. It has been consistent with our previous panel hearings in regards to workforce. In fiscal 2008, DCAA performed over 30,000 audits with approximately 4,200 employees. I believe it is Mr. Assad in his written statement that stated, "Rebuilding the DCAA workforce, while a challenge, can and must be done."

We learned from previous hearings that increasing the workforce isn't always the answer. But in this case, it does appear that the workforce is one of the major areas that needs to be addressed.

Looking forward to our witnesses. Let us hear from them.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Conaway can be found in the Appendix on page 34.]

Mr. ANDREWS. Thank you very much.

Without objection, opening statements from other members of the panel will be made a part of the record.

I am now going to proceed to read a brief biography of our witnesses. I think each of you has had extensive experience on the Hill. So you know that, without objection, your written statements will be entered into the record of the proceeding. And we will ask you to give us about a five-minute oral synopsis of your written tes-

timony so we can maximize the time for question and answers from the panelists.

Mr. Shay Assad is the Director of Defense Procurement. He assumed that role on April 3rd of 2006. In that position, he is responsible for all acquisition and procurement policy matters in the Department of Defense. He is the functional leader for contracting workforce within the Department of Defense and is also responsible for overseeing all strategic sourcing activities within the department.

Before assuming this position, Mr. Assad was the Assistant Deputy Commandant, Installations and Logistics for Contractors at headquarters of the Marine Corps here in Washington, D.C. Upon graduating with distinction from the U.S. Naval Academy in 1972, he served two tours of duty aboard the U.S. Navy destroyers and won recognition as the outstanding junior officer of the 5th Naval District.

He has received numerous federal service awards, which include the Secretary of Defense Medal for Exceptional Civilian Service, Secretary of Defense Medal for Meritorious Service, the Department of Defense Inspector General Joseph H. Sherick Award, which is the highest award given to a non-IG employee, the 24th annual Gilbert A. Cuneo Lecturer and the inaugural recipient of the 2008 Osborne A. "Oz" Day Award as the federal executive who has done the most to increase the awareness of Ability One employment opportunities for those who are blind or severely disabled.

Mr. Assad, thank you for your service and welcome to the panel this morning.

April G. Stephenson is the director of the DCAA. She is responsible for all matters related to the management of the agency and its resources. She began her career in the agency in 1987 as an auditor trainee in Mountain View, California.

She progressed through DCAA holding various positions, such as supervisory auditor, program manager, branch manager, various positions in the Policy Directorate at headquarters. She assumed the responsibility as Director in February of 2008, and she serves as the Secretary's appointee on the Cost Accounting Standards Board.

She has her B.S. degree in Business Administration from California State University at Chico and has a Masters in Administration from Central Michigan University.

She is licensed, Michael, as a CPA in the state of North Carolina. That will make you happy.

She is a member of several professional organizations, including the American Institute of Certified Public Accountants (AICPA) and the Institute of Management Accountants. She has received numerous awards and recognition throughout her DCAA career. She resides in Alexandria, Virginia. And in her spare time, which I assume is very scarce, given your responsibilities, she enjoys bird watching, gardening and reading.

Welcome, Ms. Stephenson. We appreciate your service and glad you are here this morning.

And Greg Kutz——

Did I get that, Greg, right? I am sorry—is the managing director of GAO's Forensic Audits and Special Investigations Unit. The mis-

sion of that unit is to provide us in the Congress with high quality forensic audits and investigations of fraud, waste and abuse and evaluations of security vulnerabilities and other requested investigative services.

He is a graduate of Penn State in 1983. He joined the D.C. office of KPMG Peat Marwick after graduation. He worked there for eight years. In 1991 he joined the GAO. As a senior executive at GAO, Mr. Kutz has been responsible for reports issued by GAO in testimony regarding the credit card and travel fraud and abuse, improper sales of sensitive military and dual use technology, a number of areas.

Most recently, he and I had the chance to work together on some disturbing issues of children being subjected to physical restraints in certain educational settings and did a great work in that regard.

Mr. Kutz is a Certified Public Accountant and Certified Fraud Examiner, and we welcome him to the panel and appreciate his service.

So, Mr. Assad, we will begin with you. Welcome.

STATEMENT OF SHAY ASSAD, DIRECTOR, DEFENSE PROCUREMENT AND ACQUISITION POLICY, U.S. DEPARTMENT OF DEFENSE

Mr. ASSAD. Thank you, Mr. Chairman.

First of all, let me say that I am very appreciative of the panel's focus and concern about this issue of getting a better deal for the taxpayers. I couldn't be more supportive and more aligned with that thought. We call it—I call it—the quality of the deal when I go out and speak to our employees in the field, and I have spoken to well in excess of 10,000 of them about this issue of getting a better deal for the taxpayers.

There is a disparity in far too many instances between what we are paying and the quality we are getting. We need to get a better deal. And that is why we have taken the actions that we have with regard to our workforce. That is why we are focused on improving the cost estimating and pricing capability within the department.

It is absolutely essential and critical that we improve the quality of the deal. With budgets the way they are, we have got to get better value for every dollar that we spend for the taxpayers.

Thank you for the opportunity to appear today and to participate in today's discussion. As a senior leader of the defense contracting workforce, I cannot stress enough the crucial role that DCAA plays in the department's procurement. I assure you that all of our contracting officers value and rely significantly upon the professional advice rendered by DCAA.

We recognize that the Government Accountability Office has recently identified needed improvements in DCAA's auditing processes. To assist DCAA in addressing the concerns identified, Under Secretary Hale established an oversight committee to provide advice and recommendations concerning DCAA matters.

As the department's senior procurement executive, I am also a member of the DCAA oversight committee. The senior group will assess DCAA's activities and the actions taken to correct problems identified by GAO and others.

As Under Secretary Hale has pointed out in his testimony before the Senate Homeland Security and Government Affairs Committee last month, in my role as the Director of Defense Procurement, I represent the key customer for DCAA. Given that, I would like to offer you just a few thoughts on a few areas identified for improvement by GAO.

First of all, with regard to this term called "production auditing," it has been suggested that the challenges at DCAA center around production oriented auditing and that audits have been rushed to meet contracting officer requirements. This sets up a real tension and a dichotomy between getting quality audits and getting timely audits.

An audit not delivered in a timely manner is of limited value to the government. On the other hand, it has got to be quality work or it doesn't achieve the objective, which is getting the best deal we can for the taxpayers.

But a good audit in time is better than an extraordinary audit that is late and never used. An audit is the tool of a contracting officer used to negotiate a contract, but in order to realize those benefits, it has to be of a quality nature, and it has to be timely.

While the GAO report cites examples of poor quality audits and some poor decisions that may have been made by DCAA in the past, most would seem to be heavily focused and influenced by inadequate staffing.

Based on our discussions with contracting officers, contractors and auditors, some—and possibly most—of the reductions in audit scope and responsiveness by DCAA is a direct result of the staffing draw down while workload increased. Until the staffing issues are resolved, it will not be possible for DCAA to perform at the level of quality and efficiency that is desired. Rebuilding the DCAA workforce, while a challenge, can and must be done.

The Panel on Contracting Integrity, which was really established at the initiation of the House Armed Services Committee, has proved to be a very productive and successful forum for making progress in eliminating vulnerabilities that lead to fraud, waste and abuse.

Given the success of that panel, we have recently established a new interdepartmental subcommittee that will address the adequacy of DCAA and the Defense Contract Management Agency—DCMA—oversight of contractor business systems. They both serve in that function. We expect this subcommittee to make a number of recommendations to improve the oversight with regard to business systems.

Again, I would like to thank the panel for holding this hearing, and I can assure you that we are focused on the quality of the deal and getting a better deal for our taxpayers. Thank you.

[The prepared statement of Mr. Assad can be found in the Appendix on page 36.]

Mr. ANDREWS. Thank you, Mr. Assad. Thank you very much.

Ms. Stephenson. Welcome to the panel.

STATEMENT OF APRIL G. STEPHENSON, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, U.S. DEPARTMENT OF DEFENSE

Ms. STEPHENSON. Members of the panel, thank you for the opportunity to be here today, and I sincerely appreciate your concerns in the matters regarding DCAA and the issues that we have had with quality and other issues.

And I assure you we are taking every effort we can to improve this audit process to ensure, as Mr. Assad said, the contracting officers are getting the quality product they need in order to make the best decisions for the best fair and reasonable prices the government can have, because ultimately what we need is the best value for the warfighter. That is what we are all here for.

My testimony today has two parts. First, I will briefly describe the role of DCAA in the acquisition process, challenges in auditing contractor costs, and vulnerabilities in acquisition. Second, I will briefly describe several of the improvements we have made in findings to the GAO reviews.

DCAA is a distinct agency in the Department of Defense that reports to the Under Secretary Comptroller. The DCAA mission is to perform all the necessary contract audits of contractors. We don't audit government organizations. We audit the contractors for the DOD components that are responsible for negotiation, administration and settlement of contracts. Under the acquisition regulations, not all contracts are subject to DCAA audits.

In 2009 DCAA performed over 21,000 audits covering $330 billion in contractor costs. These audits recommended reductions in proposed or build costs of $20 billion, and $12 billion in estimated costs where the contractor did not provide sufficient information to support the costs.

DCAA has about 4,400 employees at 105 field offices around the world. Decision-making authority on DCAA recommendations resides with contracting officers within the procurement organizations that work closely with DCAA throughout the contracting process. The type and extent of DCAA audit work varies, depending on the type of contract awarded.

DCAA performs audits of contractor bid proposals prior to award for both fixed price and cost reimbursable contracts when cost data is provided and contracting officials determine the need for an audit. After contract award, audit effort is concentrated on cost reimbursable contracts. These contracts pose an increased risk of overspending, often with little incentive to control costs.

Regulations covering acquisitions using competitive procedures and commercial item procedures rarely involve DCAA audit services. The regulations generally prohibit contracting officials from obtaining cost data from contractors to support the bid estimate.

In theory, when cost data is not required, DCAA audit support is not required. This theory holds true when the government is one of many buyers of identical goods and services in the marketplace. However, there are instances where, due to the magnitude of complexity of the government's requirements, the marketplace is limited or nonexistent, and consequently, market forces are not driving contract prices.

DCAA has faced a number of challenges in auditing contractors. I have detailed these more in my written statement, but in essence there are three major challenges that we have.

The first one Mr. Assad briefly mentioned, and that is the contracting officers' need for speed, as we call it, in awarding contracts is often at times at odds with the time necessary for DCAA to perform sufficient testing and auditing procedures.

Second, DCAA auditors are often faced with delays in obtaining data from contractors, and this has resulted in some audits taking longer than is necessary. Such delays in providing information from contractors is sometimes an attempt to stall the timely completion of the audits, knowing that we do have a need for speed in awarding these contracts. Such delays are unacceptable.

We often face challenges for contractors' commitment to correct business system deficiencies. And as Mr. Assad stated, this is going to be addressed under the new subcommittee under the Panel on Contracting Integrity.

As far as contracting vulnerabilities, we have mentioned three in our testimony, one being the commercial item definition has two areas of vulnerability of a type and offered for sale. This is also being addressed by the Adequate Pricing Subcommittee of the Panel on Contracting Integrity and which I chair.

Second is competitive pricing when only one bid is submitted. In one of these cases, and one case that I discuss in my testimony, we had an instance where a contractor received profit in excess of 30 percent on a competitively awarded firm fixed-price contract where only one bid was submitted.

Time and material contracts have also been an area of risk and continue to be looked at for the Department.

Now, regarding the GAO's review, in my written testimony I have detailed a number of improvements we have taken. We have taken over 50 specific improvement actions in the past year to address these issues, but there are two in which I want to briefly discuss. I realize my time is close, and I just ask if you would let me just briefly discuss these two——

Mr. ANDREWS. Yes, of course. Please take the time. Yes, ma'am.

Ms. STEPHENSON [continuing]. The first being in the independence issue, as you mentioned, Mr. Chairman. Independence is really at the heart at what an auditor performs. I am sure that anyone that is familiar with the auditing standards knows that that is the basic tenet of what an auditor does, and we were certainly quite appalled at some of the things in which the GAO discovered, both in 2008, 2009, regarding independence.

There were two major areas that led to the independence concerns, and unfortunately, these were processes that were not only supported, but also encouraged by the Department, and which we have now ceased.

First was involvement in what is called an integrated product team, which is where the government would team with the contractor, and that government, including DCAA, would often sit at the table as the contractor was putting together their bid estimate or an improvement plan or whatever else it is that they are working with the government.

DCAA would often be at the table and offer suggestions on draft procedures or draft parts of the proposal as a contractor was putting it together and then audit that proposal once it was submitted. We have ceased that process. That process was stopped in August of 2008.

We no longer sit at the table. We no longer participate in joint meetings with the contractors prior to an audit. We will support the contracting officer, but we will not be involved with anything related to a draft. We will only perform audits once the contractor has said this is a final submission for the government.

That was a major change we made in the summer of 2008, and we worked with Mr. Assad and the service acquisition chiefs in an attempt to have a smooth transition from that process, because that was a major change.

A second change that led to independence were in areas such as what you described, Mr. Chairman, in your opening statement about when a contractor had inadequate systems. We would often review their draft policies and procedures to offer comments as to whether it was headed in the right direction. It wasn't as though we prepared them, but we did provide feedback as to whether, yes, we think this would correct it, or, no, you are off base, you need to do something more.

That was something that was also supported by the department in an attempt to try to resolve system deficiencies on a timely basis and try to get them corrected sooner rather than waiting till a complete system was put in place and DCAA come in and audit.

We realized that that could have—and as the GAO said—could impair auditors' objectivity to give feedback on a draft policy and procedure, and then audit that policy and procedure. We have ceased that process as well. We will no longer offer any sort of comments on a draft procedure. Only once it is completed and implemented and actually had transactions run through the system for several periods, then we will test that.

It will result in some delay in resolving these issues. But we feel that that will improve our independence.

The last one I want to discuss is risk-based planning. And this was an area that the GAO had suggested that we implement, and we have in 2010.

We have staffing to cover about 65 percent of the required audits that need to be done. Because of that, we have had to focus our audit efforts in 2010 with those audits that are the highest risk to the Department.

One area we define as high risk is the greatest rate of return back to the Department—that being war-related effort, that being bid proposal, and also the accounting and billing systems at our largest contractors.

And in closing, Mr. Chairman and members of the panel, thank you for this hearing today. We do appreciate being part of the panel's efforts on acquisition issues, and we would not mind coming back again and talking about other issues with you.

But I do want to leave you with a thought. We have taken all these issues with the utmost seriousness, because our audits have to stand on their own. They have to be in accordance with the auditing standards. But at the same time, we need to make sure con-

tracting officers get them in a timely basis, so they can make good decisions.

Mr. Chairman, thank you for the extra time.

[The prepared statement of Ms. Stephenson can be found in the Appendix on page 48.]

Mr. ANDREWS. Thank you, Ms. Stephenson. We appreciate your efforts and your contribution.

Mr. Kutz, welcome to the panel.

STATEMENT OF GREGORY D. KUTZ, MANAGING DIRECTOR, FORENSIC AUDITS AND SPECIAL INVESTIGATIONS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. KUTZ. Mr. Chairman and members of the panel, thank you for the opportunity to discuss defense acquisition reform.

My testimony has two parts. First, I will discuss our recent work related to the Defense Contract Audit Agency. And second, I will briefly discuss our high-risk acquisition areas.

First, our recent work on DCAA began with allegations we received on our hotline in 2006. In July of 2008, we reported that these allegations were accurate. Specifically, 14 audits of 3 California locations we found did not meet professional audit standards.

In our second report issued last month, we found that 65 of the 69 engagements that we reviewed also did not meet professional standards. To date, DCAA has rescinded 81 audit reports.

Our two reports and recent Inspector General (IG) reports clearly show widespread audit quality problems. Key themes from our two reports include, as everyone has mentioned here, the lack of independence, insufficient audit work and removal of findings from draft reports by DCAA management without sufficient evidence.

Examples of these issues include, first, contractor and buying command pressure resulted in a DCAA manager dropping adverse findings for a satellite launch proposal. The inspector general recently reported that this flawed audit may have resulted in the contractor recovering $271 million of unallowable cost.

Second, DCAA issued an adequate opinion on a billing system with insufficient audit work. One auditor told us that testing was limited in this case, because—and I quote—"the contractor would not appreciate it."

