

IMPROVING FEDERAL CONTRACT AUDITING

HEARING

BEFORE THE

AD HOC SUBCOMMITTEE ON CONTRACTING
OVERSIGHT

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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CONTENTS

Opening statements:	Page
Senator McCaskill	1
Senator Brown	4

WITNESSES

TUESDAY, FEBRUARY 1, 2011

Thomas P. Skelly, Director, Budget Service and Acting Chief Financial Officer, U.S. Department of Education	5
Ingrid Kolb, Director, Office of Management, Office of Deputy Secretary, U.S. Department of Energy	8
Hon. Brian D. Miller, Inspector General, U.S. General Services Administration	9
Patrick J. Fitzgerald, Director, Defense Contract Audit Agency, U.S. Department of Defense	10
Jeanette M. Franzel, Managing Director, Financial Management and Assurance, U.S. Government Accountability Office	21
E. Sanderson Hoe, Partner, McKenna, Long, and Aldridge on behalf of the U.S. Chamber of Commerce	23
Nick Schwellenbach, Director of Investigations, Project on Government Oversight	25

ALPHABETICAL LIST OF WITNESSES

Fitzgerald, Patrick J.:	
Testimony	10
Prepared statement	55
Franzel, Jeanette M.:	
Testimony	21
Prepared statement	65
Hoe, E. Sanderson:	
Testimony	23
Prepared statement	98
Kolb, Ingrid:	
Testimony	8
Prepared statement	40
Miller, Hon. Brian D.:	
Testimony	9
Prepared statement	46
Schwellenbach, Nick:	
Testimony	25
Prepared statement	105
Skelly, Thomas P.:	
Testimony	5
Prepared statement	37

APPENDIX

Fact sheet referenced by Senator McCaskill	113
Questions and Responses for the Record from:	
Mr. Skelly	117
Ms. Kolb	119
Mr. Fitzgerald	123
Mr. Miller	130

(III)

IMPROVING FEDERAL CONTRACTING AUDITING

TUESDAY, FEBRUARY 1, 2011

U.S. SENATE,
AD HOC SUBCOMMITTEE ON CONTRACTING OVERSIGHT,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:40 p.m., in room SD-342, Dirksen Senate Office Building, Hon. Claire McCaskill, Chairman of the Subcommittee, presiding.

Present: Senators McCaskill and Brown.

OPENING STATEMENT OF SENATOR MCCASKILL

Senator MCCASKILL. The Subcommittee will come to order.

I am told that Senator Brown is on his way. So we will begin, and I am sure he will not mind it if I begin my opening statement, and we will have plenty of time for his opening statement when he gets here.

If there is not enough evidence that I am strange, I will add more to the record, and that is that we are going to deal with two of my favorite topics today, auditing and the oversight of contracts.

This Subcommittee hearing is all about how those two things need to be merged together so that we are doing the best job we know how to, in fact, manage contracts in the Federal Government.

This is not a gotcha hearing. This is an informational hearing. This is a hearing so that we understand what contract oversight is ongoing through the very important management tool of contract audits.

Last Congress the Subcommittee held a number of hearings that reviewed the fundamentals of contract management and oversight across the Federal Government. This afternoon's hearing continues that work with an examination of contract audits, one of the most important components of effective and efficient contract oversight.

This is a subject which may sound dry to almost everyone except those sitting inside this room, and likely some of this room would also agree that it is a very dry subject matter, but this is essential to good contractor oversight.

Contract audits help ensure the government gets what it pays for and are one of the best weapons the government has to safeguard taxpayer dollars against waste, fraud, and abuse.

Last year the Subcommittee asked for information from 22 Federal agencies about how they use contract audits. My staff has prepared a fact sheet summarizing this information, and I ask for

unanimous consent that the fact sheet and the underlying data be admitted into the record.¹ I think I have unanimous consent.

The information the Subcommittee received showed that there is a wide variation in the agencies' use of contract audits. The Defense Department (DOD) which relies on the Defense Department Contract Audit Agency (DCAA), to perform audits conducted approximately 17,000 contract audits in 2009.

All of the civilian agencies combined conducted fewer than 1,800 contract audits; 17,000 in DOD, fewer than 1800 in the rest of the government.

Let us put it another way. The Defense Department conducted an average of one audit for every 25 million it spent on the contracts. The rest of the government on average conducted one audit for every 511 million spent through contracts.

Of course, there is a lot of variation among the agencies. The Department of Energy (DOE), who will testify today, conducted one audit for every 82 million in contracts. Another witness, the Department of Education, conducted one audit for every 1.5 billion spent through contracts.

I am interested to hear from these witnesses about the different approaches their agencies take to contract auditing. I am also looking forward to the perspectives of Patrick Fitzgerald, the Director of the Defense Contract Audit Agency, and Brian Miller, the Inspector General (IG) of the General Services Administration (GSA), who can provide expert testimony regarding the conduct and the importance of contract auditing for the Federal Government.

Let me pause for a moment and congratulate Brian Miller, the Inspector General of GSA, because I realize that today we had something that does not happen very often. We had very good news about the oversight capacity of the Federal Government.

Oracle agreed to pay \$46 million to settle a kickback complaint that came about in part because of the audit work of the Inspector General at GSA. A number of computer firms were paying government employees to recommend them for IT contracts; and in fact, it was the work on contract auditing that exposed some of these problems and ultimately brought about a number of different actions by the Department of Justice; and today the announcement that Oracle is going to repay the Federal Government \$46 million or repay \$46 million for the problems that they are responsible for.

We will also hear testimony on behalf of the Chamber of Commerce as well as from the Project on Government Oversight and the Government Accountability Office (GAO) who will help us take a broader look at this issue.

I am proud, very proud to be a former government auditor and a passionate defender of the importance of auditing but that does not mean that I think that more audits alone is the answer to good contract management and oversight.

If the government is going to be a good steward of taxpayer dollars, we need to have an integrated comprehensive contract management; and everyone involved in the process, from the line contracting officials to senior leadership and department heads, they

¹ The information referenced by Senator McCaskill appears in the appendix on page 113.

need to be involved, engaged, and probably most important accountable.

Auditing is one part of that continuum and I hope that today we can have an open conversation about how auditing can and should fit into the overall framework of contract oversight.

In a time of scarce government resources and an inadequate contracting workforce, the government must evaluate where it is most vulnerable and focus resources where they can most effectively protect taxpayer dollars.

I look forward to the witnesses' testimony and the opportunity to discuss how we can better use contract audits to oversee government contracting and I encourage all of our witnesses, particularly the witnesses on the second panel this afternoon, to speak frankly and openly about what improvements are necessary.