And finally, another auditor wrote in a memo—and I quote again—"We are not holding this contractor with a history of questioned costs, poor internal controls and shoddy practices to a high standard by downgrading what are clearly significant deficiencies."

We have made 15 recommendations to DOD with the intent of strengthening DCAA's independence and effectiveness. One key recommendation is to develop a risk-based audit approach, focused on the quality of audits rather than the quantity of audits. We found audits of accounting and billing systems completed in two or three weeks. These audits often consisted of conversations with the contractor and a quick look at a few transactions.

Further evidence of the need to cut corners is the 22,000 reports issued in 2008 by DCAA's 3,600 auditors. That is 60 reports issued every day of the year, including weekends and holidays. If all

22,000 reports are truly necessary, then clearly, 3,600 auditors is not enough.

And I agree with Mr. Assad, what he said in our recommendations, for DOD to address this clear imbalance between resources and requirements.

We reported contract management of weapons system acquisition as high-risk areas since the early 1990s. These high-risk areas leave hundreds of billions of dollars vulnerable to fraud, waste and abuse. I have Mr. Bill Woods with me today, who would also be available to answer any questions you have on our past high-risk work.

In conclusion, our longstanding high-risk areas highlight the importance of strengthening DCAA's audits. I believe the DCAA has thousands of good auditors that have been trapped in a bad system. Positive steps have been taken or are under way to address many of the issues. We look forward to working with this panel and DOD to help DCAA achieve its full potential.

Mr. Chairman, I look forward to answering your questions. And that is my statement.

[The prepared statement of Mr. Kutz can be found in the Appendix on page 78.]

Mr. ANDREWS. Thank you very much. I thank each of the witnesses, and we will begin with the questioning session.

Mr. Kutz, I want to go back and talk about these hotline examples that came up. It is my understanding that in July of 2006, there were reports at—was it several offices? Or was it only California?

Mr. KUTZ. There were three offices in California, primarily.

Mr. ANDREWS. So, three offices in California. And the GAO wound up reporting about these examples. I guess last year was the report?

Mr. KUTZ. In July of 2008 was the report, and then the Senate had a hearing on that in September of last year.

Mr. ANDREWS. And is your testimony that you looked initially at 14 audits, and each one of them failed to meet the standards of professionalism that you would articulate?

Mr. KUTZ. That is correct.

Mr. ANDREWS. And you said 65 to 69 engagements. What does an engagement mean in this——

Mr. KUTZ. In the second report we issued, which was a broader look, I believe 40 or 50 of them were considered audits. The other ones were not characterized as audits meeting government auditing standards. They were still important work, but we called them engagements. That includes mostly audits, but some other not-audit engagements also.

Mr. ANDREWS. And you have given us some illustrative examples of the weaknesses here, that the work papers did not support the conclusions frequently. Is that one of the examples?

Mr. KUTZ. Yes. And in fact, related to that I mentioned the changing of the opinions, too, where management would go in. And there would be, let us say, eight significant findings, and they would basically get rid of all the findings and issue an adequate opinion without any additional work. And you mentioned that, I think, in your opening statement.

Mr. ANDREWS. Is it fair to characterize it, then, that some of the audit conclusions were just not supportable by the work papers? And then others, the work papers actually, took you in a different direction, and that the agency should not have reached the conclusion that it did. Is that——

Mr. KUTZ. I would say those are both true, yes——

Mr. ANDREWS. Okay.

Mr. KUTZ [continuing]. In some of the cases we looked at.

Mr. ANDREWS. You used, I think, an interesting phrase a minute ago, that we have thousands of good auditors trapped in a bad system. And I would take that as a premise from which we would start.

I mean, I assume that the vast majority of the 4,400 employees and 3,600 auditors are very highly ethical people who are trying to do the right thing for their country. I would just start with that as a presumption.

But I would then want to look at why we have this deficiency that was reported here. I mean, it strikes me that there would be a standards problem, which is to say that the auditors are being asked to not do the wrong thing, but the standards that are governing their work are not the right ones. And that would go to this quantitative issue rather than qualitative.

The second would be that there is a competence problem, that people want to do the right thing, but don't know how to do it. And then the third would be a motivation problem, where perhaps some of the people don't have the right motivation.

If you were to look at that threesome of causes, which one is the predominant cause of the problems that you found on the hotline investigations that you did?

Mr. KUTZ. Well, the overall problem, I think, is the production environment, trying to issue 22,000 reports or 30,000 audits with 3,600 people. And that leads to inadequate auditing.

In some of the cases, it may have led to management trying to—I will use the word "whitewash." These reports got whitewashed, basically, these reports, because it is quicker to get a report out with no issues and no findings than it is to get one out that has a ton of findings.

Mr. ANDREWS. Is it fair to characterize your conclusion that there is too much of a quantitative emphasis, you have to get "X" number of audits out, rather than an emphasis on the quality of the audits that you do? Do you think that is a fair statement?

Mr. KUTZ. It was a requirement, and it was something that was built into the performance standards for staff. And so, there was a lot of pressure.

And, you know, the public accounting world—I think we have another accountant here, too—you know, eating hours, working on weekends and not charging the time actually to the job, so it makes it look like the job costs less than it really did, which creates a cycle the next time someone comes back to do that audit. It took 200 hours, but it really should have taken 300, because they worked weekends and late nights, and didn't charge the actual cost——

Mr. ANDREWS. Now——

Mr. KUTZ. So it created that kind of an environment.

Mr. ANDREWS. Mr. Assad and/or Ms. Stephenson, do you agree or disagree with that characterization of the environment in which the auditors are operating?

Ms. STEPHENSON. I can address this, Shay.

Yes, I do believe that there were a considerable number of pressures put on DCAA with the advent of acquisition reform in the mid-1990s. There was certainly the auditor's need to do it cheaper, faster. And that was something that we heard at all levels within the organization, and it was something that was supported within the department as well.

Part of it is, we do need to get the audits quickly to contracting officers. I think what happened in that instance, then, we were not putting the sufficient hours on the assignments. And often, what got compromised was the documentation.

Mr. ANDREWS. Do you agree with the hypothesis that 60 audits a day couldn't possibly be done in a high level of quality by personnel this size?

Ms. STEPHENSON. Yes and no. The reason I say "no" is, many of those assignments are quite small. It might be a 40-hour assignment to review a $10,000 interim progress payment on a fixed-price contract. They are not all a multibillion-dollar Logistics Civilian Augmentation Program (LOGCAP) proposal, which would take thousands of hours. So, there is a mix.

And I think when you look at, if we were to take all the small assignments and all the low-risk assignments, such as what we have done for 2010, in which we will not be doing a great many of those, and looking at the higher risk, there is a vastly reduced number of assignments.

At one point, this agency was doing 35,000, if not up to 40,000 assignments. We have now made that down to about 25,000, now probably to 20,000. So, just in the last year or so of not performing some of these low-risk assignments to put the effort into the high risk, we are performing fewer assignments.

Mr. ANDREWS. I am sorry, Mr. Assad, what do you think? Do you think that the culture in which the agency has been operating over-stresses quantity of audits done to the detriment of quality?

Mr. ASSAD. I think that there is a tremendous pressure to get contracts awarded. And in some cases for good reason. I mean, we are at war. We need to get this equipment to our warfighters. On the other hand, you know, we have got to get a good deal for the taxpayers. So, one of the things that we are doing with DCAA——

Mr. ANDREWS. If I may, though, is your answer "yes" or "no"? Do you think that the environment in which the agency is operating is unduly slanted toward the quantity, or not?

Mr. ASSAD. I think it is, yes, the environment is one that stresses timeliness.

Mr. ANDREWS. Okay. I am going to yield to the senior Republican, Mr. Conaway, for his questions.

Mr. CONAWAY. Thank you, Mr. Chairman.

What happens to a contract officer who can't get an audit on time? Do we put those into a special higher risk category? In other words, if you can't get the report done, and the contract officer needs to move forward with the contract, do our systems put that

into a higher risk category that we follow up with later in a different regard?

Mr. ASSAD. I think two things happen, Mr. Congressman. Most times, it just means that the contract award is delayed. Because, you know, there is only a small number of our contracting officers percentage-wise who can actually move forward without the assistance of a DCAA audit, who would have the skills and the capability to be able to go forward and still get a fair deal for the taxpayer.

So, most of the time, it results in a delayed award. And in those cases where——

Mr. CONAWAY. Well, is that an inadequacy in training for the contracting officers?

Mr. ASSAD. Oh, yes.

Mr. CONAWAY. Okay.

Mr. ASSAD. You know, no doubt about it.

Mr. CONAWAY. April, you know, one of the allegations is undue pressure from the top from, you know, partners, in effect, on the managers. What are you doing to address that? Because that is systemic to public accounting firms everywhere. What are you doing to address and protect the auditors from upper management, so to speak, in these issues where you have got overrides that occur?

Ms. STEPHENSON. Sir, there are two things that we are doing. First, everyone was under the pressure with the prior metrics that we had had in place that were supported by the Department. Those metrics were changed in September of 2008. Those metrics were based on productivity, hours per assignment, et cetera.

We completely removed all of those. So people do not have the budget hour constraints. We removed from the performance plans the requirement to meet budget hours. We have given the staff the hours that they need. And we have emphasized you need to take the hours necessary to do a complete audit, even if it means one versus three for that particular month.

So we have tried to reiterate the highest level down to the lowest level by removing it from the performance plan, removing the metrics. Budget hours will no longer drive these assignments. Quality will drive them. We have put more metrics in related to quality.

Number two, we have put in a place a Web site, anonymous Web site in which employees can file complaints with us when they feel that findings have been removed or other issues have happened. We have an active program on that in which we will set up an investigation for every complaint and assess whether that indeed has happened.

Mr. CONAWAY. Yes. How often has that been used so far?

Ms. STEPHENSON. It has been used quite frequently since we have set it up.

Mr. CONAWAY. Okay. That is meaningless to me. How many numbers? How many times?

Ms. STEPHENSON. I am going to guess that we have probably had 400, at least.

Mr. CONAWAY. Okay. One of the GAO's allegations is that failure to meet general accepted governmental accounting standards—or

auditing standards. Excuse me. There are 3,600 auditors. How many training hours are they provided each year?

Ms. STEPHENSON. We are required under the auditing standards to meet every 2 years the 80-hour requirement for continuing professional education and at least 20 hours every year in accounting. We far exceed that.

Mr. CONAWAY. Accounting or auditing?

Ms. STEPHENSON. In auditing. I am sorry. In auditing.

Mr. CONAWAY. Okay.

Ms. STEPHENSON. We far exceed that. I think our average hours that people have in training——

Mr. CONAWAY. You track those requirements?

Ms. STEPHENSON. Absolutely. We have an entire training system that tracks by class, by type of assignment.

Mr. CONAWAY. Who provides the training?

Ms. STEPHENSON. A vast majority of the auditing training, the technical auditing training, is provided by DCAA through our Audit Institute in which we have course developers and instructors. And we also have on staff education specialists.

Mr. CONAWAY. Yes. Are those—I mean, you are training yourself, and you are providing your own training—are you in a loop where the, you know, where the problems with the training is not adequate so that the folks being trained don't get the right kind of training? Are you——

Ms. STEPHENSON. That is definitely a concern. And when the GAO issued the report in 2008, we did a—we are in the process of completely revamping the training to ensure that we are providing the training that we need to. We are consulting with the Inspector General (IG) and, when necessary, with the GAO to ensure that we are getting the type of training that we need to our people so there isn't that loop of people that didn't learn how to do it right are now training people not to do it right.

Mr. CONAWAY. Right. Right.

Ms. STEPHENSON. That is a concern.

Mr. CONAWAY. Mr. Assad, you mentioned there is yet a panel, a panel that is the subcommittee that is working on looking at some of these recommendations. What is the timing for their report?

Mr. ASSAD. Well, we usually come out once a quarter with recommendations. I think it is going to take us about 6 months because we are really focusing on two different things. The first is the evaluation of business systems, which is a problem where we have DCMA responsible for the overall cognizance of a business system. I mean, DCMA and DCAA doing the auditing. We need to reconcile that.

And the second is this whole issue of risk-based auditing. You know, how many audits should we be doing? What is the quality of those audits? Do we really need DCAA to be doing all this work? And how do we focus them in an area, from a customer point of view, to a more focused work establishment.

Mr. CONAWAY. Yes.

Mr. ASSAD. I would say about 180 days.

Mr. CONAWAY. Okay.

Mr. Kutz, is the director of DCAA report high enough up in the food chain at DOD to protect it from whatever it needs to be protected from?

Mr. KUTZ. I can't answer that fully. I mean, one of the things that the Senate had asked us to do was to provide alternative organizational placement options. We weren't for or against them. We just put them out there as either elevating them in the organization or possibly moving it outside of DOD and having some sort of government-wide audit agency. But we didn't really study those in depth. We laid out some pros and cons.

Mr. CONAWAY. Okay.

Mr. KUTZ. But that is a potential issue.

Mr. CONAWAY. Yes. Okay.

Ms. Stephenson, one final thing: audits. I know your testimony said you guys covered $330 billion in costs, 10 percent error rate. Is that an expected error rate?

Ms. STEPHENSON. Yes, that is about what we run. I think if we were to take the contractor bid proposals—those are the ones we do before award—it is actually higher than that. It is probably running about 15 percent on average that we have questioned in bid proposals.

Mr. CONAWAY. Okay. That is a startling number that we would have 10 percent—we will call it waste rather than fraud—but 10 percent. Will you follow up on the $32 billion findings here? What ultimately winds up happening with that $32 billion?

Ms. STEPHENSON. In the first part of it, which was the contractor bid proposals, that is what the contracting officer is going to use to negotiate the price.

Mr. CONAWAY. Okay, so it is not necessarily a dollar?

Ms. STEPHENSON. No. Where we have the vast majority of our findings or the actual dollars associated with them are before contract award. After contract award we probably have about 5 to 8 percent related to the findings. On contractor business systems we are running right now where we have got at least one segment of the top 100 defense contractors one location.

A Lockheed Martin, for example, may have multiple locations. But of all those, at least of the top 100, 69 percent have one location with at least one deficient system, to put some perspective on it. But our dollar savings comes in the vast majority prior to contract award.

Mr. CONAWAY. So afterwards we are—okay. That——

Ms. STEPHENSON. After contract award we are——

Mr. CONAWAY. How much can you bifurcate your workload before contracts are signed versus follow-on auditing to make sure it was done correctly?

Ms. STEPHENSON. That is right. We do. We do about half of it. The cost reimbursable contracts are primarily what we review after contract award.

Mr. CONAWAY. Okay.

Ms. STEPHENSON. And that would be ensuring that the business systems, earned value management systems, those type of things are in place to ensure that we are not being overcharged throughout the contract process. That is about half of the audits that we do are prior to contract award.

Mr. CONAWAY. And your expected error rate in that regard is?

Ms. STEPHENSON. Is about five to eight percent.

Mr. CONAWAY. Okay. And you theoretically would allow somebody a five—the system allows people to continue having an eight percent error rate year after year? Or how does that work?

Ms. STEPHENSON. No, we would hope not. In fact, this is one of the areas——

Mr. CONAWAY. Hope is not a real good credit——

Ms. STEPHENSON. Well, what I would say is with the business systems——

Mr. CONAWAY [continuing]. As we have seen.

Ms. STEPHENSON [continuing]. For example—and I am sorry to be doom and gloom, but this is one of the areas that we had addressed with the Commission on Wartime Contracting—is oftentimes we will report a contractor business system as inadequate. In fact, we had had some that were several years of inadequacies that continued and not a lot was done.

And that is an issue that this new subcommittee that has been set up by Mr. Assad is going to look at, is what is needed both within the regulations and the statute to strengthen the contracting officer's ability to make things such as an interim withhold on payments to be an incentive for contractors to fix these systems. That is one of the challenges that I have mentioned in my testimony, is that contractors have not had a lot of incentive to correct these systems. So we have issued reports, and not a lot may happen to them.

Mr. CONAWAY. Okay. Well, the best lines an old audit partner I heard said that it is about a photographer. And the photographer said if you want a prettier picture, you have got to bring me a prettier face. So the fact that you are, you know, telling us things that are wrong with the system is—you know, we are not going to shoot the messenger because the——

Thank you, Mr. Chairman.

Mr. ANDREWS. Thank you.

The gentleman from Indiana, Mr. Ellsworth, is recognized.

Mr. ELLSWORTH. Thank you, Mr. Chairman.

Ms. Stephenson, can you tell me what triggers the pre-award audit versus the post-award audit? Is it dollar amount? Is it new contractors? What actually triggers if you do a pre-award contract?

Ms. STEPHENSON. The pre-award is——

Mr. ELLSWORTH. Or audit contract.

Ms. STEPHENSON [continuing]. Is governed by two aspects. First is primarily the contracting officer's request for an audit. What will trigger their request for an audit is the submission of cost data from a contractor. And I will give you an example.

In a sole source negotiated procurement, the regulations would call for the submission of cost data. In that case, we would be involved in performing an audit, given a dollar amount. It is $10 million cost-type. That is the threshold. And for fixed price it is $650,000.

For procurements in which there is no cost data such as the competitive and the commercial item procurements, we would generally not be involved. I say generally. It is very rare that DCAA would be involved when there is not the submission of cost data.

So that is what would trigger the bid proposal, a contracting officer request and cost data.

After contract award under the regulations, it is the cost reimbursable contracts. And in that case, there is no threshold. We do an annual audit of all contractors that have cost reimbursable contracts. We audit the costs for those years, whether it is a $10,000 contract or $1 billion contract. Regarding business systems, we only audit the business system at the largest contractors, those that have $100 million or more of cost-type contracts in a given year.

Mr. ELLSWORTH. Thank you very much.

Mr. Chairman, in 2004, 2005, I was sitting at home before I ever thought about running for Congress. And I was reading an article that was talking about defense contractors that didn't pay their—their federal income tax. And that kind of shocked me, sitting at my kitchen table, that they continue to get defense contracts even though they weren't paying their taxes.

I know we all hate to pay taxes. But it is a necessary evil.

One of my first meetings with Mr. Kutz when I came to Congress was about this. And the report said that in 2005 33,000 civilian agency contractors owed over $3 billion in unpaid taxes. In 2004, same 27,000 owed over $3 billion in taxes and yet continued to receive federal contracts.

I think, Mr. Kutz—and correct me if I am wrong—when we sat in our meeting, I asked why we would award contracts to people who weren't paying their fair share of their taxes. And it was not you. It was somebody else in the room said that some were hoping that they would pay the taxes from the first contract with the second contract profits. Didn't seem like good business sense to me.

But I guess my question to you is—and thank you very much for your work—is it getting any better since our meeting? I filed some legislation to try to prevent this. It died in the Senate, or there was no action in the Senate. I filed that again. But have you seen any improvement since we talked and going into now 2006, 2007 and 2008?

Mr. KUTZ. No, I don't think so. And it is interesting that you mention that. And Ms. Stephenson mentioned five to ten percent before. But about six percent of government contractors have known tax problems. So it is not a small issue. And it still continues.

Most of the efforts are done on the back end levying payments, as you mentioned, the logic being, of course, well, let us keep giving them money so that they can actually pay the taxes that they already owe us versus preventing them from paying taxes. So more of the effort has been on the back end, not a whole lot on the front end.

Mr. ELLSWORTH. Have we done anything about the resources to the disbarment list from—about giving to increase, to pay closer attention to the disbarment list or done anything, any improvement in that area?

Mr. KUTZ. Not with respect to taxes because the Internal Revenue Service (IRS)—I mean, people can't get information on taxpayer problems like that. That is something that can't be shared across agencies. Section 6103 of the Internal Revenue Code does not allow IRS to share that with the Department of Defense, for

example. So even when we did our investigations, we couldn't tell the Air Force and Army who the tax cheats were that we had investigated.

Mr. ELLSWORTH. Mr. Chairman?

Thank you, Mr. Kutz.

Mr. Chairman, as complex as this issue is that we are studying—it has been going on for years—this seems like one that we could almost simply take care of, of not letting people who aren't paying their taxes participate in the procurement system. And like I said, we will continue to work on that. But——

Mr. ANDREWS. If the gentleman will yield? As we discussed before, the intention of the committee is to spend time in December and January meeting among the members to discuss ideas for legislative recommendations that we would forward to the full committee and then, frankly, to the leadership because there would be some jurisdictional issues here.

I would encourage you to bring that up during those discussions. I have made a note of it now. But I would be strongly inclined to include your recommendation in our report and try to get it enacted.

Mr. ELLSWORTH. Thank you. I would yield back.

Thank you all, the witnesses.

Mr. ANDREWS. The gentleman from Colorado is recognized.

Mr. COFFMAN. Thank you, Mr. Chairman.

First of all, I am stunned.

I think, Ms. Stephenson, you had mentioned that there is little leverage when a contractor isn't performing, when the audit shows the contractor isn't performing in terms of interim steps, withholding payment in order to get contract compliance. Could you elaborate on that?

Ms. STEPHENSON. Yes. When it comes to the business systems—and I will give you an example—let us take the system that is used for preparing billings to the government. We refer to that as the billing system. If we find that there are deficiencies, and a common deficiency that we often find is that the billing has costs that are either in excess or in non-compliance with the contract terms and conditions; the contracts may have their own unique terms and conditions, which sometimes are not caught by contractors when they bill costs. That is a common finding.

In those instances, contractors will submit a corrective action plan. And oftentimes—and I would say probably most, if not all the time—the corrective action plan itself is often viewed as enough versus saying does this corrective action plan—do we need to do something in the meantime for this contractor to have an incentive to put this plan in place. Sometimes plans come in 6 to 12 or if not more after the deficiencies have been reported.

During that period of time, we think that there needs to be some leverage. There needs to be some withholdings to incentivize a contractor to put those actions in place a whole lot sooner because in the meantime that system is still vulnerable to overpayments to the government.

What we have done in those instances is we don't permit the contractor to submit billings directly to payment offices. They must

come through DCAA, in which we will then review those interim payments to ensure that that problem is not continuing.

Mr. COFFMAN. Okay.

Ms. STEPHENSON. And we think there does need to be incentives. And as I said earlier, Mr. Assad completely agrees with this and has quickly set up this subcommittee to assess what more can be done in the interim.

Mr. COFFMAN. Okay.

Would anybody else like to respond to that? Okay.

It would seem that on a fixed price versus a variable or a cost plus contract that the auditing requirements would be much less than you are really auditing on the basis of outcome in terms of meeting those performance metrics. But it seems that when you are in a variable cost structure in terms of contractual arrangement, that has got to be pretty tough because you are measuring inputs and as well as making sure that they achieve the outcome.

Has there been a trend in either direction? It would seem to me that we ought to move to fixed price whenever possible.

Mr. ASSAD. Mr. Congressman, it is actually a little bit of the opposite way. When we get fixed price contracts, we need more audit assistance because at that point once we decide on what the price is, there is no more recourse for the taxpayers. We are going to pay that price. And if there is a disparity between what we have agreed to and the value we are getting, the taxpayer has no recourse.

In redeterminable type of contract, on the other hand, if there is some incentive for the contractor to actually under-run the contract, yes, it does require post-contract award administration. But, in fact, the taxpayer is going to get a little of that money back. And one of the things that we are looking at right now while there is certainly a desire for the department to move to fixed price contracting when we can, in those instances where we are not satisfied that the fixed price is going to, in fact, provide value to the taxpayers, we are going to revert to a fixed price incentive contract where it is redeterminable.

It says, look, we are just not happy that we are getting a good deal for the taxpayers. So we are going to establish a ceiling price. And then underneath that price we are going to share it. And so, that, in fact, may even add to DCAA's workload a little bit. But we have got an issue with, you know, our ability to ensure at the outset of this committee hearing—to ensure that the price we are paying and the value that the taxpayers and warfighters are getting is fair and reasonable to the taxpayers.

And so, you know, it is a problem. And, in fact, again, in fixed price contracting we require more audit services.

Mr. COFFMAN. Thank you, Mr. Chairman. I yield back.

Mr. ANDREWS. Thank you, Mr. Coffman.

Mr. Cooper is recognized.

Mr. COOPER. Thank you. I love the troops, but we have to recognize that year in, year out the Department of Defense is considered by both the Treasury Department and GAO to be the least auditable of all government agencies. It dramatically falls short even of the standards set by some of our other agencies that have been non-compliant. And in war time you might make excuses. But this has happened year in, year out.

Here we are focusing just on the procurement side of things. And the news is really no better. To have an error rate of 64, 69, you know, approximates like 93 percent flaws, mistakes, problems. And this is a field that is pretty well circumscribed.

My friend from Texas knows better than I there are traditional rules that auditors are supposed to obey: independence, all the criteria. And for those to have been flouted in so high a percentage of cases is truly amazing. And to have findings hidden or obscured or lost is truly stunning.

So I am wondering if hiring 700 new people in an organization like this is helpful or that is just going to create more problems. Everyone who testifies before Congress promises to do better. And, you know, this is an agency that has been in place since 1965.

So I am wondering about a lot of the issues, including it almost seems like some of these audits are kind of like a doctor that only can get a health report by doing an autopsy. It is too late. You know, maybe we need folks who are embedded in these large organizations because, as my colleague from Indiana pointed out, the simple fact of tax non-compliance is stunning. And yet we have found ourselves in such red tape, we are not even able to find out the facts on that. So maybe we do need to amend Section 6103.

But given 144 previous reports on reforming Pentagon procurement since World War II, almost none of which have been successful, the challenge for this panel is to take up new solutions, come up with something that really might be effective instead of repeating the high error rate of congressional reforms in past years. We issue a report. You people look at it. Nothing changes. And we keep on wasting taxpayer dollars.

That is not the answer I want to see. So I would like to encourage each one of you to help us think of new solutions, not just hiring more people. In most bureaucratic circles being able to expand your payroll a significant percent like 20 percent would be a sign that, hey, the organization is growing and successful. Well, in this case, it is a troubled organization that needs all sorts of help.

Now, perhaps there are, you know, reporting problems or other bureaucratic things getting the boxes right so that the Pentagon pays sufficient attention or so that you have the resources or the independence so you can be more authoritative. But the basic blocking and tackling today seems simply not to be done.

And I think that the taxpayers deserve a better deal. But, you know, in a bureaucracy everyone wants to keep their job. No one wants to be punished.

And I would like to ask Ms. Stephenson: What is your dismissal rate in your department for problem auditors or problem audits? What disciplinary actions have you taken within your ranks to encourage better performance? What sort of training programs do you have to make sure that people know and follow real auditing standards instead of giving these defense contractors a slap on the hand and a little gold star that contradicts the findings of the audit that has just been conducted? So what really is going on inside your agency?

Ms. STEPHENSON. Let me first address the issue of the 700 employees over the next 3 years. We recognize that is only a piece.

Throwing more auditors solely at this issue is not the solution. And we don't say that that is the solution.

It has to be a complete revamping of how we perform the audits, what our work paper requirements are, what the requirements are when there is a disagreement over audit findings, how we address our quality assurance organization, which had been getting a clean opinion on our peer reviews from the IG for some time, how we revamp each piece in the DCAA chain.

And I don't mean just management. I mean each piece of how we perform our audits, how we interact with contractors, how we get access to records, how we interact with contracting officers. Each piece of that has had to have been addressed and is being addressed.

We also had to address our training. We had to address the infrastructure of DCAA to say what broke down in these processes.

Mr. COOPER. Excuse me. My time is running out. How many auditors have you let go for incompetence?

Ms. STEPHENSON. I do not know, sir. But I would be happy to get that data and enter it for the record.

[The information referred to can be found in the Appendix on page 97.]

Mr. COOPER. Thank you.

Thank you, Mr. Chairman. I see my time is expired.

Mr. ANDREWS. Thank you, Mr. Cooper.

Mr. Conaway, any closing remarks or follow-up?

Mr. CONAWAY. Well, I do have some follow-up questions, if you don't mind.

Mr. ANDREWS. Sure.

Mr. CONAWAY. Mr. Kutz, have you been requested to do a follow up at some point in time on your recommendations for DCAA?

Mr. KUTZ. Not formally at this point. Certainly, we will continue to work with the Senate committee. And we would be happy to work with you also. I am sure that they would have no problem jointly working with you on these matters. I am certain of that.

Mr. CONAWAY. Okay.

Ms. Stephenson, Mr. Assad, who sets the budget for DCAA?

Ms. STEPHENSON. It goes through the Office of the Secretary of Defense.

Mr. CONAWAY. Okay. But Bob Gates says that is enough money for you?

Ms. STEPHENSON. You know, to be honest, I am not sure, once it leaves the comptroller's office, how all that comes into Congress.

Mr. CONAWAY. Okay. Right. So part of where DCAA shows up in the org chart is that review.

And Mr. Assad, I hope, would say that whoever that person is has the right authority to say that they are getting the right allocation of resources.

Mr. ASSAD. Yes, I believe it is accurate to say that Under Secretary Hale is responsible for establishing the budget for DCAA.

Mr. CONAWAY. And so, part of your committee findings will decide if whether or not that is for under secretary or—I don't know what all the layers are of where that is in the——

Mr. ASSAD. No, I——

Mr. CONAWAY. But the point is is if the person who has got ultimate responsibility for deciding what the budget of the DCAA should be doesn't have enough stroke in the overall system, then it will be under-resourced.

Mr. ASSAD. I think Under Secretary Hale of the comptroller is, from my personal opinion as well as the department's opinion, is that organizationally DCAA is properly placed under his auspices.

Mr. CONAWAY. Mr. Kutz, what are the auditing standards that are missed? I mean, I spent 7.5 years on a state board of accountancy. And we had a constant flow of CPA firms who have come through the system who had failed to confirm receivables or, you know, confirm bank accounts, those kinds of things. Can you give us a sense of what these failed audits—what auditing standards were not adhered to?

Mr. KUTZ. Well, primarily the sufficient, competent evidential matter necessary for an audit. For example, if you are testing a system—and we saw this a lot—they might be looking at a one-year period and may have picked one or two transactions from one day, sometimes that the contractor even selected for them, and then gave an opinion on a system over a whole period of time. So that clearly doesn't meet sufficient, competent evidence standards for giving an opinion on a system.

Mr. CONAWAY. Ms. Stephenson, how does that occur? I mean, you and I both know that is enough work to be done to support an opinion like that. How do you determine those levels of testing?

Ms. STEPHENSON. Yes, the transaction testing and work paper documentation were the two primary areas in the auditing standards in which we had the difficulties with. In some instances, there were a few in which they had tested a few transactions during the actual billing system audit and had used testing that was done in other assignments of contractor costs to augment the testing within that particular assignment.

I am not saying that is right or wrong. That is what happened.

Mr. CONAWAY. Okay.

Ms. STEPHENSON. We no longer do that. We are now requiring the testing on a billing system to be done within that billing system assignment.

Mr. CONAWAY. The timeline for analysis, the risk-based management, risk-based auditing focus is what?

Ms. STEPHENSON. We have instituted that right now. That started in October of 2010.

Mr. CONAWAY. And we will determine later whether GAO believes that is the right model. I mean, Ms. Stephenson, quite frankly, to have a system that allows one transaction to be tested and then you issue an audit opinion on that, to allow that to go forward, then to have the same group of people tell us that they now have the right risk-based auditing standards in place—you know, it is a trust and verify thing. So I am not real comfortable with the statements that, you know, we have now put in a risk-based auditing system, because it is the same people who decided that one transaction was okay.

Ms. STEPHENSON. Well, one transaction didn't happen very often——

Mr. CONAWAY. But then that is an anomaly, but nevertheless——

Ms. STEPHENSON. But what I will say to you that we did is we stopped the manner in which we have previously done system reviews. We have completely revamped it. And part of this risk-based approach that we announced on October 1st is we are not going to start any system reviews this year until we have the revised guidance out in the field. That process is being pilot tested right now in which we will look at significantly more transactions across the entire system.

And we are working with the IG to ensure that that process will indeed meet the auditing standards. So, yes, you are right. And in looking at this to say, well, how can I give you assurance that isn't going to continue this year. It is because I have stopped it.

Mr. CONAWAY. Okay.

Ms. STEPHENSON. And I have issued it to the workforce saying we are not going to do them until I give you revised guidance that has the sufficient testing necessary to express an opinion on these systems.

Mr. CONAWAY. Okay. You mentioned quality assurance system with DCAA. Can you briefly describe that to us?

Ms. STEPHENSON. Our quality assurance organization has two parts. One, we use the DOD Inspector General to perform our peer reviews, which are done on a three-year basis. Every three years it will look at three years' worth of audits that we do.