I was going to compliment Senator Brown right now and I bet he would rather wait to be here to hear it. That is a disease that most of us have around here. We love to hear good things about ourselves. So I will wait to compliment Senator Brown when he gets here, and now I will introduce the opening panel of witnesses that we will be hearing this morning.

First, we have Thomas Skelly, who currently serves as a Director of Budget Service for the Department of Education and has been the Department's Acting Chief Financial Officer (CFO) since 2008.

In that capacity, Mr. Skelly coordinates internal controls and audit follow-up and manages contracts and acquisitions for the Department.

He is also responsible for the Department's 77 billion annual budget. Mr. Skelly has served as a Federal employee since 1974 and is a member of the career senior executive service. Welcome, Mr. Skelly.

Ingrid Kolb has been the Director of the Office of Management for the Department of Energy since her appointment in 2005. As Director, she is responsible for the Department's project and acquisition management.

Ms. Kolb has served in budget and financial management roles for both the Department of Homeland Security (DHS)—that is a tough one—and the Department of Energy.

Prior to joining the Department of Energy, Ms. Kolb was the Director of the training and development center at the Department of Education.

Brian Miller has served as the Inspector General for the General Services Administration since his conformation by the Senate in July 2005. He is also the Vice Chair of the National Procurement Fraud Task Force and a member of the Department of Justice's Recovery Act fraud working group. Mr. Miller received the Attorney General's Distinguished Service Award in 2008.

Patrick Fitzgerald has served as the Director of the Defense Contract Audit Agency since his appointment in November 2009. As Director, Mr. Fitzgerald is responsible for all management and operational decisions at the agency.

He previously served as the Auditor General for the United States Army.

Before we turn to your testimony, Mr. Skelly, I will tell Senator Brown I finished my opening statement, and my last paragraph of

my opening statement was complimenting you, and I said I was going to hold off on the paragraph because I knew you would want to be here to hear it.

Senator BROWN. Absolutely.

Senator MCCASKILL. I would like to take a moment to recognize his contribution to this Subcommittee. There are not a lot of people who wake up in the morning excited about talking about contract oversight and auditing. So I felt very lucky to have the opportunity to work with Senator Brown over these months.

I do not think we know yet for sure who is going to be Ranking Member on the Subcommittee for this Congress, but I am confident that he and I will continue to work together on important oversight issues I hope in this Subcommittee; but if not, I know that work will continue.

And I turn to you for your opening statement.

OPENING STATEMENT OF SENATOR BROWN

Senator BROWN. Thank you, Madam Chairman. I apologize for being a little late. I lost track of time.

First of all, as the Ranking Member of the Subcommittee, it has also been my honor and pleasure to work with you in exploring important issues of this Subcommittee that go to the core of how government conducts its business.

Unfortunately, this may be my last meeting as Ranking Member as you are aware of. So I want to just take a brief minute to thank you and your staff for being so cordial and thoughtful and helpful in welcoming me to the Subcommittee and also providing me with the opportunity to kind of spread my wings a little bit and be part of something that is very important. It has been a great experience and I look forward to continuing to work with you.

In Fiscal Year 2009, the Federal Government contracted over \$530 billion on goods and services. And while I intend to work with my fellow members of Congress to reduce this amount, it also means that we must be incredibly vigilant in ensuring that the effective contract oversight actually occurs.

With \$530 billion taxpayer dollars at stake, the government needs strong controls to provide reasonable assurance that these contract funds will not be lost to waste, fraud, and abuse.

I want to commend the Chairman and former Missouri state auditor for calling this hearing to focus on a key part of the contract control system which is contract audits.

While contract auditing can be an important control mechanism, in our current fiscal environment the reality is we cannot audit everything nor should we. We must focus our limited resources on examining those activities presenting the greatest risk to the government and which justify the return on the investment.

For the audits that are necessary, we must have an efficient system that accomplishes the task in a cost effective and timely manner.

The current system is not working the way it was intended and this is evidenced by the backlog in audits that prevents contracts from closing down in a timely manner. This delay on closing out contracts increases cost to contractors and to the government.

And while I understand today's hearing will not discuss far-reaching reforms to the Federal acquisition system, we should keep in mind whose money we are spending and try to operate a government more like a business.

In today's hearing, I am interested in finding solutions to the problems in Federal contract auditing, look forward to hearing those witness perspectives on the critical issues, and I thank the witnesses obviously for being here today.

And on a more personal note, in one of the bills we were able to work in a bipartisan, bicameral manner, it really started in this Subcommittee with the Arlington National Cemetery.

It was something that not only provided great insight to me as to what the process is but it really served a real need with our Nation's heroes.

You should be commended for that and it has been an honor to be here in this Subcommittee. I am actually going to still be involved in the Subcommittee if it, in fact, works out that it will be obviously the contracting arm associated with it. I am hopeful I will still be able to participate. I still am on this Subcommittee if I am not mistaken so it is not like you are losing me totally. So thank you.

Senator McCASKILL. Thank you, Senator Brown.

It is the custom of the Subcommittee to swear in all witnesses that appear before us. So if you do not mind, I would ask you all to stand.

Do you swear that the testimony you will give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. SKELLY. I do.

Ms. KOLB. I do.

Mr. MILLER. I do.

Mr. FITZGERALD. I do.

Senator McCASKILL. Thank you all.

We will be using a timing system today. We would ask that your oral testimony be no more than 5 minutes. Obviously your written testimony will be printed in the record in its entirety, and we will not be, as long as you do not get close to 7, 8, 9, or 10 minutes, we are going to be very tolerant if you go over slightly. I do not want anyone to feel like they are under the gun, so to speak, in terms of finishing their testimony.

We will turn to you, Mr. Skelly, for your testimony. Thank you very much for being here.

**TESTIMONY OF THOMAS P. SKELLY,¹ ACTING CHIEF
FINANCIAL OFFICER, U.S. DEPARTMENT OF EDUCATION**

Mr. SKELLY. And thank you, Chairman McCaskill and Ranking Member Brown. Thank you for this opportunity to discuss Federal contract auditing and thank you for your leadership on this important issue.

My name is Tom Skelly. I am the Director of Budget Service in the U.S. Department of Education. Since 2008, I have also been

¹ The prepared statement of Mr. Skelly appears in the appendix on page 37.

delegated the authority to perform the functions and duties of the Chief Financial Officer.

In this role, I lead the organization that provides accurate and timely accounting and financial management information, coordinates internal controls and audit follow-up, and manages contracts and acquisitions.

I am proud to report that the Department's financial statements received a clean opinion for the ninth straight year and we also have achieved recognition for excellence in financial reporting from the Association of Government Accountants (AGA).

In the past, we have not had many opportunities to benefit from contract audits. In our April 2010 response to you, we identified only one external audit, and we expect only one this year. The primary reason for not having many contract audits is that most of our contracts are fixed-price, and the government's cost risk on that type of contract is relatively low.