Mr. CONAWAY. Yes. Why would you not use senior management within the other offices to audit? You know, in public accounting firms, one of the things that we did was we had audit partners from one office audit the work that was done within the firm by other auditors. I mean I don't—go ahead. Why don't you discuss this?

Ms. STEPHENSON. That is right. We have two pieces. One is the external, which is what the DOD Inspector General does for us. The other piece is internal, which is we have a separate Assistant Director for Quality Assurance at our headquarters that performs quality assurance reviews across the agency.

Mr. CONAWAY. Okay. And that person is new?

Ms. STEPHENSON. That person is a senior executive.

Mr. CONAWAY. No, no, no. We have a new person there, given the problems we have had with the systems?

Ms. STEPHENSON. Yes, that person is new and has just been put in place this month.

Mr. CONAWAY. The position is just put in place, or the new person has been in place ?

Ms. STEPHENSON. Both. We had the position at a 15 level, and we had it performed by each of our regions. Regions would be similar to the partners——

Mr. CONAWAY. Right.

Ms. STEPHENSON [continuing]. In a firm. Each of the regions performed reviews of other regions, and it was more decentralized. We in 2008 brought that up to the headquarters level and stood up a new division in which I filled the position last year, but I have got it an Assistant Director senior executive position now.

Mr. CONAWAY. Okay. Is this person in a position that if Mr. Kutz or his follow-on folks bring us a GAO report that looks like the one we just got, that person would be fired?

Ms. STEPHENSON. I don't know if they would be fired. I mean the reason I say that is I don't know if it was during their timeframe. We would have to say whether these assignments happened during their timeframe.

Mr. CONAWAY. Yes, that is fine, but I am just saying if under that person's tutelage, the system doesn't get any better.

Ms. STEPHENSON. I would certainly say if we don't catch these areas ourselves and instantly correct them, yes.

Mr. CONAWAY. Okay.

Mr. Assad, elevating the DCAA's findings and recommendations that would actually have some teeth and prevent these going on—what are you going to do to elevate those findings so that either we keep track of them from the congressional side or the system itself uses that data and information to actually improve the process?

Mr. ASSAD. Well, we are going to provide you a report on an annual basis to Congress on the findings of the Contracting Integrity Panel, so you will know exactly what it is that we are recommending and exactly the action—including there will be the action plans as to when we will put in place.

Mr. CONAWAY. Okay.

Mr. Chairman, just one final comment on Mr. Cooper's earlier comments. This year's Defense Authorization Act—the House attempted to accelerate the timeframe in which the DOD is auditable from 2017 to 2013. And our colleagues on the other side of the building were a lot more lenient than what our position was, and somehow we wound up with the lenient version in this year's round.

This is an important issue, auditing across the entire system, not just the auditing work Ms. Stephenson and her team does, and we are going to continue to shine a light on it, because this is important to the system, so——

And I yield back.

Mr. ANDREWS. If the gentleman would yield, I would say to him what I said to Mr. Ellsworth. I certainly would want that recommendation included as part of this panel's report, that if anything, the hearing today and the other work that we have done points out the compelling need for a systemic audit of the Department of Defense as soon as practicable. And I think that is an issue that we should revisit very aggressively. I agree with you.

Mr. CONAWAY. And I would also recommend that we somehow work our side of the system to make sure that the GAO comes back on a follow on behind the DCAA audits that they have already done.

Mr. ANDREWS. I agree, and I just want to sum up this morning with that in mind, that the panel will consider the evidence that we have derived from these hearings over the course of the next three months or so, and we will meet among the members of the panel and discuss recommendations that we have and generate for public review a series of policy recommendations which, if adopted by the panel, would then be forwarded to the full committee for consideration as part of next year's reauthorization.

Dr. Assad, we would certainly—Mr. Assad, excuse me—we would welcome the subcommittee that you are involved with, its recommendations, so we could evaluate them.

Ms. Stephenson, any input you would like to give us we would like as well.

And certainly, I want to formally extend to GAO our request for your recommendations, based upon the work that you have done, that we would then work with Senators Lieberman and Collins to find a common position. I would personally like to see those recommendations focus on altering the standards from standards which encourage an increase in the quantity of audits to those that increase the quality.

We really shouldn't be surprised when we get a defective work product, if the organization is tilted toward simply getting the reports out. And I think that we need to track that question very, very closely.

The record of the proceeding will remain open for anyone who would like to supplement any of their comments today. I know that there are a couple of questions pending for Ms. Stephenson that Mr. Cooper would ask. The same would go for the members.

We appreciate everyone's involvement.

And with that, the hearing is adjourned.

[Whereupon, at 9:20 a.m., the panel was adjourned.]

A P P E N D I X

October 15, 2009

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

OCTOBER 15, 2009

Mr. Andrews Statement for the Record

Welcome to today's hearing entitled 'Can the Department of Defense Protect Taxpayers When It Pays Its Contractors?' It continues the panel's series of hearings which focus on a particular hypothesis about where value is lost in defense acquisition.

Today's hypothesis is pretty straightforward: DOD loses value in acquisition when it doesn't properly mitigate the risk that it will overpay its contractors. The risk comes in two stages, first, that DOD will enter into risky contract types when they are not necessary; second, that DOD's process for auditing and correctly paying bills submitted under riskier contracts will breakdown.

The House Armed Services Committee led the way in 2007 in establishing the Panel on Contracting Integrity within DOD to try and steer the Department away from more vulnerable contract types whenever possible. When using such contracts does prove necessary, however, DOD must be able to rely on the Defense Contract Audit Agency to help contracting officers ensure that contractors are paid only what they deserve.

The size and complexity of defense procurement means that relatively simple billing errors can lead to massive overpayments by DOD. The DOD IG discovered in 2008 that the use of an improper cost index as an inflation adjustment on the multiyear procurement contracts for the C-17, F/A-18 E&F, and Apache Longbow led to over $500 million in duplicate charges.

In 2009, GAO identified unallowable costs charged under the EELV program potentially totaling as much as $1 billion that resulted from the improper inclusion of 'commercial' costs in a pool of costs charged to DOD. There are more potential examples in this area than could possibly be listed in our allotted time, but suffice it to say that the simple matter of paying DOD's bills correctly can be anything but simple.

Today's hearing is important not just because these problems have occurred, but because there is substantial disagreement between DOD and GAO over how best to mitigate risk in reimbursing its contractors. I anticipate that we will hear a vigorous debate today about how DOD can best organize its audit and contract management functions to both protect the taxpayer and serve the warfighter. And I should emphasize that this committee, as always, is highly attuned to the mission of serving the warfighter. In mitigating the risks of overpayment, we must not impede the timely delivery of critical war materiel.

With the help of our witnesses today, we will try and find the right balance of these priorities. Finding this balance is at the core of the mandate that Chairman Skelton and then Ranking Member McHugh gave the panel when it was established in March of this year.

I now turn to my colleague from Texas, a CPA, for his opening remarks.

Statement of Rep. Conaway

Hearing of the

Defense Acquisition Reform Panel
on

"Can the Department of Defense protect Taxpayers When it Pays Its Contractors?"

October 15, 2009

Good morning, Mr. Chairman, ladies and gentlemen. I would like to thank our witnesses for taking time out of their busy schedules to be with us this morning.

Today's hearing examines an area of acquisition that is near and dear to me: auditing. The basic question is how vulnerable is the Department to overpaying its contractors on acquisition programs and how robust are its systems for preventing overpayments? The Defense Contract Audit Agency (DCAA) provides the Department's primary internal means of detecting, preventing, or correcting the majority of potential contractor overpayments.

There have been recent articles based upon GAO findings in regards to DCAA. Based on written testimony, there are major disagreements between the Department and the GAO. I would only add that we are here today to learn all view points. We have a group of very qualified witnesses and we are glad that you are here with us today to help us understand these issues.

Finally, I would just say that once again, a reoccurring theme that has been consistent with most of our panel hearings is in regards to the workforce. In fiscal year 2008, DCAA performed over 30,000 audits with approximately 4,200 employees. I believe it was Mr Assad in his written statement that stated, "Rebuilding the DCAA workforce, while a challenge, can and must be done." We've learned from previous hearings that increasing the workforce isn't always the answer, but in this case it appears that the workforce is one of the major areas that need to be addressed.

With that I look forward to hearing from our witnesses.

Thank you Mr. Chairman.

**HOLD UNTIL RELEASED
BY THE HOUSE COMMITTEE
ON ARMED SERVICES**

STATEMENT BY

MR. SHAY D. ASSAD

ACTING DEPUTY UNDER SECRETARY OF DEFENSE

(ACQUISITION & TECHNOLOGY)

BEFORE THE

ACQUISITON REFORM PANEL
HOUSE COMMITTTEE ON ARMED SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

**DEPARTMENT OF DEFENSE
DEFENSE PROCUREMENT AND ACQUISITION POLICY**

OCTOBER 15, 2009

**HOLD UNTIL RELEASED
BY THE HOUSE COMMITTEE
ON ARMED SERVICES**

INTRODUCTION

Chairman Andrews, Ranking Member Conaway, Members of the Committee: My name is Shay Assad and I am the Director of Defense Procurement and Acquisition Policy. I am also presently serving as the Acting Deputy Under Secretary of Defense for Acquisition and Technology, in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics (AT&L).

After serving tours on board two Navy destroyers, I began my career in acquisition thirty-two years ago as a Naval Procurement Officer at the Naval Sea Systems Command. I left the Navy in 1978 and joined the Raytheon Company. Over my twenty-two year career at Raytheon I held a variety of contracting and operational positions ultimately serving as a corporate Vice President, a Senior Vice President, and finally, as Corporate Executive Vice President and Chairman and Chief Executive Officer of one of its major subsidiaries. I retired from Raytheon in July 2000.

In 2004, I entered Government service as the senior civilian contracting official for the U.S. Marine Corps. In April 2006, I was promoted to serve as the Director of Defense Procurement and Acquisition Policy.

DISCUSSION

Thank you for the opportunity to appear before you and to participate in today's discussion. As the senior leader of the Defense contracting workforce, I cannot stress enough the crucial role DCAA plays in the Department's procurements. I assure you that

all of our contracting officers value, and rely significantly, upon the professional advice rendered by DCAA.

We recognize that the General Accountability Office (GAO) has recently identified needed improvements in DCAA's auditing processes. To assist DCAA in addressing the concerns identified, Under Secretary Hale established an oversight committee to provide advice and recommendations concerning DCAA matters. The committee membership includes the Auditors General of the Army, Navy and Air Force, the Department's Deputy General Counsel for Acquisition & Technology and as the Department's Senior Procurement Executive, I am also a member of the DCAA Oversight Committee. This senior group will assess DCAA's activities and the actions taken to correct problems identified by GAO and others. I have been actively engaged in working with DCAA to address many of the issues identified by the GAO.

Occasionally, there are differences of opinion between the DCAA auditor and the contracting officer on audit findings. That is to be expected as DCAA is accounting oriented, while the contracting officer is business oriented, and must balance many factors and considers input from many technical advisors, including DCAA, in his decision-making process. Deputy Secretary Hale and I recognized that we needed a process that allows DCAA to elevate those disagreements if they can't be resolved at the contracting activity and field audit office level. Under this process, DCAA may appeal to me as Director of Defense Procurement and Acquisition Policy. If the matter is not resolved, further appeal could be made to the Under Secretary of Defense (Acquisition,

Technology & Logistics) and to the Under Secretary of Defense (Comptroller). We expect that appeals to the Under Secretary level will be very rare.

As Under Secretary Hale pointed out in his testimony before the Senate Homeland, Security & Government Affairs Committee last month, in my role as the Director, Defense Procurement and Acquisition Policy, I represent the key customer for DCAA. Given that, I would like to offer you my thoughts on several areas identified for improvement in the GAO Report GAO-09-468 (GAO Code 195099) "DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform."

1. Auditing in the Public Interest

The report could be interpreted in a manner to suggest that the DCAA mission should be refocused toward protecting the taxpayer's interest instead of facilitating the DoD contracting workforce. The report adopts a position that because DCAA is serving the interests of Contracting Officers, that DCAA is not auditing in the interest of the public. DCAA is a service organization created to provide financial information, audits, and advice to support decision making by DoD Contracting Officers. DCAA serves the public interest by providing timely and useful information to Contracting Officers. It is erroneous to imply that contracting officers do not seek to protect the public interest.

The contracting officer is bound by regulation to meet the public interest in the broadest sense, for the entire matter surrounding a contract. The contracting officer, in the award and administration of a contract, is the government official responsible for insuring that all requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, have been met. Any logic

that presumes that by focusing on supporting contracting officials, DCAA somehow failed to act in the public interest is inappropriate in our view. Someone trained and named in both law and regulation has to look at all facets of a contracting action, and not just the audit, if the public interest is to be served—the contracting officer is that person.

Numerous provisions of the Federal Acquisition Regulations (FAR), for instance, speak to the issue of all members of the acquisition and administration community serving the public interest and note that each member of the acquisition team is responsible and accountable for the wise use of public resources as well as acting in a manner which maintains the public's trust. Fairness and openness require open communication among team members, internal and external customers, and the public. (FAR 1.102(c)(1))

And speaking directly to contracting officers, the FAR states that they are responsible for ensuring performance of all necessary actions for effective contracting, ensuring compliance with the terms of the contract, and *safeguarding the interests of the United States in its contractual relationships.* In order to perform these responsibilities, contracting officers should be allowed wide latitude to exercise business judgment. (FAR 1.602-2)

By serving the interests of contracting officers well, DCAA does serve the public interest. It is not one or the other as might be interpreted.

2. Production Auditing

Throughout the report, the GAO implied and in some instances states that the problem is "Production-Oriented Auditing" and that audits have been rushed by

contracting officer requirements. This sets up a dichotomy between "quality" audits and timely audits; however, an audit not delivered in a timely manner is of limited value to the Government.

For example, a proposal review delivered after negotiation has started and decisions have already been made is of greatly diminished usefulness. Likewise, an incurred cost review that is not completed in a reasonable period after the costs are incurred loses contemporaneous support—employees of the contractor and the Government leave, some records are lost or are placed in deep storage. Similarly, business system reviews need to be issued while a problem is still subject to correction before the fact to protect the Government's interests, not two and three years later.

Timeliness is a critical element of quality. Delays in award have consequences to the warfighter. Contracting officers are required to consider those consequences and hence, they are very concerned that DCAA has not been able to consistently deliver timely reports and advice. The GAO has previously recognized there are consequences to award delays. (GAO-06-722, DOE CONTRACTING, Better Performance Measures and Management Needed to Address Delays in Awarding Contacts, June 30, 2006) Specifically, GAO acknowledged that delays in awarding contracts could increase costs and could also affect the willingness of companies to compete for future contracts.

A contracting officer knows that delays can impact funding decisions and disrupt program management plans. Contracts are often interrelated and codependent, such that a delay in awarding one contract can delay an entire system and put off fielding dates, with consequences distributed and cascading through a range of other contracts and

plans, and might ultimately result in mission failure. The contracting officer, also by regulation, has to consider and respect the opinions of other specialists and not just that of the auditor. A good audit in time is better than an extraordinary audit that is late and never used. An audit is a tool the contracting officer uses to negotiate a contract, but in order to realize the benefits of the auditor's work, *the audit must be timely.*

3. Generally Accepted Government Auditing Standards (GAGAS)

As the GAO correctly pointed out, DCAA performs most of its audits and reviews in conformance with GAGAS. We believe that, for some reviews and financial advice provided by DCAA, it is possible that it may not be necessary to provide a fully conforming GAGAS audit report to support certain contracting officer functions. DCAA should use auditing standards and techniques that produce creditable information that can be relied upon by the contracting community in the awarding and administrating of contracting. However, we believe that all DCAA reports and reviews types should be examined to determine if the standard being applied and reported by DCAA is the appropriate standard given the requirement causing the audit or review to be performed.

4. Staffing

While the GAO report alleged examples of poor quality audits and some poor decisions made by DCAA management, most would seem to be heavily influenced by lack of adequate staffing. Based on our discussions with contracting officers, contractors, and auditors, some and possibly most of the reductions in audit scope and responsiveness by DCAA is a direct result of the staffing drawdown while workload increased. Until the

staffing issues are resolved, it will not be possible for DCAA to perform at the level of quality and efficiency that is desired.

Rebuilding the DCAA workforce, while a challenge, can and must be done. The workforce build-up will require years of effort to hire and train the staff required to do the work envisioned by the GAO audit.

5. Placement of DCAA Elsewhere in the Executive Branch

The GAO report raised the question of DCAA's placement within DoD or elsewhere in the Executive Branch. Currently DCAA performs most of the contract auditing functions within the Executive Branch. Even if DCAA performed the remaining contract audits not currently being performed by DCAA, DoD would remain by a large factor the majority user of the audit services. We do not believe that any useful purpose would be served by moving DCAA outside DoD. DoD has the most vested interests in a well functioning DCAA.

In our view, in reporting to the Comptroller, DCAA is insulated from direct influence from contract procurement and contract administration offices. For similar reasons DCMA is in the AT&L chain of command to insulate it from pressures it might have placed on it if it were in the same chain of command as the procurement offices. The Comptroller is in the best position to understand the DCAA requirements while maintaining its independence from the audit report users.

6. Risk Based Auditing

According to the DCAA Contract Audit Manual, all audit planning is risk based. This applies to both the annual planning for types of audits and staff requirements as well as for the planning of specific audits. The Audit Manual is quite clear that the final budget set for the assignment is be based on the circumstances and risk attached to the assignment being planned. Further, it also clearly sets out that as circumstances change or the risk is found to be different than considered during the planning stage then budget changes should be made.

The GAO report contains the finding that budgeted hours do not reflect the risk and that risk found during the field work have not resulted in changed budgets. This is obviously not a policy matter or DCAA not doing risk-based auditing, since the findings are clearly at odds with the DCAA policy. We believe that the failure to follow the policy is a result of staffing constraints that made it impossible for DCAA to perform all the assigned review requirements to the standards expected.

7. Direct Billing

This GAO report comments on the Direct Billing program and the problems noted in DCAA administration of voucher reviews. Direct Billing approval was not designed to reduce review of vouchers. It was designed to administratively take advantage of technology to better process vouchers in an efficient manner and to better comply with the Prompt Payment Act. In appropriate circumstances, using risk-based analysis of contractor past performance and the quality of its business systems, contractors were to

be allowed to be paid before review of vouchers instead of requiring review of the vouchers before payment.

The nature of the review program for any given contractor should not have changed due to placement on Direct Billing. The DCAA guidance requires voucher reviews of all contractors every year that the contractor has Direct Billing authority. Where DCAA believed based on past performance or poor systems that there was a significant chance of improper billing, the contractor was not to be included in the Direct Billing program. The review program for the contractors should have been the same as it would have been based on risk factors even if there was no Direct Billing program.

The problem with voucher reviews both before the Direct Billing program and after the initiation of the program is that DCAA did not have sufficient staff to perform the reviews required by the risk-based analysis. New contractors and problem contractors should have voucher reviews before payment just as required by DCAA policy. Established contractors with adequate past performance should have vouchers reviewed after payment using a reasonable plan tailored to the contractor's circumstances just as required by DCAA guidance. Changing the decision authority for participation in Direct Billing should have no impact on what vouchers are reviewed. Taking a contractor off of the program does not ensure that the vouchers will be properly reviewed prior to payment if there is not sufficient staff to perform the reviews.

8. Panel on Contracting Integrity

I would also like to address DCAA's role and participation in the Panel on Contracting Integrity. DCAA chairs a subcommittee focused on Adequate Pricing. A

number of matters have been addressed by that panel: 1) the development of a Contract Policy Execution Review Plan that recognizes Department-wide risks, promotes consistency in procurement policy execution across all components, and encourages Peer Reviews; 2) an assessment of the need for revised/additional training on competition requirements and differing pricing alternatives; 3) increased level of approval for commercial item determinations, increased level of approval for Time & Material contracts, and; 4) an assessment of the need for a legislative proposal that would change the definition of "commercial item" by deleting the phrase "of a type" and revising the language to require commercial items to have been "sold" rather merely "offered for sale".

The Panel on Contracting Integrity has proved to be a productive forum for making progress in eliminating vulnerabilities that lead to fraud, waste and abuse. The subcommittees continue to highlight and address areas of concern and are in the process of identifying the initiatives that they will pursue in Calendar Year 2010.

Given the success of the Contracting Integrity Panel in addressing such issues, I have established a new interdepartmental subcommittee that will address the adequacy of DCAA and Defense Contract Management Agency (DCMA) oversight of contractor business systems. The Commission on Wartime Contracting has identified contractor business systems as a vulnerability that may permit waste and abuse to occur. The Commission made recommendations regarding the need for better cooperation between DCAA and DCMA on dealing with contractor business systems.

The new subcommittee will review current policy, processes, and practices within DoD regarding the audit, evaluation, and administration of contractor's business systems to include contractor internal control systems or other contractor systems the subcommittee may identify. The following discussion points will guide the subcommittee's efforts:

- Develop a common definition of contractor business systems
- Is there a need for additional contract clauses or regulations for each system, to include remedies such as withholds and guidelines for audit frequency?
- Is there a need for defined expectations or criteria for each system to determine adequacy?

The goal of this subcommittee will be to develop recommendations for corrective action and changes in regulations and guidance as required.

SUMMARY

I want to express my continuing support and appreciation for the advice and services provided by both DCAA and DCMA. Those organizations are truly essential partners in the Department's mission to procure the best for the Warfighter at the lowest cost to the taxpayer.

Thank you for the opportunity to speak to you today.

Testimony

of

April G. Stephenson
Director, Defense Contract Audit Agency

before the

House Committee on Armed Services
Defense Acquisition Reform Panel

October 15, 2009

Mr. Chairman, members of the Panel, thank you for the opportunity to appear before you today; I am pleased to be part of the Panel's efforts to explore improvements in contract acquisition. As requested, I will describe the role of the Defense Contract Audit Agency (DCAA) in the acquisition process. I will also discuss the improvements and mitigating actions we have taken in response to the findings from recent GAO and DoD Inspector General reviews.

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 audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. Under the acquisition regulations, not all contracts are subject to audit. 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 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 has about 4,400 employees and 105 field audit offices around the world.

DCAA Contract Audit Effort and Results

Mr. Chairman, as previously stated, DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting. DCAA plays an integral part in the oversight and management instituted by DoD to ensure integrity and regulatory compliance by contractors performing on DoD contracts. Decision-making authority on DCAA recommendations resides with contracting officers within the procurement organizations who work closely with DCAA throughout the contracting process.

The type and extent of DCAA audit work varies based on the type of contracts awarded. For example, DCAA performs audits of contractor bid proposals prior to contract award in accordance with the Federal Acquisition Regulations for both fixed price and cost reimbursable contracts when cost data is provided and contracting officials determine the need for audit services. Audits of contractor bid proposals represented about 33 percent of all audits completed in FY 2009. After contract award, audit effort is concentrated on cost reimbursable contracts. DCAA audits of fixed price contracts after contract award are very limited and are generally focused on audits for compliance with the Truth in Negotiations Act and auditing contractor interim payment requests when determined necessary by contracting officials.

Audit Services Prior to Contract Award. Under current regulations, contracting officers procure goods and services using various acquisition strategies. DCAA audit services are generally limited to those procurements under Federal Acquisition Regulation Part 15. For acquisitions through a sole source, contracting officers may request DCAA to perform an audit of the contractor's bid proposal to assist in determining a fair and reasonable price. During

FY 2009, DCAA conducted 7,004 audits of contractor proposals covering $219 billion and reported exceptions of about $31 billion.

Regulations covering acquisitions using competitive procedures and "commercial item" procedures under Part 12 of the acquisition regulations rarely involve DCAA audit services. In these instances, the regulations generally prohibit contracting officials from obtaining "cost data" from contractors to support the bid estimate. In theory, when cost data is not required, DCAA audit support is also not required. This theory holds true when the Government is one of many purchasers of identical goods and services offered by many vendors competing in the market place.

The Department acquires many goods and services using competitive or commercial item procedures where competition in the market place drives prices down and results in best value for the Government. However, there are instances when -- due to the magnitude or complexity of the Government's requirements -- the market place is limited or nonexistent. In such cases, prices may be overstated, as market forces driving down contract prices are absent. This is an area of vulnerability in the current acquisition environment that we discuss further in the section of this testimony on Vulnerabilities in the Acquisition Process.

Audit Services After Contract Award. Audit support during contract performance is generally focused on cost reimbursement, time-and-material, and labor-hour contracts. These types of contracts pose an increased risk of overspending, often with little incentive to control costs. As a result, audit effort is continuous from contract award to final closeout and payment depending on the size of the contract. This continuous effort is concentrated on audits of contractor business systems and annual testing of contract costs for compliance with contract terms.

DCAA Audits of Contractor Business Systems. 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 are essential for protecting the Government's interest and preventing contractor overpayments. 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.*

DCAA audit procedures include tests of key contractor internal controls that we believe a contractor business system should possess 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. Generally Accepted Government Auditing Standards require DCAA to report all significant deficiencies identified during its review of contractor business systems and to determine whether the deficiencies are considered material weaknesses.

When a contractor's business system and related internal controls contain significant deficiencies, 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.

During FY 2009, we issued about 250 reports addressing contractor internal controls of which 127 audits reported at least one significant internal control deficiency. To put the systemic nature of system deficiencies into perspective, of the top 100 DoD contractor segments that are audited by DCAA, approximately 69 percent have at least one business system with a significant internal control deficiency.

To mitigate the risk of overpayment to the Government due to internal control deficiencies, DCAA takes various actions including recommending that contracting officers withhold a percentage of interim cost payments, requiring contractors to submit interim cost payments through DCAA rather than directly to the payments office, and recommending contracting officers suspend or disapprove specific costs.

Although DCAA has recommended that contracting officers implement a percentage withhold on interim billings when contractors have significant internal control deficiencies, however, vague language within the Federal Acquisitions Regulations has caused some concerns with the contracting officer's authority regarding withholds.

DCAA has experienced instances where a percentage withhold on interim billings has been a positive incentive for contractors to correct deficiencies. In 2004, we issued an audit reporting significant deficiencies in the labor system for a major contractor performing linguist

services in-theatre. The withhold lasted several years and over $40 million of labor costs were withheld at one point, but the contractor made significant effort to correct the deficiencies including adequately staffing the Government accounting and billing departments. The contractor eventually corrected the system deficiencies and a portion of the withhold was returned as each section of the system was corrected.

The issue of actions necessary to incentivize contractors to timely correct system deficiencies was discussed at length at hearings of the Commission on Wartime Contracting on August 11th and 12th. As a result of these hearings, the Director, Defense Procurement and Acquisition Policy, established a subcommittee under the Panel on Contracting Integrity to address Government actions related to contractor business systems including procedures for implementing withholds on contractor billings and whether revisions to the acquisition regulations are necessary to provide the contracting officer the necessary authority. As the Director, DCAA, I am a member of the subcommittee.

In addition to recommending withholds on provisional payments, when deficiencies relate to controls over costs billed to the Government, DCAA will remove contractors from the "direct billing program." Contractors with adequate business systems for billing costs to the Government, are permitted to submit interim payment requests directly to the payment offices. This process of direct payment submission is known as the direct billing program. However, when deficiencies exist, the contractor will be removed from the direct billing program and payment requests are required to be submitted to DCAA for review prior to submission to the payment office. In FY 2009 alone, DCAA has removed over 300 contractors from the direct billing program.

Annual Cost Audits. During the life of cost reimbursable contracts, DCAA performs a number of audits covering contractor compliance with contract terms depending on the size of the contract and risk associated with the contractor. These audits often result in early detection of overpayments during contract performance. When significant overpayments are discovered during contract performance, DCAA often issues a DCAA Form 1, *Notice of Contract Costs Suspended and/or Disapproved*, suspending costs due to unreasonable and unsupported costs, many of which stem from deficient systems. DCAA audit effort in this area is best demonstrated through various examples of recent significant audit findings resulting in the issuance of a DCAA Form 1.

One of the areas of greater risk identified in the last few years has been time and material contracts. Time and material contracts provide for acquiring supplies or services based on direct labor hours at fixed labor rates and actual costs for materials. These contracts pose increased risk of overpayments as there is decreased incentive to the contractor for cost control.

Our audits have determined that the Government is at risk for contractors charging the Government for labor costs of employees that have not met the labor qualifications specified in the contract – leading to potential windfall profits while the Government is not getting the level of services required by the contract.

Another example of the results of our testing during contract performance, relates to our Iraq/Afghanistan related contract audit effort. DCAA has established an initiative to perform real-time testing of direct costs under these contracts such as material purchases. Our direct cost testing on Iraq contracts have yielded significant exceptions. As discussed during a hearing of the Commission on Wartime Contracting held on May 4th, DCAA audits of costs under the

largest program performed in-theatre found numerous transactions which were either not allowable under the acquisition regulations or unsupported.

DCAA discovered numerous instances of inflated prices for dining facilities, living units, and various other logistical support items related to the war effort. DCAA has issued over 140 Forms 1 suspending or disapproving over $655 million on the largest program, an unprecedented number of suspensions for a single program in the history of DCAA. Of this amount, $439 million has been resolved. Unresolved amounts have been temporarily recovered from the contractor pending Contracting Officer final determinations.

During the life of the contract, DCAA also performs tests of contractor billings to ensure billed amounts reconcile to the contractor books and records and are in accordance with contract terms. During a recent audit of a major weapons systems contract, DCAA identified costs being billed by a major subcontractor which were not supported. DCAA issued a Form 1 to suspend $8 million of the billed costs and the prime contractor has agreed to withhold over $20 million from the subcontractor until adequate support is provided.

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.

DCAA audits contractor costs for compliance with the Cost Accounting Standards during the pre-award audit effort as well as during contract performance. The standards apply to cost reimbursable contracts and fixed price contracts under certain circumstances.

When a contractor fails to submit the required Disclosure Statement or to comply with its disclosed 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. In FY 2009, we issued over 200 audit reports citing contractors for not complying with the Cost Accounting Standards. Noncompliances with the Cost Accounting Standards generally result in overbillings to the Government.

Suspected Irregular Conduct Referrals to Investigative Agencies

When auditing a contractor's records in accordance with the Generally Accepted Government Auditing Standards, auditors may receive information constituting evidence or causing suspicion of fraud or other suspected irregular conduct. It is DCAA policy that these suspected irregularities shall be referred to the appropriate investigative organization.

Referrals may be made using the DCAA Suspected Irregularity Referral Form 2000 (DCAA Form 2000) or by using the DoD Hotline. When the referral comes from an audit finding or when the auditor has information to supplement that obtained from an external source, the DCAA Form 2000 is preferred because it specifies information needed by investigators and provides for appropriate consideration of the audit impact. In FY 2009, DCAA issued 156 referrals to the investigative authorities, a significant increase in the number of referrals over prior years.

Audit Challenges

DCAA faces a number of challenges auditing contractors. The testimony today focuses on three of the more significant challenges.

Balancing compliance with auditing standards vs. contracting officers "need for speed." A significant challenge for DCAA is balancing the contracting officer's need for timely audit reports while complying with the Generally Accepted Government Auditing Standards. Contracting officers are often called upon to award contracts quickly in order to get needed goods and services to the war fighters. DCAA is sensitive to the contracting officer's need for rapid turn around of audits, but has little flexibility; it must comply with the 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. The need for extensive testing under the auditing standards is often at odds with the contracting officer need for a "quick" audit. We have instituted a number of processes to perform audits in a more timely manner. We are continuously working with contracting organizations to better educate them on the time necessary for adequate audits. Although progress has been made in FY 2009, balancing the needs for compliance with the auditing standards and the quick turnaround for contracting officers will continue to be a challenge for DCAA and the procurement community.

Timely Access to Contractor Data. DCAA auditors obtain evidence through various methods, almost all of which require that 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 some audits being issued much later than the contracting officers would desire.

Gaining access to needed data and contractor personnel has been a long standing challenge. DCAA has implemented a number of initiatives to mitigate this challenge and has made resolution of issues related to untimely data a high priority. In FY 2009, DCAA significantly streamlined the processes for gaining access to contractor records. Expectations for contractors were clarified including requiring that supporting data 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. When encountered, access to records issues, including lack of timely contractor responses, is quickly elevated within the contractor chain of command. When data is not provided in a timely fashion, costs may be suspended or exceptions reported until adequate data is provided.