The Department also has many competing priorities for administrative funding. Therefore, even with cost-reimbursement contracts, we limit the use of contract audits to those situations that need a review of incurred costs to help us closing out contracts.

Although the Department has one of the largest discretionary budgets, the Department also has the smallest workforce of any cabinet-level agency. Less than one percent of our annual funding is spent on administrative activities.

In fiscal year 2010, the Department had approximately 4,200 employees. This number represents a decrease of about 10 percent over the past decade, even though the workload has grown during that period.

For example, the enactment of the Ensuring Continued Access to Student Loans Act of 2008 and the more recent Student Aid and Fiscal Responsibility Act of 2010 greatly expanded our student loan work.

These loan programs and related increase in Pell Grant applications have been the main drivers of our increased work, but the Department also had a key role in the Recovery Act implementation through which innovative and competitive kindergarten through 12 education reform efforts we expanded through such grants as Race to the Top and Investing in Innovation.

The majority of our funds, though, are really for grants and loans. They are not for contracts. We have used contracts to perform much of the increased work involving delivery of Federal student aid, and the dollar volume of contracts has increased.

For example, we spent approximately \$1.5 billion on contracts in 2009 and approximately \$1.8 billion in 2010. Most of the increase was for student-aid processing and loan-servicing contracts. These contracts tend to require performance of high volumes of routine and similar tasks, like application processing, loan origination, and loan servicing and collection.

We have contracted for these kinds of activities, and we have done these kinds of contracts for even three decades, but the work volume has increased dramatically in recent years.

In fiscal year 2010, only 21 percent of the contract dollars and 9 percent of the contract actions awarded by the Department were

cost-reimbursement, and we are further reducing our reliance on cost-reimbursement contracts each year.

In fact, eight of the Department's top ten contracts, representing 96 percent of the spending on our largest contracts, are fixed-price. Examples of cost-reimbursement awards that we do have include contracts to analyze student achievement data from the National Assessment of Educational Progress (NAEP) and an ongoing contract we had with Reading Is Fundamental which distributes inexpensive books to children and undertakes other activities that promote reading and literacy.

The Department's Office of Inspector General (OIG) conducts independent audits, investigations, inspections, and other reviews of programs and operations. Part of this responsibility includes contract audits. In determining what to review, our Inspector General's Office considers internal risk assessments, Department requests, Congressional requests, and hotline information and other sources that contain allegations of concern.

As noted in last April's response to you about contract audits, in fiscal year 2009, OIG completed an incurred cost audit of a contract that the Department had entered into for the administration of part of the National Assessment of Educational Progress.

The purpose of the audit was to determine whether the costs incurred in fiscal year 2006 under the contract were, quote, reasonable, allowable, and allocable in accordance with the terms and conditions of the contract and applicable acquisition regulations. The approximate cost to the Department to perform this audit was \$255,000.

As a direct result of this audit, our Inspector General's Office recommended that: One, the Department recoup unallowable costs paid to the contractor; and, two, to then conduct a follow-up review of the costs not included in Inspector General's sample. The Department recouped \$229.7 thousand dollars from the contractor for the fiscal year 2006 costs identified by the Inspector General.

In addition, the contractor disclosed during the audit that it had inappropriately billed the Department for post-retirement medical benefits during the period September 2002 through December 2007. The contractor returned to the Department \$2.7 million in April 2009 for these improper billings.

I point this out because it shows we did get some additional benefits from the contract audit in addition to the amounts we recovered throughout negotiations with the vendor. So there is obviously some deterrent effect from doing audits. It encourages vendors to keep good records, revise their procedures, and maybe return things to us before we actually get into the audit.

We considered several options for the follow-up audit that the IG had recommended. The IG itself decided not to devote limited resources to a broader audit. Then the Department initiated a request to the Defense Contract Audit Agency for audit support to review the incurred costs not included in OIG's sample.

To obtain this support, the Department representatives worked with DCAA in 2010 to determine the scheduling and the cost of the follow-up audit, which was estimated to cost \$27,000.

In December 2010, DCAA confirmed that the requested audit was not programmed in its schedule for fiscal year 2011. As a re-

sult, since the IG did not want to do it, the DCAA did not want to do it, we contracted on our own for audit support services. The contract we obtained includes performing incurred cost audits of this and other kinds of activities and it will be providing services this fiscal year.

The Department faces challenges regarding contract audits in deciding whether they take priority over other demands for other limited funds. The Department's Inspector General has multiple priorities, and DCAA cannot always accommodate non-DOD requests for audit support. Obtaining audit support from a non-governmental firm can be costly and time-consuming.

In conclusion, we support efforts to maximize the performance of contractors in delivering Department services. We rely on many contractors to get the work done. We believe that fixed-price contracts are the preferred option over cost-reimbursement contracts as they provide a better value to the taxpayer.

Thank you, Madam Chairman, for your attention to this important issue, and I would be happy to answer any questions.

Senator McCASKILL. Thank you very much. Ms. Kolb.

TESTIMONY OF INGRID KOLB, DIRECTOR,¹ OFFICE OF MANAGEMENT, OFFICE OF DEPUTY SECRETARY, U.S. DEPARTMENT OF ENERGY

Ms. KOLB. Thank you, Chairman McCaskill and Senator Brown, and I, too, appreciate your leadership on this very important topic.

My name is Ingrid Kolb. I am the Director, Office of Management at the U.S. Department of Energy. I am pleased to be here today to discuss with you how the Department uses audit services to detect and prevent waste, fraud, and abuse in government contracts, to provide contracting officers with reasonable assurance whether contractor submissions are free of material misstatement, and also to provide contracting officers with assistance and advice in the establishment of fair and reasonable prices for products and services.

In fiscal year 2010, the Department spent approximately \$26 billion on contracts. The bulk of the dollars, about 80 percent, was spent on the Department's unique management and operating contracts. These contracts are used primarily to manage Department laboratories, its national laboratories as well as other government-owned or controlled facilities.

The Department's Office of Inspector General is the auditor for management and operating contracts; and in fiscal year 2010, the Department spent approximately \$1.1 million for 17 of these IG audits.

The Defense Contract Audit Agency has traditionally been the primary auditor for our other contracts. In fiscal year 2010, the Department spent approximately \$9.4 million for 273 audits of varying types, performed by DCAA. The majority of these are for incurred cost audits.

DCAA has provided us with excellent service in the past and remains our primary source of audit service for non-management and operating (M&O) contracts.

¹ The prepared statement of Ms. Kolb appears in the appendix on page 40.