DCAA obtains assistance from contracting organizations when significant delays are encountered. However, timely access to contractor data and people continues to be a significant issue. Although contractors recognize the need for DCAA access to records, there is often a disconnect on the expectation for "timely" access and contractors often

delay auditors access to information in an attempt to stall the timely completion of audits. Such delays are unacceptable.

One of the more significant complaints contractors have with DCAA is that we request too much data and have unrealistic due dates. These complaints are without merit and represent an attempt to impede DCAA audits. DCAA needs to be given real-time access to contractor records and people in order to perform effective audits.

Lack of Contractor Attention to Correction of Significant System Deficiencies. The 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. Contractors 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.

As discussed earlier in the testimony, the issue of actions related to contractor business systems was discussed at length in prior hearings of the Commission on Wartime Contracting. The issues are currently being addressed by a new subcommittee that was recently established under the Panel on Contracting Integrity.

Vulnerabilities in the Acquisition Process

We appreciate the Panel's efforts to strengthen the acquisition process. Although we do not audit contracting officers nor Government acquisition policy, there are various vulnerabilities we have discovered through our audits of contractor costs. We have limited today's testimony to three of the more significant vulnerabilities. These issues have been discussed with the Director, Defense Procurement and Acquisition Policy, and are currently being worked by the Panel on Contracting Integrity.

Definition of "Commercial Item" Contracts. Under current regulations, DCAA does not audit commercial item procurements. For commercial acquisitions, the contracting officer is required to determine price reasonableness based on price analysis which includes market analysis. Commercial item procurements are exempt from the protection of cost overpayments and excessive contract prices under the acquisition regulations, the Cost Accounting Standards, and the Truth in Negotiations Act.

The commercial item definition under FAR 2.101 has two areas that have resulted in significant vulnerability of overstated contract prices – "of a type" and "offered for sale." The phrase "of a type" has resulted in the use of commercial acquisitions to inappropriately acquire sole source, military-unique items that are not closely related to items already in the marketplace. The determination of price reasonableness is nonexistent and in some instances has resulted in excessive windfall profits.

The term "offered for sale" permits the treatment of an acquisition as a commercial item when the item has not been sold in a commercial marketplace. Absent an existing marketplace,

there is no evidence whatsoever of a reasonable price in the sense of a price tested and proven in the market.

Contractors and contracting officials relied on these terms in the definition of a commercial item to justify that items were commercial, exempting the contractor from having to complying with most rules and regulations. The GAO reported in report GAO-06-838R, *Contract Management: DoD Vulnerabilities to Contracting Fraud, Waste and Abuse*, dated July 7, 2006, that although the use of commercial item procedures is an acceptable practice, misclassification of items as commercial can leave DoD vulnerable to accepting prices that are not the best value for the Department. The situation cannot be rectified unless the statutory definition of "commercial item" is amended and clarified appropriately. The case of the Air Force attempting to classify the C-130J program as a commercial item is an example of misapplication of the commercial item definition.

DCAA believes that this language is a contract pricing vulnerability where fair and reasonable prices may not be established due to the lack of competition and the lack of a requirement for cost or pricing data. The Panel on Contracting Integrity, Adequate Pricing Subcommittee, which I chair, is currently assessing this vulnerability.

Use of "One-Bid" Competitive Procedures. DCAA is concerned that current regulations permit awards using competitive pricing procedures when only one bid is actually received and the associated vulnerabilities that arise in the absence of cost data that could be audited by DCAA and used to assist the contracting officer in developing fair and reasonable contract prices, ensuring that maximum value is received for the dollars spent.

For example, a DCAA audit disclosed where a major contractor was earning profit in excess of 30 percent for a "competitively" awarded firm-fixed price contract. The contracting officer awarded the contract expecting to use full and open competition, which exempted the contractor from submitting cost or pricing data. However, the incumbent was the only contractor to bid on the contract. Due to the absence of other competitive bids and the absence of analysis of cost or pricing data, the contractor earned a windfall profit in excess of 30 percent.

Time and Material Contracts. Time and material (T&M) contracts are considered the least preferred contracting method. There are no profit incentives for the contractor to control costs or perform efficiently. Contracting officers often turn to T&M contracts as they can be awarded quickly, often with unclear requirements. Contracting officers are required to document their determination that no other contract is suitable. However, the GAO has continued to report that contracting officials often do not document this determination (GAO Report 07-273, *Defense Contracting: Improved Insight and Controls Needed over DoD's Time-and-Materials Contracts,* dated July 2007 and GAO Report 09-579, *Contract Management: Minimal Compliance with Safeguards for Time-and-Material Contracts for Commercial Services and Safeguards Have Not Been Applied to GSA Schedules Program,* dated June 2009).

As discussed earlier in the testimony, DCAA audits have determined that the Government is at risk from contractors who charge the Government for labor costs of employees, without meeting the labor qualifications specified in the contract. This can lead to potential windfall profits, while depriving the Government of the level of services required by the contract. DCAA has reported significant exceptions related to the issue of contractors substituting employees that did not possess the proper level of qualifications as required under the contract.

Actions Taken by DCAA As a Result of Current External Reviews

As requested, I will describe the actions taken by the Defense Contract Audit Agency (DCAA) as a result of two reports issued by the Government Accountability Office (GAO): (1) the July 2008 GAO Report regarding allegations that certain DCAA audits did not meet professional standards (*DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*) and (2) the report issued most recently covering audits of contractor internal controls and related audits.

We have worked diligently since late 2008 to accomplish a number of actions to improve the quality of the audit services and to improve the working environment for our employees. As shown in the Appendix of the submitted testimony, we have completed over 50 specific improvement actions. We are not done yet and have various long-term actions in place that we will accomplish in FY 2010 and several years thereafter.

GAO Report Findings and Root Causes

Insufficient Testing of Contractor Internal Controls

In its recent review, the GAO identified noncompliances with the auditing standards for nearly all the assignments it reviewed. The assignments covered 2004 to 2006, several years prior to the implementation of the many improvements we accomplished over the last year. One of the primary deficiencies involves the amount of transaction testing that is performed in audits that provide an opinion on contractors' internal control systems. The GAO has concluded that DCAA has not performed sufficient transaction testing to provide an opinion of "adequate."

Contractor internal control systems involve hundreds of "control points." Auditors assessed the risk of the control points on Government contracts and established the level of testing based on that risk. When the auditors determined that the risk was low, fewer control points were tested. When the risk was higher, more control points were tested and at a greater depth. The GAO did not agree with our policy on transaction testing and consequently concluded the audit work was deficient. In some instances, auditors permitted prior metrics and internal due dates to inappropriately reduce the level of testing performed in audits.

We recognize the GAO's concerns and initiated a project in 2009 to reassess the manner in which DCAA tests contractor business systems. Although the auditing standards do not require that DCAA express an opinion on the adequacy of the contractors' internal control systems, we did so to provide contracting officials meaningful information to approve or disapprove a contractor's system as stipulated under the Federal Acquisition Regulations (i.e., the adequacy of the contractor's internal control systems affects the accuracy and reliability of the underlying data processed and generated by the accounting system). We are currently assessing the type of systems DCAA will need to audit and the type of opinion to be provided. We will continue to seek advice from the GAO and the DOD Inspector General. We anticipate our revised processes will be tested in early FY 2010 starting with the contractor's system for preparing interim and final billings to the Government. We envision the revised processes will consolidate testing of contractor billings currently performed in three different types of audits into a single audit.

Ineffective Quality Assurance Program

The GAO concluded that DCAA's Quality Assurance program was deficient and as a result the risk of assignments that did not comply with the auditing standards is increased. After the GAO's issuance of the investigative report in July 2008, we recognized that improvements were required not only with the structure of the quality assurance organization, but the manner that we conducted the quality assurance reviews. In August 2008, we centralized the quality assurance function by moving it to Headquarters and reassigned all quality assurance employees to the new Headquarters directorate. However, centralizing the functions was not enough. We also changed the manner in which we performed the quality assurance reviews.

We more than doubled the number of assignments reviewed for each office. We no longer provide a rating of pass or fail that was dependent on the number of deficient assignments. Rather, any field audit offices that are determined to have at least one assignment not in compliance with the auditing standards will be required to provide a meaningful corrective action plan. Corrective actions are monitored at the Headquarters level and not the regional level as in prior years. Moreover, all offices are reviewed on a three-year cycle, and all types of assignments are included in the sample universe. Performing quality assurance reviews is a full-time commitment of the quality assurance organization, and no other projects are undertaken, as had been done in prior years when the quality assurance function was at the regional level.

Lack of Independence

In its most recent review, the GAO concluded that DCAA lacked independence in seven assignments. The reason for the lack of independence in the recent review is somewhat different than the root cause discussed in the July 2008 investigative report. The root cause that

led to the GAO's conclusion in July 2008 was DCAA's participation in Integrated Product Teams (IPTs). IPTs were established by DoD in the mid-1990s as a means of expediting the assessment of contractor bid proposals and the resolution of outstanding issues. DCAA discontinued participation in IPTs in August 2008.

In its recent review, the GAO concluded that DCAA's independence was impaired primarily due to auditors providing input on draft corrections to internal control policies and procedures and then auditing the final policies and procedures. In several instances, the auditors issued a no-exception audit report when the contractor corrected the deficiencies during the audit. It is not uncommon for contractors with system deficiencies to seek input from the auditors while they are developing corrections to the systems. In many instances, providing feedback throughout the process expedites the correction of the deficiencies. However, the GAO has concluded that this "feedback" impairs the auditors' objectivity as they will audit information that they have provided feedback on prior to implementation. We have corrected both of these issues. Auditors no longer provide feedback to contractors on draft corrections to systems and no longer remove deficiencies from audit reports when the deficiencies are corrected during the audit.

DCAA Actions

Mr. Chairman, as a result of the 2008 GAO investigation and the most recent review, we have taken a number of actions. The Appendix to my submitted testimony contains a list of actions completed to date, as well as actions that are in process as of today. In addition, I would like to discuss some of the more significant actions at this time.

Structure

1. With regard to the organizational structure of DCAA, we completed a bottoms-up staffing assessment, including an assessment of staffing for the quality assurance function, to determine whether we have the appropriate staffing at all levels of the organization. Staffing shortfalls were provided to the DoD Comptroller in September 2008 and discussed throughout FY 2009.

We submitted a proposal to DoD under the Defense Acquisition Workforce Development Fund in December 2008 and received funding in March, April, and August 2009. We were approved to hire 300 new auditor trainees in FY 2009, and 200 in FY 2010. We have tentative approval for 200 in 2011 depending on budget priorities, for a total of 700 new trainees by the end of FY 2011. We have met our hiring goal in FY 2009 and anticipate easily meeting the hiring goals in FY 2010 and 2011.

Although the increase in trainees is a good start toward improving our staffing situation, we will continue to work with the Department on how best to address future staffing needs.

2. We added 26 new field audit offices increasing from 79 offices in September 2008 to 105 offices in September 2009. This equates to an additional 26 field office managers and a number of new supervisory positions. We reduced the span of control for managers and supervisors to provide greater training to the new employees as well as to ensure appropriate oversight of audit quality.

3. As stated earlier, we completely revamped the quality assurance organization. We changed the manner in which the reviews are performed and greatly expanded the number of reviews conducted at each office every year.

Culture

1. With regard to the culture of DCAA, we completely revised the performance measure process. As stated earlier, we eliminated 18 measures and implemented 8 new measures to focus on audit quality. We held focus groups in FY 2009, and feedback was favorable as most employees reported that they did not feel pressure to meet the performance measures on individual assignments.

2. As mentioned earlier, we ceased participation in IPTs to avoid the appearance of a lack of independence. We also ceased participation in Source Selection Evaluation Boards. We no longer provide feedback to contractors during audits and will report deficiencies discovered during an audit even when the deficiencies are corrected prior to report issuance.

3. We established an anonymous web site and ombudsman program for employees to report inappropriate actions by management or other employees. We have assigned a dedicated team to the ombudsman function in the Agency.

4. I established a Senior Advisory Council for Improvement which I chair, to oversee the implementation of improvements as a result of recommendations from various external reviews.

Processes

Finally, to address the improvements in processes:

1. We instituted a revised process for determining the audit requirements for FY 2010. Based on the audits required under laws and regulations and an estimate of the audits required to meet contracting officials' demand requests, the field audit offices developed the hours necessary to

accomplish the workload, taking into consideration the risk of the various contractors, the skill level of the audit staff and an estimate of the additional hours required to comply with the auditing standards. Based on the hours, we developed Agency-wide priorities. Since our funding provides for only about 65% of the resources required to perform all needed audits, we based the FY 2010 priorities on the audits of highest risk. This process is consistent with the GAO's recommendation of performing a risk-based approach to auditing rather than "production line" auditing.

We engaged the Army Force Management Support Agency to evaluate DCAA's process for planning FY 2010 audit needs as well as our staffing requirements. This effort is expected to be completed in October 2009.

2. We are in the process of improving the development and delivery of what is referred to as "life-cycle" training. The goal is to provide necessary training throughout the career of the staff, including auditors, management, and support staff.

3. The Administration is considering whether it would make sense legislatively to expand the DCAA documentary subpoena authority to the contractor accounting records and other information necessary to accomplish the contract audit function.

Closing

In closing, Mr. Chairman, DCAA is committed to ensuring that the Agency is above reproach, that all of its audits are performed in accordance with auditing standards, and that its culture promotes the kind of vigilance and quality that protects the interests of the American taxpayers. I want to underscore that DCAA has worked closely with all acquisition organizations to promote an integrated, well-managed contract audit process. DCAA 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 by carrying out our contract audit role to ensure the Department obtains the best value.

Mr. Chairman, thank you again for the opportunity to address the Panel. I am happy to answer your questions.

Appendix to Written Statement of Ms. April G. Stephenson
House Committee on Armed Services
Defense Acquisition Reform Panel
Specific DCAA Actions in Response To The GAO Reports

Structure

- Approved agency-wide reduction in supervisory span of control (June 2008).
- Approved 26 new field audit offices and 5 new Regional Audit Managers lowering the span of control (May – July 2009).
- Completed Agency-wide staffing assessment and requested staffing increase to Comptroller on September 10, 2008. Updates on staffing shortfalls were provided to the Comptroller at regular intervals throughout FY 2009.
- Realigned Quality Assurance to report directly to the Deputy Director (August 2008)
    - Submitted request to OSD for SES level position for the Integrity and Quality Assurance (QA) function (September 2008). Request was initially denied by DoD in January 2009 and the position was filled at the GS-15 level. However, after another attempt by the Director for a SES position, DCAA received approval in July 2009 and a job announcement was issued shortly thereafter.
    - Expanded the next round of QA reviews.
    - Revised process for tracking and following-up on QA findings.
    - Revised process for next 3-year cycle to ensure all audit offices are covered, after consultation with the DoD IG.
    - Completed assessment on level of QA staffing.
    - Issued revised comprehensive instruction on DCAA's QA program (December 2008).
- Submitted request for funds under Section 852 acquisition workforce fund in December 2008. Under the Defense Acquisition Workforce Development Fund, DCAA has received $17.2 million to date (allotments in March, April, and August).
    - DCAA brought on-board 375 new interns in FY 2009 easily meeting the goal of 300 by the end of September, and is well on the way to hiring a cumulative of 500 interns by the end of FY 2010.
- Realigned all Financial Liaison Advisors from the Field Detachment region (region that handles all Top Secret audits) to Headquarters to avoid the appearance of a lack of independence. As of November 2008, all Financial Liaison Advisors report directly to Headquarters.
- At the request of the Director, the DCAA point of contact for the Office of Special Counsel investigation was moved from the DCAA General Counsel to the DoD General Counsel's office due to the investigation being expanded.