However, over the past few years as DCAA has experienced challenges with an increasing workload and fewer resources which have caused some concern for the Department of Energy, our ability to obtain cost-incurred audits in a timely manner has diminished and in some instances at some procurement sites this has caused a backlog of closeouts for our contracts.

In response to the increased workload associated with the American Recovery and Reinvestment and Recovery Act and the corresponding demand for the DCAA audit services around the government, the Department of Energy conducted a competitive procurement to obtain supplemental audit services.

In coordination with DCAA, a private accounting firm was awarded a contract in May 2010 to provide audit services primarily for financial assistance awards. The contract also provides full contract audit services, and to date the contractor's performance has been timely and we have been satisfied with the quality of their work.

Last month senior officials from the Department along with three other civilian agencies met with Pat Fitzgerald, the head of DCAA, who will be testifying in a few moments, to explore ways to work more efficiently with DCAA.

And I am glad to report the meeting was very productive and there are future discussions that we have planned to help streamline the process. I believe that this ongoing dialog with DCAA will strengthen our audit function at the Department of Energy.

Again thank you for this opportunity to testify before the Subcommittee. This completes my oral statement and I am happy to answer any questions the Subcommittee may have.

Senator MCCASKILL. Thanks very much. Mr. Miller.

TESTIMONY OF THE HON. BRIAN D. MILLER,¹ INSPECTOR GENERAL, U.S. GENERAL SERVICES ADMINISTRATION

Mr. MILLER. Madam Chairman, Ranking Member Brown, ladies and gentlemen, thank you for the opportunity to testify on the importance of contract audits in detecting and preventing fraud, waste, and abuse in government contracts, and thank you for your continued support of Inspectors General and for the Subcommittee's strong commitment to oversight.

This hearing is especially important as the President and the Congress look to aggressively pursue fraud, waste, and abuse in Federal spending. Contract auditing plays a vital role in fighting fraud.

A key component of the President's plan to reduce the national debt is rooting out fraud, waste, and abuse from Federal programs such as health care programs. This is no less true in the procurement area.

Across the government, contract audits result in saving billions of taxpayer dollars and ensuring that, when Federal dollars are spent, they are spent wisely.

My office has a great deal of experience with contract audits. In my view they provide a critical oversight mechanism for GSA's handling of billions of taxpayer dollars.

¹ The prepared statement of Mr. Miller appears in the appendix on page 46.

Over the last 2 years, my office has identified about \$1.1 billion in potential cost avoidances and \$33 million in questioned costs. We have also worked very closely with the Department of Justice in obtaining over \$400 million in False Claims Act (FCA) recoveries.

And thank you, Madam Chairman, for mentioning the recovery yesterday from Oracle and from Sun Microsystems of \$46 million.

Overall, GAO's 2008 report recognized that for every dollar budgeted, our office had a return on investment of \$19. I am proud of the work our office does in saving taxpayer dollars.

I agree with the President and the Congress that we need to restore fiscal discipline to the Federal Government and to find ways to make the government more effective. Contract auditing is one way to do so.

Unlike other government programs, contract auditing saves Federal dollars. It identifies wasteful spending and ensures that taxpayer dollars are spent wisely. Most other Federal programs, however useful and good, do not return dollars to the Treasury or prevent Federal dollars from being spent.

At a time when the acquisition workforce is stretched thin, overworked, and under trained, contract audits are crucial to protecting taxpayer dollars. Contract audits are the taxpayers' last line of defense against losing money to fraud, waste, and abuse.

To prevent overcharging, our office reviews the pricing that contractors give to GSA. Too often, the prices given to GSA are not fair and reasonable. As the largest volume buyer, the Federal Government deserves the best prices. Yet our auditors often find that contractors have given better prices to other customers.

Our success hinges on both our autonomy from the agency and on our contract expertise. However, we do face perennial oversight challenges.

Contractor lawyers and consultants have sometimes delayed responses to information requests for months and, yes, at times even for years. These kinds of delays should not be tolerated.

Thank you for calling attention to the need for more contract audits and for more effective contract audits. In these times of tight budgets and calls for smaller government, we need to continue to be serious about rooting out fraud, waste, and abuse.

I am proud of the record of the GSA Office of Inspector General and hope that we can do more in the coming years to save Federal money.

Thank you for your attention. I ask that my statement and written materials be made a part of the public record and I would be pleased to respond to the questions.

Thank you.

Senator McCaskill. Thank you. Mr. Fitzgerald.

TESTIMONY OF PATRICK J. FITZGERALD,¹ DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, U.S. DEPARTMENT OF DEFENSE

Mr. FITZGERALD. Good afternoon, Chairman McCaskill, Ranking Member Senator Brown. Thank you for the opportunity to appear

¹ The prepared statement of Mr. Fitzgerald appears in the appendix on page 55.

before you today. I am pleased to provide you with an overview of the role that the Defense Contract Audit Agency plays in performing contract audits for agencies other than the Department of Defense.

I became the Director of the Defense Contract Audit Agency 15 months ago, and prior to that, I was the Auditor General of the Army and headed up the Army audit agency. I am a Certified Public Accountant (CPA) and have over 30 years of government auditing experience.

The Defense Contract Audit's mission supports efforts to obtain the best value for dollars spent in government contracts.

To carry out this mission, we have about 4,700 dedicated employees at 114 field offices around the world. We have hired 500 auditors in the last 2 years. Currently 99 percent of our auditors have a four-year college degree, and in addition 29 percent hold advanced degrees and 28 percent are certified public accountants.

I consider the work we do for civilian agencies an important part of our contract audit mission. The Defense Contract Audit Agency has performed contract audits for civilian agencies since its creation in 1965. The type and scope of our efforts in civilian agencies are very similar to the audits we perform in the Department of Defense.

Since 2000, the percent of our total budget devoted to the reimbursable work has ranged from 9 to 13 percent, and the total reimbursable funding has ranged from about \$45 million to \$58 million.

In an average year, we provide audit services to more than 30 civilian agencies. However, our reimbursable work is heavily weighted toward just a few civilian agencies. For example, just two civilian agencies, National Aeronautics and Space Administration (NASA) and the Department of Energy, make up more than 50 percent of the reimbursable work that we do.

As a result of our DOD audits, we have already established a presence at many of the civilian agency contractors. In 2010, over 90 percent of the contractors we audited were engaged in some type of DOD work.

Using DCAA for contract audit at these locations is a cost-effective use of both government and contractor resources and provides assurance that comprehensive audits are accomplished.

Over the past several years, the Department of Defense has taken initiatives that have improved contract processes. I would like to highlight three that, in my opinion, will provide similar benefits throughout the Federal Government.

These are, one, establishing a formal adjudication policy that ensures that contract audit findings and recommendations receive timely and adequate consideration; two, developing new business system rules that will strengthen contractor systems to prevent fraud, waste, and abuse by improving the transparency and oversight of these systems.

And finally, creating a risk-based approach to ensure that the limited auditing resources are focused on the areas with the greatest risk and largest payback to the taxpayer.

Let me assure you we are committed to providing civilian agencies with high-quality audits that protect the interests of the American taxpayer.

Over the past year, we have implemented many initiatives to improve the quality of our audits and improve the work environment of our talented workforce. To assist in developing our workforce, we are overhauling our training programs as well as making changes to our hiring and promotion policies.

We have also issued extensive audit policy and process changes to improve the quality of our audit services and audits. These changes have resulted in auditors performing additional tests of contractors' controls and transactions.

We are reaching out to our stakeholders to better inform them of our process improvements while working with them to revisit the contracting time frames to allow sufficient time to perform thorough audits that are necessary to protect the taxpayer's interest.

In summary, we have changed the way the Defense Contract Audit Agency does audits by using a more collaborative and comprehensive approach to contracting audits.

We have institutionalized these initiatives in our recently issued strategic plan that provides a clear roadmap for executing these changes. We believe we have made significant strides but recognize there is more work to be done, and I know our workforce is committed to providing high-quality audits that serve the American taxpayer.

Again I appreciate the opportunity to testify before you today, and I would be glad to answer any of your questions. Thank you.

Senator McCASKILL. Thank you, Mr. Fitzgerald. Let me start by, I am trying to get a handle on, I know that the work you are doing, the majority of it is in a few agencies and I know the majority of it is with agencies that have some connection to the Department of Defense.

The large policy issue that I want this hearing to talk about is—are there sufficient contract auditing resources in the Federal Government, do agencies have the ability to be aggressive about contract audits, and how is that process working now?

It is not clear to me; and if you can help, is there an overall risk assessment that is being done across all of the agencies that anybody has responsibility to look at and say we have a cost-plus contract over here at Interior that no one has ever looked at and there has never been a question asked about it and it has grown and it is a fairly large contract now.

Is there someplace that there should be—I mean, are we doing this in stove pipes and you are just being called in on a piecemeal basis? Reassure me that there is some overall strategy here as to where these audit resources are going.

Mr. FITZGERALD. Senator McCaskill, from the defense contract audit point of view, we have worked over the last year with the Department of Defense and all the stakeholders involved with that to make sure that our auditors are being allocated to the highest risk, the highest priority work.

We are now starting to work with each individual civilian agency to do that, realizing that one, a risk-based approach for DOD may not be the same thing for DOE or something like that.

So we are working civilian agency by civilian agency to make sure that we are providing the service and allocating our resources where we believe and they believe are the highest risk area.

Senator McCASKILL. So is there some document that is being prepared in each civilian agency about a risk assessment in terms of contract audit work?

Mr. FITZGERALD. Senator McCaskill, I am not sure but what I would like to do is, because I think I can meet the needs of the civilian agencies if I know what that workload is——

Senator McCASKILL. Right.

Mr. FITZGERALD [continuing]. For the future so I can build the workforce capacity to do that.

Senator McCASKILL. Well, it looks like you by default are it. Is that a fair assessment?

I do not mean you are the only game in town. Therefore, we got to use you. I mean, obviously you are a strong agent, audit agency with a lot of professionals.

Well, let me ask. I mean, do you sense, Ms. Kolb, is there a risk assessment that your agency is doing that prioritizes contract audit work within your agency?

Ms. KOLB. Yes, we definitely prioritize contract audit work within our agency. We have certain dollar thresholds that trigger an audit, trigger a contracting officer to request an audit. And so that is how we go about determining the risk level.

Senator McCASKILL. And in Education the same thing?

Mr. SKELLY. Pretty much. Our biggest audit, our biggest contracts are fixed-price so we do not see as much need for that; but if we are closing out one of the cost-plus contracts, then we do see a need to.

Senator McCASKILL. Well, there has actually been some waste in fixed-price contracts, too. I know they are not as risky as cost-plus.

Mr. SKELLY. Just overall I think our strategy is to try to maximize fixed-price contracts. That is the biggest contract reform we are trying to implement and we have direction from the White House and the Office of Management and Budget (OMB) on doing that.

Senator McCASKILL. If I could just make sure that the Defense Department had as many fixed-price contracts as you have, I would be a happy camper. There is certainly not the level of cost-plus going on in your agency that there is in Defense.

So I guess what I am getting at here is that it appears to me that we have never really had across the government anyone going, OK, are we doing the right audit work? Your priority has to be Defense because you are the Defense Contracting Audit Agency and the other agencies.

And what is a comparison of price? When you get reimbursed for your cost, Mr. Fitzgerald, how does that compare with contracting with private sector auditors to do contract work?

Give me an apples to apples comparison here.

Ms. KOLB. I can give you a comparison with the experience we have had with our independent auditor. The price that we pay for DCAA is about \$114 an hour. The comparison with our independent private sector auditor is \$150 an hour.

However, I will say that one of the big issues for us is timeliness, and DCAA is stretched fairly thin, and sometimes it is very difficult for them to free up auditors to perform high priority work. So we have had to go to our independent auditor.

But for us, it is worthwhile because we need the audit work in order to make timely business decisions. So we have had to pay that extra amount in order to get that service.

Senator McCASKILL. Right. Senator Brown.

Senator BROWN. I guess my biggest concern when we do all these hearings is, are we getting the most bang for our buck, is there something we can do better, or you can do better, or we can give you guidance to do better.

So why do I not just start with Mr. Fitzgerald, if that is OK. Is there something we are not doing correctly to the maximum bang for our buck?

Mr. FITZGERALD. Well, Senator, I think having this hearing is helpful to bring some light on contract auditing. Our agency did not grow through the boom that happened in DOD. As result of some external reports, we have the support from the Department to grow our workforce.

We are making sure that we are doing a quality product for not only DOD but our civilian agencies too.

We have made some changes over the last year but we believe we are seeing, as result of doing a better quality product and service, that the amount of dollars that we are questioning, that has significantly gone up over the last 2 years as we have done, in what we believe, a more comprehensive and thorough approach to our audits.

Senator BROWN. At some point does it not lose its cost effectiveness? There are some audits that I cannot believe we are auditing their people. Do you ever have that moment in your office?

Mr. FITZGERALD. I think one of the first things we did was to look at a risk-based approach, and we have made some adjustments where we have decided, based on the risk, that we would re-allocate our auditors to contracts above a certain dollar threshold, and only do below that threshold if there was additional risk or we do believe we might kind of use the Internal Revenue Service (IRS) model where we will do some work in that area just on a random basis but clearly our focus will be on higher dollar value, higher risk contracts because we will never have nor would we be purporting to have auditors be able audit every contract.