Culture

- Revised policy for resolving difference in audit results and opinions – elevate within management structure from two to four levels (July 2008).
- Ceased participation as members of Integrated Product Teams (IPTs) to avoid the appearance of a lack of independence (August 2008).
- Revised performance measures – eliminated 18 measures and added 8 measures (September 2008).
- Established web site for employees to anonymously voice concerns about the inappropriate use of performance measures and other inappropriate actions (September 2008).
- Engaged OPM to conduct an organizational assessment survey and are assessing results of the survey conducted by OPM – the working group is evaluating results and developing actions.
- Ceased participation as members of Source Selection Evaluation Boards to avoid the appearance of a lack of independence – requested audits will still be provided (November 2008).
- Director/Deputy Director staff presentations emphasize the need to perform quality audits and discuss performance measures (various presentations through 2008 and 2009).
- Established a Senior Advisory Council for Improvement chaired by the Director to oversee the implementation of improvements as a result of the Defense Business Board recommendations (report issued January 22, 2009).
- Issued several memorandums reiterating the importance of cooperating with GAO, IG and other reviewers/investigators.
- Held stand down day for audit quality at all DCAA locations (August /September 2008 and again in August 2009).
- Completed annual independence training (September 2008 and September 2009).
- Held focus groups to obtain feedback on implementation of performance measures issued in September 2008 which revealed minimal problems with implementation of new measures (February/March 2009).
- The Director required all regions to assess whether exceeding budget hours on individual assignments was inappropriately used to lower performance ratings. The regions completed the assessments and implemented corrective actions (December 2008).
- Established new process to obtain input regarding the new hire employment experience and to identify reasons why employees leave DCAA (November 2008).
- Revised job objectives/performance plans for the 0511 (auditor) positions to eliminate the language on meeting audit budget hours and productivity measures and added language strengthening the need to execute audits in accordance with the auditing standards and Agency policy (February 2009).
- Revised supervisory development curriculum based on feedback from focus groups and other feedback mechanisms to emphasize leadership skills and the more common day-to-day activities which supervisors perform (April 2009).

Processes

- Issued memorandum on adequate working paper documentation (July 2008).
- Completed Agency-wide assessment to determine whether GAO's findings are systemic across DCAA. Six of the forty assignments reviewed contained noncompliances. Actions being taken to address issues (September 2008).
- Raised the field audit office signature authority for all audit reports to the level of the manager or higher (August 2008).
- Revised policy for the monthly quality review of issued audit reports from regions to the Headquarters Quality Assurance division (October 2008).
- Revised DCAA Quality Checklist for Review of Audit Working Papers (checklist is used by auditors and supervisors prior to report issuance) (December 2008).
- Issued guidance clarifying DCAA's process for pursuing access to contractor records and initiating a subpoena (December 2008).
- Issued clarifying guidance on what constitutes a significant deficiency in contractor internal control systems (December 2008).
- Revised policy on reporting results of the review of contractor systems and related internal controls to eliminate the inadequate in-part opinion so that the overall opinion on the system is either adequate or inadequate (December 2008)
- Issued guidance on performing and reporting on limited scope internal control audits (December 2008)
- Issued guidance reminding auditors to report suspected contractor fraud and other irregularities encountered during the audit and emphasized that managers do not approve the Form 2000, but rather review it for clarity (February 2009).
- Issued guidance on documentation of judgmental sampling (February 2009).
- Revised guidance for reporting unsatisfactory conditions related to actions of Government officials wherein certain unsatisfactory conditions will be reported directly to the DODIG in lieu of reporting the conditions to a higher level of management (March 2009).
- Issued guidance clarifying requirements for contractor eligibility to participate in the Direct Bill Program (April 2009).
- Issued guidance to remove major contractors from direct billing where contractor has implemented a new billing system or accounting system that significantly impacts Government billings and the new system has not been examined (April 2009).
- Revised a self study training course (CMTL 1326) to include new guidance on identifying key elements of an effective internal control audit report and the requirements for issuing a real-time (flash) report (May 2009).
- Issued an audit alert emphasizing existing guidance which requires that a separate Cost Accounting Standards noncompliance audit report will be issued when a noncompliance is found during any audit (June 2009)
- Issued an audit alert to clarify that forward pricing due dates should be based on the realistic assessment of risk factors for each specific contractor and proposal under review (June 2009).
- Issued guidance on contract audit closing statement reviews in July (after receipt of DOD IG comments). This completes the last action item from the peer review.

- Instituted a revised process of determining audit requirements for FY 2010. Developed Agency-wide audit priorities. Current budget for FY 2010 only covers about 65% of requirements – audits planned for FY 2010 based on higher risk assignments with lower risk assignments deferred to FY 2011 (backlog of audits growing each year since war effort) (September 2009).
- Submitted a legislative proposal expanding DCAA access to contractor information similar to the authority provided the DOD IG (September 2009).

Long-Term Planned Actions

- Obtained the services of the Naval Postgraduate School, Center for Defense Management Reform to assist with the Agency-wide cultural transformation. The initial effort started June 2nd with the DCAA executive team. As a result, four major initiatives were adopted for incorporation in the DCAA Strategic Plan. Teams of executives were assigned to each initiative to further develop the milestone plan for executing the objective. The four items are:

  1. How can DCAA put people first to guide its decisions, actions and values? For example, an increased emphasis on "soft skills" such as building morale and developing employees (in terms of broad understanding as well as technical proficiency).

  2. How can DCAA develop leaders to serve the employees and the organization?

  3. How can DCAA structure the organization to facilitate compliance with GAGAS; maximize audit results/ROI; and better align agency workload/resources?

  4. How can DCAA identify and resolve different expectations of contracting officers, contractors, the public (Congress), and external review organizations?

  These items will be worked for about the next three years. Once the milestone plan for each of the four initiatives is developed, it is envisioned that each objective will have various completed actions throughout the next three years. Once the milestone plans are developed, the objectives will be communicated to the workforce.

- Performing a comprehensive assessment and revision to DCAA training by instituting a life-cycle training process. Effort started in FY 2008 and will conclude in about three years.
- Conducting a comprehensive organizational assessment (based on Baldrige). Estimated completion in FY 2010.
- Performing a comprehensive review of DCAA's approach for performing internal control audits. Estimated completion of baseline audit opinions in FY 2010.
  - Briefed DOD IG on September 3rd – favorable feedback. Proceeding with developing plan for pilot testing.
  - Reassessing the "direct billing" program which permits contractor submission of interim payment invoices directly to the payment office without DCAA approval.

- Engaged the Army Force Management Support Agency to evaluate DCAA's process for planning FY 2010 audit needs as well as staffing requirements. The effort is expected to be completed by the end of September.
- Revamping the Strategic Plan and Human Capital Plan (planned December 2009).
- Reassessing performance plans to better align standards to work expectations. Effort started in FY 2009 and will continue in FY 2010.
- Submitting legislative proposal to DoD to expand DCAA's subpoena authority and greater access to contractor records similar to IG authorities.

Based on advice from GAO, on September 4th, we requested extension to peer review to assignments completed in FY 2011. FY 2010 will be a rebuilding year for audits of contractor business systems.

United States Government Accountability Office

GAO

Testimony

Before the Panel on Defense Acquisition Reform, Committee on Armed Services, House of Representatives

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DEFENSE MANAGEMENT

Widespread DCAA Audit Problems Leave Billions of Taxpayer Dollars Vulnerable to Fraud, Waste, Abuse, and Mismanagement

Statement of Gregory D. Kutz, Managing Director Forensic Audits and Special Investigations

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GAO-10-163T

October 15, 2009

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Highlights

Highlights of GAO-10-163T, a testimony before the Panel on Defense Acquisition Reform, Committee on Armed Services, House of Representatives

DEFENSE MANAGEMENT

Widespread DCAA Audit Problems Leave Billions of Taxpayer Dollars Vulnerable to Fraud, Waste, Abuse, and Mismanagement

Why GAO Did This Study

In fiscal year 2008, the Department of Defense (DOD) obligated over $380 billion to federal contractors, more than doubling the amount it obligated in fiscal year 2002. With hundreds of billions of taxpayer dollars at stake, the government needs strong controls to provide reasonable assurance that contract funds are not being lost to fraud, waste, abuse, and mismanagement.

The Defense Contract Audit Agency (DCAA) is charged with a critical role in contractor oversight by providing auditing, accounting, and financial advisory services in connection with DOD and other federal agency contracts and subcontracts. However, last year GAO found numerous problems with DCAA audit quality at three locations in California, including the failure to meet professional auditing standards. In a follow-up audit issued this September, GAO found that these problems existed agencywide.

Today's testimony describes widespread audit quality problems at DCAA and provides information about continuing contract management challenges at DOD, which underscore the importance of DCAA audits that meet professional standards. It also discusses some of the corrective actions taken by DCAA and DOD and key GAO recommendations to improve DCAA audit quality.

In preparing this testimony, GAO drew from issued reports and testimonies. These products contained statements regarding the scope and methodology GAO used.

View GAO-10-163T or key components. For more information, contact Gregory D. Kutz at (202) 512-6722 or kutzg@gao.gov.

What GAO Found

GAO found substantial evidence of widespread audit quality problems at DCAA. In the face of this evidence, DOD, Congress, and American taxpayers lack reasonable assurance that billions of dollars in federal contract payments are being appropriately scrutinized for fraud, waste, abuse, and mismanagement. An initial investigation of hotline allegations at three DCAA field office locations in California revealed that all 14 audits and 62 forward pricing reports GAO examined were not performed in accordance with professional auditing standards. For example, while auditing the satellite launch proposal for a major U.S. defense contractor, a DCAA manager experienced pressure from the contractor and the DOD buying command to drop adverse findings. The manager directed his auditors to drop the findings, and DCAA issued a more favorable opinion, allowing the contractor to win a contract that improperly compensated the contractor for hundreds of millions of dollars in commercial business losses. Specifically, of $271 million in unallowable costs related to commercial losses, the contractor has already been paid $101 million. This incident is under criminal investigation by the DOD Inspector General (IG).

In September of this year, GAO followed up on its initial investigation and identified audit quality problems agencywide at DCAA. Audit quality problems included insufficient audit testing, inadequate planning and supervision, and the compromise of auditor independence. For example, of the 69 audits and cost-related assignments GAO reviewed, 65 exhibited serious deficiencies that rendered them unreliable for decisions on contract awards, management, and oversight. DCAA has rescinded 81 audit reports to date as a result of GAO's and DOD IG's work. Because the rescinded reports were used to assess risk in planning subsequent audits, they affect the reliability of hundreds of other audits and contracting decisions covering billions of dollars in DOD contract expenditures. GAO determined that quality problems are widespread because DCAA's management environment and quality assurance structure were based on a production-oriented mission that prevented DCAA from protecting the public interest while also facilitating DOD contracting.

GAO has designated both contract management and weapon systems acquisition as high-risk areas since the early 1990s. DOD acquisition and contract management weaknesses create vulnerabilities to fraud, waste, abuse, and mismanagement that leave hundreds of billions of taxpayer dollars at risk, and underscore the importance of a strong contract audit function.

In response to GAO's findings and recommendations, DCAA has taken several steps to improve metrics, policies, and processes, and the DOD Comptroller has established a DCAA oversight committee. To ensure quality audits for contractor oversight and accountability, DOD and DCAA will also need to address the fundamental weaknesses in DCAA's mission, strategic plan, metrics, audit approach, and human capital practices that have had a detrimental effect on audit quality.

Mr. Chairman and Members of the Panel:

Thank you for the opportunity to discuss our work related to the Defense Contract Audit Agency (DCAA). DCAA is charged with a critical role in DOD and other federal agency contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts. DCAA contract audits are intended to be a key control to help ensure that prices paid by the government for needed goods and services are fair and reasonable and that contractors are charging the government in accordance with applicable laws, the *Federal Acquisition Regulation* (FAR), *Cost Accounting Standards* (CAS), and contract terms. DCAA's mission encompasses both audit and nonaudit services in support of DOD contracting and contract payment functions.

The majority of DCAA audits focus on cost-reimbursable and other flexibly priced contracts, including progress payments on major weapon systems and time-and-materials contracts. These contract types pose the highest risk to the government because the government has agreed to pay the actual incurred cost, plus profit. DCAA audits of contractor business systems and related internal controls support decisions on pricing, contract awards, and billing. For example, the FAR requires government contracting officers to determine the adequacy of a contractor's accounting system before awarding a cost-reimbursement or other flexibly priced contract.[1] Audits of estimating system controls support negotiation of fair and reasonable prices.[2] Also, billing system audits support decisions to authorize contractors to submit invoices directly to DOD payment offices for payment without government review.[3] Internal control audits also impact the planning and reliability of other DCAA audits, such as audits of contractors' pricing proposals and annual incurred cost claims, because DCAA uses the results of its internal control audits to assess risk and plan the nature, extent, and timing of tests for these audits.

Since the early 1990s, we have reported DOD weapon systems acquisition and contract management as high-risk areas.[4] DOD acquisition and

[1] FAR §§ 16.104(h) and 16.301-3(a)(1).

[2] DCAA, *Contract Audit Manual* (CAM) 5-1202.1.a and *Defense Federal Acquisition Regulation Supplement* (DFARS) 215.407-5.

[3] FAR § 42.101 and DFARS § 242.803.

[4] GAO, *High-Risk Series: An Update*, GAO-09-271 (Washington, D.C.: January 2009).

contract management weaknesses create vulnerabilities that leave hundreds of billions of taxpayer dollars at risk, and underscore the importance of a strong contract audit function. Every dollar wasted during the development and acquisition of weapon systems is money that is not available for other priorities within DOD and across the government.

Today, I will discuss the findings from our two recent DCAA reports and note some of the challenges in DOD's contract management that make DCAA audits a key control for assuring that prices paid by the government for needed goods and services are fair and reasonable and that contractors are not overcharging the government. I will conclude by highlighting some of the recent actions taken by DCAA and DOD and key recommendations we have made to improve DCAA audit quality.

In preparing this testimony, we relied on the work we performed during our DCAA hotline investigations and our DCAA performance audit, as well as our extensive body of work on DOD's contract management. A list of these products is provided at the end of this testimony. Our audit work was conducted in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform our audits to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We performed our investigative procedures in accordance with quality standards set forth by the Council of the Inspectors General on Integrity and Efficiency (formerly the President's Council on Integrity and Efficiency).

Widespread DCAA Management Environment and Audit Quality Problems

Our investigation of DCAA hotline allegations and our DCAA-wide follow-up audit document systemic weaknesses in DCAA's management environment and structure for assuring audit quality. Last year, our investigation of hotline allegations[5] substantiated auditor concerns made on all 14 audits we reviewed at two locations and 62 forward pricing reports we investigated at a third location. We found that (1) workpapers did not support reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their

[5] GAO, *DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, GAO-08-857 (Washington, D.C.: July 22, 2008).

changes, and (3) sufficient audit work was not performed to support audit opinions and conclusions. In addition, we found that contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and opinions of some audits—a serious independence issue. This year, our follow-on audit[6] found DCAA-wide audit quality problems similar to those identified in our investigation, including compromise of auditor independence, insufficient audit testing to support conclusions and opinions, and inadequate planning and supervision.

For example, of the 69 audits and cost-related assignments we reviewed,[7] 65 exhibited serious GAGAS and other deficiencies that rendered them unreliable for decisions on contract awards and contract management and oversight. Although not as serious, the remaining four audits also had GAGAS compliance problems. Of the 69 audits and cost-related assignments, 37 covered key contractor business systems and related controls, including cost accounting, estimating, and billing systems. Contracting officers rely on the results of these audits for 3 or more years to make decisions on pricing, contract awards, and payments. In addition, while DCAA did not consider 26 of the 32 cost-related assignments we reviewed to be GAGAS audits, DCAA did not perform sufficient testing to support reported conclusions on that work related to contractor billings.

DCAA has rescinded 81 audit reports in response to our work and the DOD Inspector General's (IG) follow-up audit because the audit evidence was outdated, insufficient, or inconsistent with reported conclusions and opinions and reliance on these reports for contracting decisions could pose a problem. About one-third of the rescinded reports relate to unsupported opinions on contractor internal controls and were used as the basis for risk-assessments and planning on subsequent internal control and cost-related audits. Other rescinded reports relate to CAS compliance and contract pricing decisions. Because the conclusions and opinions in the rescinded reports were used to assess risk in planning subsequent audits, they impact the reliability of hundreds of other audits and contracting decisions covering billions of dollars in DOD expenditures.

[6] GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, GAO-09-468 (Washington, D.C.: Sept. 23, 2009).

[7] Of the 69 DCAA assignments we reviewed, 37 were audits of contractor systems and related internal controls and 32 were cost related audits and assignments.

Investigation of Hotline Allegations Identified Serious Audit Deficiencies

Our hotline investigation found numerous examples where DCAA failed to comply with GAGAS. For example, contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions and opinions, and reporting in three cases we investigated—a serious independence issue. For 14 audits at two DCAA locations, we found that (1) audit documentation did not support the reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate evidence for their changes, and (3) sufficient audit work was not performed to support audit opinions and conclusions. We also substantiated allegations that forward pricing audit reports at a third DCAA location were issued before supervisors completed their review of the audit documentation because of the 20- to 30-day time frames required to support contract negotiations.