So we are looking to make sure that our limited audit capability is applied and allocated to the highest risk area.

Senator BROWN. So you are doing that now?

Mr. FITZGERALD. Yes, sir.

Senator BROWN. Is it true that you are about 10 percent over in terms of the actual close-outs that there are some that have been going on for, as I think has been discussed already, for a while.

Is it about 10 percent or do you have that number?

Mr. FITZGERALD. Senator Brown, to be very up front with you, our circurred audits, which are the audits that we do at the end of the contract, and many times they are needed to close out the contract, that backlog has quadrupled over the last 8 years. So again that is why we are using—

Senator BROWN. Quadrupled from what to what, just in rough numbers so everyone knows approximately. We do not need an exact number. I mean, has it gone from like one to four?

Mr. FITZGERALD. No, it is a significant backlog that we have to work. I could give you specific numbers.

Senator BROWN. The reason I am kind of zeroing in on this particular area because we have a lot of Massachusetts businesses that deal in this type of work.

And not only are they waiting for close-out, it is costing them real money, real dollars. So in addition to the health care bill and the taxes they are paying and the regulations that they are dealing with and now they have audits so it is like—what is next.

They need closure and they need certainty. And is there a way, is there something that we can provide you or is there something that you need that we are not giving you to get these things done? They have been going on, some of them, for years.

Mr. FITZGERALD. Senator, we have to get after that backlog. Hiring 500 new auditors over the last 2 years will be helpful in that. And I would add, not to mitigate that at all, but we do work closely with the contracting officers to make sure that their billing rates are appropriate so that there are no overages or shortages so that the contractors get the money that they need to be paid as we monitor the billing throughout the contract before we do a final cost-incurred audit. We work closely to make sure that is a minimum amount.

Senator BROWN. Sure. You are saying you are hiring 500 new auditors. Can you believe it, folks? We are doing 500 new auditors in addition to the thousands of other new auditors in various agencies.

I mean, at what point do we actually just hire new workers, like new construction folks, or just a regular private sector employee.

The fact that we are hiring 500 new auditors just smacks of me saying, "Wow, something is broken somewhere." There is a disconnect somewhere.

So hiring 500 new auditors to deal with a load that has been quadrupled after a period of time, some of these audits have gone on for years.

So I guess at what point do we say, "My gosh, something is broken." Are we auditing the proper folks that need to be audited, the entities that need to be audited? Where is the breakdown?

It is not kind of working for me really.

Mr. FITZGERALD. Senator, just to try to put it a little in perspective. The DOD procurement budget just exploded from 2000 to 2010. DCAA's workforce was flat throughout that period.

In the early 1990s the Defense Contract Audit Agency was about 7,000 folks. That steadily went down and then stayed flat. We are working to both adjust to workload requirements and build the workforce capacity to get a good balance there so that we can effectively provide a quality product which is, in my opinion, a quality product must be a timely product.

Senator BROWN. I will reserve for the next round.

Senator MCCASKILL. I wanted to point out that Senator Brown was not yet a Senator when all hell broke loose at DCAA. To say that Mr. Fitzgerald had a challenge is an understatement. It was

determined that DCAA was not meeting yellow book standards for government auditing.

There were some real management challenges, not that there are not, and I want to say this on the record, thousands of wonderful auditors at DCAA. I do not mean to disparage the wonderful people that work at DCAA because literally we would not have known about the problems if somebody at DCAA had not come forward. But they had some real management issues.

And Mr. Fitzgerald was drafted to take over an agency which had traditionally only had the people move up in the organization to head the organization. I think it may have been, I do not know, was it the first time, Mr. Fitzgerald, that somebody came from outside the organization to head it?

Mr. FITZGERALD. Yes, Senator.

Senator MCCASKILL. So they never had anybody come from outside in a management capacity. So I am usually not the one making, I do not mean to sound like I am making excuses but I know the challenges that he faced.

And while I do not think they are there yet, they have made significant progress in, I think, turning around the management capacity at DCAA since his arrival. So for what that is worth.

Senator BROWN. May I make a note on that?

Senator MCCASKILL. Sure.

Senator BROWN. Listen, I do not disagree. I am aware. I have obviously done my homework and I am aware of your challenges. I just want to make sure that we are auditing the right entities and that we are not wasting our money and that the audits that we are participating in, it affects real people, real jobs, real companies, not only in my State but in yours, and that is why I asked is there something that we can do or that we are missing to help you get that closure so people can move on and just start creating real jobs.

Senator MCCASKILL. I certainly agree. I think that this is one of those areas where we've got to be careful because there are areas of government where the investment that we make comes back.

That segues into the question I want to ask you all and that is pre-award and post-award auditing. I would like any of your all's take on that. I just think there is, I know that you have done a lot of it at GSA but it appears to me, Mr. Miller, that you all could do a lot more of it because every time you have done it, we found real money, have we not?

Mr. MILLER. We have, Madam Chairman, and we could do a lot more of it. And I think it would save Federal money. That may sound ironic, but we will save money if we do more contract audits, if we invest the money there.

I would like to say briefly that we do not currently use DCAA. We have used DCAA in the past a few times in relatively limited capacities but currently, we do the auditing at GSA and that has worked out very well.

One of the areas that you point out is the pre-award and post-award audits. The Sun Microsystems settlement of \$46 million that you mentioned earlier started off as an audit in our office that we worked up, developed, and referred over to the Department of Justice. It was later on combined with the Qui Tam action and settled.

But we do save lots of money. As I pointed out in my testimony, \$1.1 billion in cost avoidances for the last 2 years. So thank you for asking that.

Senator MCCASKILL. Well, and I think many times those pre-award audits have what I would call a deterrent effect because everyone who is out there competing for Federal contracts it gives them a heads up that somebody is going to be paying attention to their numbers before all the documentation is signed and before the contract is executed.

And I think that kind of has everyone on better behavior as it relates to Federal contracting.

Let me address Mr. Skelly and Ms. Kolb. As we began what I am going to call the lean era in the Federal Government which I believe the next decade will be, I do not think you are going to see much expansion of either one of your departments.

I think, in fact, you will see some contraction at both the Department of Education and Department of Energy. I am not saying that we are talking about massive layoffs. But I am just thinking that the whole footprint, I believe, will shrink to some extent just because we are going to have a real obligation to begin to cut back on all kinds of spending, including discretionary.

Be honest with me. What kind of pressure is that going to put on you to squeeze the resources you spend on contract auditing because there will be some other pressure to keep the money in programming at your agencies?

Mr. SKELLY. I think it is going to be a significant pressure. We have been squeezed already. I think I have mentioned that we declined about 10 percent in the last decade in staff already.

We have tried to make investments in key areas such as contract officers, contract officers' representatives so they can do a better job at monitoring our contracts. I think that is a priority since we are going to rely on contracts to get a lot of our student loan and student aid work done in particular.

I think it is a good investment, though, and I encourage you not to reduce our footprint at the Department of Education, particularly our administrative funds.

We need the money to make sure that we award these contracts and deliver our aid. And indeed, in our direct loan program which we went to 100 percent as a result of the Student Aid and Fiscal Responsibility Act (SAFRA) legislation, we believe we will actually save about \$5 billion a year.

It will be a savings of \$5 billion per year or more in the mandatory area but we are going to have to spend a couple hundred million dollars more as noted in contracts in our discretionary budget.

I think there will be pressure on things like contract audits and anything else that is not directly related to some of our providing our services and doing them very well.

Senator MCCASKILL. Who is doing the audits now? You are contracting with people in terms of the application process. Who is doing the checking on whether or not the people that are getting this money actually even exist on the Pells? Who is the check on—there is always a different thing.

I think the current cable TV ads are that you can become a culinary chef online which I think is tricky but that is the latest profit

center for some of these institutions is stay in your kitchen and become a world-class chef if you just sign up to make sure we get your Pell grant money. Who is doing that audit work?

Mr. SKELLY. Well, our Inspector General is independent in the Department of Education and can decide which areas to look into and looks into areas that have the highest risk where there might be abuses on the part of some parties in our programs.

We also have, in looking at the contracts that provide our services, we are relying primarily on our first line of defense with our contract officers and our contract officers' representatives.

Those are the employees in the Department of Education who work with the contracts, make sure they are doing what they are supposed to do. If the work statement is clear, if the expectations are clear, if their performance measures in the contract, then it is easier for those employees to check up on whether the contractor is performing.

These contracts are just providing the mechanical operation in getting the aid to the students and colleges. We have other people who are assigned the job of making sure that colleges are complying with the rules.

They have certain reports they have to file. We are reviewing those. Both our program officers are doing that but also our Office of Inspector General is looking into that.

Senator MCCASKILL. I would give them a heads up. I do not think we need a hotline to figure out that there may be a little bit of over marketing in the area of the become a world-class culinary chef from the comfort of your own home.

Mr. SKELLY. Also I think one of the other committees here in the Senate got a report from the Government Accountability Office recently where they had also looked into the situation.

Senator MCCASKILL. Right.

Ms. Kolb, the question about whether or not your auditing resources are going to get squeezed as the top line budget may get squeezed.

Ms. KOLB. Actually, I think that we do a very efficient job of ensuring that we have the audits available that we need to make business decisions.

Last year, for example, we spent a total of about \$10 million for \$32 billion worth of contracts and financial assistance awards that were made. That is a very small percentage. I would envision us staying committed to providing that level audit work.

So I do not think that the consolidation will impact our commitment to putting forward those dollars. We will stay with that.

Just to pick up on a few points that Pat Fitzgerald was making. First of all, he was talking about moving to a more risk-based approach. We completely support that, and we are doing a few things at the Department to try and move in that direction.

First of all, we do not always need a comprehensive audit, and DCAA does a very thorough job, and their preference is to conduct a thorough, comprehensive audit.

We want to work with DCAA to make sure that where a targeted audit is all that is needed and that is what we end up doing. We believe that is very important and this will ensure that there is a more efficient use of resources.

Then also I had mentioned earlier that we have thresholds that trigger an audit. We are in the process of raising those thresholds to make sure that we are really targeting those contracts where we need the audit work completed.

Senator McCASKILL. That is great. Senator Brown.

Senator BROWN. Thank you, Ms. Kolb.

Also you speak of a decline in the DCAA audit support for the use of contractor's price proposals which has impacted the Department's ability to negotiate fair and reasonable prices, and we have heard from other agencies, business groups, and Project on Government Oversight (POGO) that DCAA's current practices submitting these audits to the Generally Accepted Government Auditing Standards (GAGAS) standards is both unnecessary and may contribute to these reviews taking more time and is uncostly.

Is that your opinion of what they are saying about this whole process?

Ms. KOLB. The concern that we have had with the services provided by DCAA, and Pat Fitzgerald and I have talked about this, really is one of timeliness.

We think that DCAA does a very good job. Again, we would like to see more targeted audits as opposed to comprehensive audits unless they are absolutely needed. But the timeliness issue has to be addressed and DCAA is committed to making those improvements.

Senator BROWN. Should proposal reviews of cost and pricing data be considered financial advisory services which are not subject to all the GAGAS requirements?

Ms. KOLB. In the pre-award area, we depend heavily on DCAA to examine the prices and we want to continue to have them look at the proposed prices above a certain threshold.

Senator BROWN. Mr. Skelly, you have been awfully lucky tonight so I figured I just you—

Mr. SKELLY. My whole life, I think, Senator.

Senator BROWN. I know the feeling.

According to your testimony, the Department of Education spent approximately \$1.5 billion on contracts in fiscal year 2009 and \$1.8 billion in fiscal year 2010.

A key concept in contract auditing is that the cost of control activity should not outweigh the benefit.

With over a billion dollars at stake, what contract controls does the Department of Education have in place to ensure that the taxpayers' money is spent wisely in accordance with applicable regulation and the Department is receiving the best value possible for its money?

Kind of an extension of what I asked Mr. Fitzgerald.

Mr. SKELLY. Our main strategy is to use fixed-price contracts. Approximately 71 percent of our contract dollars are awarded through fixed-price contracts at least where the unit price is fixed in a contract.

We found that it is the best solution. One ounce of prevention is worth a pound of cure. We are better off doing at the start, stipulating what is expected to be delivered under the contract, having good performance measures, following up that work through the work of our contract officers and our contract officers' representa-

tives. We have to do that to make sure that we are spending our money well.

When we do use contract audits, it is for the incurred costs. It is sort of after-the-fact, after the contract is finished, and we are trying to close it out. But because we have relatively few cost reimbursement contracts, there is not as much for the auditors to find.

Senator BROWN. So based on your experience, just somebody who is listening or watching, if somebody is not adhering to the terms of their contract, what do you actually do? What is a typical scenario?

Mr. SKELLY. It is notifying them that they are not living up to the standard. A report has come in. We are monitoring the activity. We get management information reports, for example, on how many people are applying, how many people are using the free application for Federal student assistance, the Free Application for Federal Student Aid (FAFSA) form.

About 20 million people use that form to apply. Many of them are doing it over the web. So it is easy to monitor how many are coming in and going out. We check those management information reports to see are they coming in timely.

There is actually an incentive built into the contract for the contractor to process those quickly. We have incentives in our servicing contracts where the contractors are given additional funds if they make sure that people do not go into delinquencies or defaults.