Throughout our investigation, auditors at each of the three locations addressed in the hotline allegations told us that the limited number of hours approved for their audits directly affected the sufficiency of audit testing. Deficient audits do not provide assurance that billions of dollars in annual payments to these contactors complied with the FAR, CAS, or contract terms. We also found that DCAA managers took actions against staff at two locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment. The following discussion highlights some of the examples from our investigation.

- In planning an estimating system audit of a major aerospace company, DCAA made an up-front agreement with the contractor to limit the scope of work and basis for the audit opinion. The contractor was unable to develop compliant estimates, leading to a draft audit opinion of "inadequate-in-part." The contractor objected to the draft findings, and DCAA management assigned a new supervisory auditor. DCAA management then threatened the senior auditor with personnel action if he did not delete the findings from the report and change the draft audit opinion to "adequate."

- Another audit of the above contractor related to a revised proposal that was submitted after DCAA had reported an "adverse"(inadequate) opinion on the contractor's 2005 proposal to provide commercial satellite launch capability. At the beginning of the audit, the buying command and contractor officials met with a DCAA regional audit manager to determine how to resolve CAS compliance issues and obtain a favorable audit opinion. Although the contractor failed to provide all cost information requested for the audit, DCAA's regional audit manager instructed the

auditors that they could not base an "adverse" opinion on the lack of information to audit certain costs. The manager directed the auditors to exclude any reference to CAS noncompliance in the audit documentation and to change the audit opinion "inadequate-in-part." Based on the more favorable audit opinion, the buying command negotiated a $967 million contract which has since grown to over $1.6 billion through fiscal year 2009. The Defense Criminal Investigative Service is completing a criminal investigation conducted in response to our findings.

The DOD IG performed a follow-up audit and confirmed our findings that DCAA's audit was impaired because of a lack of independence; the audit working papers did not support the reported opinions in the May 8, 2006, proposal audit report; and the draft audit opinion was changed without sufficient documentation. In addition, the DOD IG concluded that the DCAA regional audit manager (RAM) failed to exercise objective and impartial judgment on significant issues associated with conducting the audit and reporting on the work—a significant independence impairment—and that the RAM did not protect the interests of the government as required by DCAA policy. The DOD IG also concluded that the contractor's unabsorbed Program Management and Hardware Support (PM&HS) costs represented losses incurred on other contracts and prior accounting periods, including commercial losses—a CAS noncompliance. The DOD IG recommended that the Air Force buying command withhold the balance of $271 million for unabsorbed PM&HS costs (of which $101 million had already been paid) and that the Air Force cease negotiations with the launch services contractor on a $114 million proposal for unabsorbed costs. DCAA is currently performing CAS compliance audits on the commercial satellite launch contract costs. If DCAA determines that the contractor's costs did not comply with CAS related to unallowable costs,[8] cost accounting period,[9] and allocation of direct and indirect cost[10] and the FAR related to losses on other contracts,[11] DCAA findings should provide the basis for recovering amounts already paid.

[8] FAR 9904.405-40 provides generally that unallowable costs shall be separately identified and be excluded from any billing, claim, or proposal on a government contract.

[9] FAR 9904.406.40a states that a contractor generally is to use a fiscal year as its cost accounting period.

[10] FAR 9904.418-20 states the purpose of CAS 418, which is to provide for consistent determination of direct and indirect costs; to provide criteria for the accumulation of indirect costs; and to provide guidance on selection of allocation measures between an indirect cost pool and cost objectives.

- For a billing system audit of a contractor with $168 million in annual billings to the government, the field office manager allowed the original auditor to work on the audit after being assured that the auditors would help the contractor correct billing system deficiencies during the performance of the audit. After the original auditor identified 10 significant billing system deficiencies, the manager removed her from the audit and assigned a second auditor who then dropped 8 of the 10 significant deficiencies and reported one significant deficiency and one suggestion to improve the system. The final opinion was "inadequate-in-part." However, the DCAA field office retained the contractor's direct billing privileges—a status conveyed to a contractor based on the strength of its billing system controls whereby invoices are submitted directly to the government paying office without prior review. After we brought this to the attention of DCAA western region officials, the field office rescinded the contractor's direct billing status.

DCAA-wide Audit Identified Widespread Audit Quality Problems Requiring Significant Reform

Our follow-up audit found that a management environment and agency culture that focused on facilitating the award of contracts and an ineffective audit quality assurance structure are at the root of the DCAA-wide audit failures that we identified for the 69 audits and cost related assignments that we reviewed. DCAA's focus on a production-oriented mission led DCAA management to establish policies, procedures, and training that emphasized performing a large quantity of audits to support contracting decisions and gave inadequate attention to performing quality audits. An ineffective quality assurance structure, whereby DCAA gave passing scores to deficient audits compounded this problem. Although the reports for all 37 audits of contractor internal controls that we reviewed stated that the audits were performed in accordance with GAGAS, we found GAGAS compliance issues with all of these audits. The issues or themes are consistent with those identified in our prior investigation.

Lack of independence. In seven audits, independence was compromised because auditors provided material nonaudit services to a contractor they later audited; experienced access to records problems that were not fully resolved; and significantly delayed report issuance, which allowed the contractors to resolve cited deficiencies so that they were not included in the audit reports. GAGAS state that auditors should be free from

[11] FAR 31.205-23.

influences that restrict access to records or that improperly modify audit scope.[12]

Insufficient testing. Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions. GAGAS for examination-level attestation engagements require that sufficient evidence be obtained to provide a reasonable basis for the conclusion that is expressed in the report.[13] For internal control audits, which are relied on for 2 to 4 years and sometimes longer, the auditors would be expected to test a representative selection of transactions across the year and not transactions for just 1 day, 1 month, or a couple of months.[14] However, we found that for many controls, the procedures performed consisted of documenting the auditors' understanding of controls, and the auditors did not test the effectiveness of the implementation and operation of controls at all.

Unsupported opinions. The lack of sufficient support for the audit opinions on 33 of the 37 internal control audits we reviewed rendered them unreliable for decision making on contract awards, direct-billing privileges, the reliability of cost estimates, and reported direct cost and indirect cost rates.

Similarly, the 32 cost-related assignments we reviewed[15] did not contain sufficient testing to provide reasonable assurance that overpayments and billing errors that might have occurred were identified. As a result, there is little assurance that any such errors, if they occurred, were corrected and that related improper contract payments, if any, were refunded or credited to the government. Contractors are responsible for ensuring that their billings reflect fair and reasonable prices and contain only allowable costs, and taxpayers expect DCAA to review these billings to provide reasonable assurance that the government is not paying more than it should for goods

[12] See GAO, *Government Auditing Standards*: 2003 Revision, GAO-03-673G, (Washington, D.C.: June 2003) § 3.19, and GAO, *Government Auditing Standards*: 2007 Revision, GAO-07-731G, (Washington, D.C.: July 2007), 07-731G, § 3.10.

[13] GAO-03-673G, § 6.04b.

[14] American Institute of Certified Public Accountants, *Statements on Auditing Standards*, AU 350 and *Audit and Accounting Guide: Audit Sampling*, §§ 3.14, 3.29-3.34, 3.58, and 3.61.

[15] The 32 cost-related audits included 4 incurred cost audits, 2 audits of requests for equitable adjustment, 16 paid voucher reviews, and 10 overpayment assignments.

and services. Based on our findings that sufficient voucher testing was not performed to support decisions to approve contractors for direct-billing privileges, DCAA recently removed over 200 contractors from the direct-bill program.

Production environment and audit quality issues. DCAA's mission statement, strategic plan, and metrics all focused on producing a large number of audit reports and provided little focus on assuring quality audits that protect taxpayer interest. For example, DCAA's current approach of performing 30,000 or more audits annually and issuing over 22,000 audit reports with 3,600 auditors substantially contributed to the widespread audit quality problems we identified. Within this environment, DCAA's audit quality assurance program was not properly implemented, resulting in an ineffective quality control process that accepted audits with significant deficiencies and noncompliance with GAGAS and DCAA policy. Moreover, even when DCAA's quality assurance documentation showed evidence of serious deficiencies within individual offices, those offices were given satisfactory ratings. Considering the large number of DCAA audit reports issued annually and the reliance the contracting and finance communities have placed on DCAA audit conclusions and opinions, an effective quality assurance program is key to protecting the public interest. Such a program would report review findings along with recommendations for any needed corrective actions; provide training and additional policy guidance, as appropriate; and perform follow-up reviews to assure that corrective actions are taken. GAGAS require that each audit organization performing audits and attestation engagements in accordance with GAGAS should have a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and have an external peer review at least once every 3 years.[16] On September 1, 2009, the DCAA Director advised us that DCAA needs up to 2 years to revise its current audit approach and establish an adequate audit quality control system before undergoing another peer review.

[16] GAO-07-731G, §§ 3.50-3.52.

Contract Management Issues That Require Greater Oversight

For fiscal year 2008, DOD reported that it obligated over $380 billion for payments to federal contractors, more than double the amount it obligated for fiscal year 2002. With hundreds of billions in taxpayer dollars at stake, the government needs strong controls to provide reasonable assurance that these contract funds are not being lost to fraud, waste, abuse, and mismanagement. Moreover, effective contract audit capacity is particularly important as DOD continues its use of high-risk contracting strategies. For example, we have found numerous issues with DOD's use of time-and-materials contracts,[17] which are used to purchase billions of dollars of services across the government. Under these types of contracts, payments to contractors are based on the number of labor hours billed at a fixed hourly rate—which includes wages, overhead, and profit—and the cost of any materials. These contracts are considered high risk for the government because the contractor's profit is tied to the number of hours worked. Because the government bears the responsibility for managing contract costs, it is essential that the government be assured, using DCAA as needed, that the contractor has a good system in place to keep an accurate accounting of the number of hours billed and materials acquired and used.

In addition, we have said that DOD needs to improve its management and oversight of undefinitized contract actions, under which DOD can authorize contractors to begin work and incur costs before reaching a final agreement on contract terms and conditions, including price.[18] These contracts are high risk because the contractor has little incentive to control costs while the contract remains undefinitized. In one case,[19] we found that the lack of timely negotiations on a task order issued to restore Iraq's oil infrastructure increased the government's risk when DOD paid the contractor nearly all of the $221 million in costs questioned by DCAA.

[17] GAO, *Contract Management: Minimal Compliance with New Safeguards for Time-and-Materials Contracts for Commercial Services and Safeguards Have Not Been Applied to GSA Schedules Program*, GAO-09-579 (Washington, D.C.: June 24, 2009) and *Defense Contracting: Improved Insight and Controls Needed over DOD's Time-an- Materials Contracts*, GAO-07-273 (Washington, D.C.: June 29, 2007).

[18] GAO, *Defense Management: Actions Needed to Overcome Long-standing Challenges with Weapon Systems Acquisition and Service Contract Management*, GAO-09-362T (Washington, D.C.: Feb. 11, 2009) and *Defense Contracting: Use of Undefinitized Contract Actions Understated and Definitization Time Frames Often Not Met*, GAO-07-559 (Washington, D.C.: June 19, 2007).

[19] GAO, *Defense Contract Management: DOD's Lack of Adherence to Key Contracting Principles on Iraq Oil Contract Put Government Interests at Risk*, GAO-07-839 (Washington, D.C.: July 31, 2007).

More timely negotiations, including involvement by DCAA, could have reduced the risk to the government of possible overpayment.

DCAA Actions and Additional GAO Recommendations

DCAA initiated a number of actions to address findings in our July 2008 report as well as findings from DOD follow-up efforts, including the DOD Comptroller/Chief Financial Officer (CFO) August 2008 "tiger team" review and the Defense Business Board study, which was officially released in January 2009. Examples of recent DCAA and DOD actions include the following.

- Eliminating production metrics and implementing new metrics intended to focus on achieving quality audits.
- Establishing an anonymous Web site to address management and hotline issues. In addition, DCAA's Assistant Director for Operations has been proactive in handling internal DCAA Web site hotline complaints.
- Revising policy guidance to address auditor independence, assure management involvement in key decisions, and address audit quality issues. DCAA also took action to halt auditor participation in nonaudit services that posed independence concerns.
- DCAA also has enlisted assistance from other agencies to develop a human capital strategic plan, assist in cultural transformation, and conduct a staffing study.

Further, in March 2009, the new DOD Comptroller/CFO established a DCAA Oversight Committee to monitor and advise on DCAA corrective actions.

While these are positive steps, much more needs to be done to address fundamental weaknesses in DCAA's mission, strategic plan, metrics, audit approach, and human capital practices that have resulted in widespread audit quality problems. DCAA's production-oriented culture is deeply imbedded and will likely take several years to change. DCAA's mission focused primarily on producing reports to support procurement and contracting community decisions with no mention of quality audits that serve taxpayer interest. Further, DCAA's culture has focused on hiring at the entry level and promoting from within the agency and most training has been conducted by agency staff, which has led to an insular culture where there are limited perspectives on how to make effective organizational changes. To address these issues, our September 2009

report[20] contained 15 recommendations to improve the quality of DCAA's audits and strengthen auditor effectiveness and independence.

Key GAO recommendations relate to the need for DCAA to develop a risk-based audit approach and develop a staffing plan in order to match audit priorities to available resources. To develop an effective risk-based audit approach, DCAA will need to work with key DOD stakeholders to determine the appropriate mix of audit and nonaudit services it should perform and determine what, if any, of these responsibilities should be transferred or reassigned to another DOD agency or terminated in order for DCAA to comply with GAGAS requirements. We also made recommendations for DCAA to establish in-house expertise or obtain outside expertise on auditing standards to (1) assist in revising contract audit policy, (2) provide guidance on sampling and testing, and (3) develop training on professional auditing standards. In addition, we recommended that DOD conduct an independent review of DCAA's revised audit quality assurance program and follow-up to assure that appropriate corrective actions are taken.

Mr. Chairman and Members of the Panel, this concludes my statement. We would be pleased to answer any questions that you may have at this time.

Contacts and Acknowledgments

For further information about this testimony, please contact Gregory D. Kutz at (202) 512-6722 or kutzg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Major contributors to our testimony include William T. Woods, Director, Acquisition and Sourcing Management; F. Abe Dymond, Assistant General Counsel; Gayle L. Fischer, Assistant Director; Financial Management and Assurance; Richard Cambosos; Jeremiah Cockrum; Shawnda Lindsey; Andrew McIntosh; Lerone Reid, and Angela Thomas.

[20] GAO-09-468.

Related GAO Reports

High-Risk Series

DOD's High-Risk Areas: Actions Needed to Reduce Vulnerabilities and Improve Business Outcome, GAO-09-460T, Washington, D.C.: March 12, 2009.

High-Risk Series: An Update, GAO-09-271, Washington, D.C.: January 2009.

DCAA Audits

DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform, GAO-09-468, Washington, D.C.: Sept. 23, 2009.

DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform, GAO-09-1009T, Washington, D.C.: Sept. 23, 2009.

DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated, GAO-08-993T, Washington, D.C.: Sept. 10, 2008.

DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated, GAO-08-857, Washington, D.C.: July 22, 2008.

Contract Management

Contract Management: Minimal Compliance with New Safeguards for Time-and-Materials Contracts for Commercial Services and Safeguards Have Not Been Applied to GSA Schedules Program, GAO-09-579, Washington, D.C.: June 24, 2009.

Defense Acquisitions: Charting a Course for Lasting Reform, GAO-09-663T, Washington, D.C.: April 30, 2009.

Defense Management: Actions Needed to Overcome Long-standing Challenges with Weapon Systems Acquisition and Service Contract Management, GAO-09-362T, Washington, D.C.: Feb. 11, 2009.

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OCTOBER 15, 2009

Performance-Based Actions

1. Employees removed during probationary period

Total	2005	2006	2007	2008	2009
45	5	7	14	7	12

2. Non-probationary period employees removed

Total	2005	2006	2007	2008	2009
35	7	8	7	4	9

3. Employees that resigned after they received a proposed notice of removal but before the final decision was delivered to the employee.

Total	2005	2006	2007	2008	2009
19	6	0	1	10	2

4. Employees reduced in grade (e.g., supervisor reduced to an auditor)

	Total	2005	2006	2007	2008	2009
Unacceptable Perform.	1	1	0	0	0	0