So we try to build those incentives into the contract up front, and we try to monitor that as closely as we can.

Senator BROWN. Have there ever been any instances that you are aware of where there has just been a total breach of the contract or not adherence to the terms of the contract?

Mr. SKELLY. I am sure we have lots of humans involved in this and we are making mistakes, but I do not recall specifically.

Senator BROWN. I have nothing further. Thank you.

Senator MCCASKILL. Thank you, Senator Brown.

I want to thank the panel very much for your work and I appreciate the time and effort you put into appearing at this hearing today.

And we will take the second panel.

I said I would not put the witnesses in a hot box. As it turned out, it kind of is hot. Is it as hot out there as it is up here? Hot out there. Man, it is hot in here. It is not going to kill us.

I want to thank the witnesses.

First, let me introduce this panel.

Jeanette Franzel is the Managing Director of the Financial Management and Assurance Team at the Government Accountability Office, GAO. In her role, she heads GAO's oversight of financial management and auditing issues across the Federal Government which includes review of internal control, financial management systems, cost management, improper payments and accountability, and corporate governance issues.

Ms. Franzel is also responsible for overseeing the GAO's development of the government Auditing Standards, also known to all of us who know and love it as the Yellow Book, the standards used

in the United States and as a model for the private sector and governments around the world as it relates to auditing standards.

Nick Schwellenbach is the Director of Investigations for the Project on Government Oversight. Mr. Schwellenbach conducts investigations which include examination of the effectiveness of government oversight.

He has previously worked as a writer for the Center for Public Integrity and is a reporter and researcher for the Nieman Watchdog, a project of the Nieman Foundation for Journalism at Harvard University.

E. Sanderson Hoe is a partner at the law firm of McKenna, Long, and Aldridge. He has practiced government contract law for over 36 years. He has expertise in areas including contract formation, the structuring of complex private financing of government contracts, and resolution of post-award contract disputes.

He co-chaired the Committee on Privatization, Outsourcing, and Financing at the Public Contract Law section of the American Bar Association since 1999, and he is currently serving as a pro-bono counsel to the government of Liberia in the drafting of a new procurement code.

Thank you all for being here, and we will begin, oh, I have to swear you in.

It is the custom to swear in the witnesses in the Subcommittee. I would ask you to stand.

Do you swear that the testimony you will give before this Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you God? Thank you very much.

Ms. FRANZEL. I do.

Mr. HOE. I do.

Mr. SCHWELLENBACH. I do.

Senator MCCASKILL. Ms. Franzel, we welcome your testimony.

TESTIMONY OF JEANETTE M. FRANZEL,¹ MANAGING DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. FRANZEL. Good afternoon, Madam Chairman.

Thank you for the opportunity to be here today to discuss the role that contract audits can serve in effective contract oversight and internal control in the government.

As the government has become increasingly reliant on contractors over recent years, effective contract oversight is key to protecting the taxpayers' interests. In fiscal year 2010, Federal agencies reported obligating approximately \$535 billion for contracted goods and services. The sheer size of Federal contract spending poses significant risk if effective oversight and controls are not in place.

Today, I will describe the contracting cycle and related internal controls, DCAA's role in performing contract audits, and risks associated with ineffective contract controls and auditing.

In preparing this testimony, we relied on the work we performed during our DCAA engagements as well as our extensive body of work on Federal contract management.

¹The prepared statement of Ms. Franzel appears in the appendix on page 65.

The contracting cycle consists of activities throughout the acquisition process including pre-award and award, contract administration and management, and ultimately the contract closeout.

Effective contract oversight includes internal control throughout the process, and the Standards for Internal Control cover agencies' control environment, risk assessment, control activities, information and communication, and monitoring.

As we heard in the previous panel, the type of contract used really determines the types of internal control and contract auditing activities needed to help protect the government's interest.

Specifically, contract types can be grouped into three broad categories: Fixed-price, cost-reimbursable, and time and materials contracts.

For fixed-price contracts, the government agrees to pay a set price for goods or services regardless of the actual cost to the contractor. So in those cases, the contractor is assuming most of the cost risk.

Under cost-reimbursement contracts, the government agrees to pay contractor costs that are allowable, reasonable, and allocable based on the contract. Consequently, the government assumes most of the cost risk in a cost-reimbursement contract, and it is a similar situation for time and materials contracts.

Contract audits are intended to be a key control in the contracting process to help ensure that prices paid by the government for 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; and contract terms.

DCAA plays a critical role in contract oversight by providing contract auditing services that DOD and other agencies rely on when making these contract decisions and when providing oversight.

The majority of DCAA audits focus on cost-reimbursable and time and materials contracts as these contract types pose the highest risk to the government.

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.

Also billing system audits support decisions to authorize contractors to submit invoices directly to the government for payment without further government review.

Audits of contractor incurred cost, claims and voucher reviews directly support the contract payment process by providing the information necessary to certify payment of claimed costs.

And finally, closeout audits include reviews of final vouchers and the cumulative costs and may include adjustments and recoveries, if necessary.

Our work has identified significant contract management weaknesses in Federal agencies, problems with agency controls over payments, and weaknesses in contract auditing; and all of these pieces need to fit together in order to have effective contract oversight. These weaknesses increase the risk of improper payments; fraud, waste, abuse; and mismanagement.

For example, our work at various agencies has found that contract officers are not performing detailed reviews of invoices prior to paying invoices. In some cases even if the contract officer had attempted to review the invoices, the invoices provided by the contractor did not provide sufficient detail to facilitate such a review.

There were also instances in which contracting officials decided to rely primarily on DCAA's audits rather than performing normal internal control procedures.

We also discovered cases in which contracting officers did not even use the DCAA audits that are available to them. We also found instances in which the agency was not obtaining the required audits of contractors' accounting systems and incurred audits.

Finally, our work has found problems with contracting auditing itself. In 2009, we reported on audit quality problems at DCAA offices nationwide. We found serious quality problems in the 69 audits that we reviewed including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision.

As a result of our work, DCAA rescinded over 80 audit reports and has been making many changes in its operations.

We concluded that at the root of DCAA's audit problems was DCAA's focus on a production-oriented mission that emphasized performing a large quantity of audits with inadequate attention to performing quality audits.

In our 2009 report, we made 17 recommendations to DOD and the DOD IG to improve DCAA's management environment, audit quality, and oversight.

And in response DOD and DCAA have taken a number of actions. Our 2009 report also offered some potential actions for strengthening the organizational effectiveness of DCAA and the contract audit function in the Federal Government.

Those potential actions would require further study as well as potential congressional action and include actions intended to strengthen DCAA's independence, including potential organizational changes.

Madam Chairman, this concludes my statement and I will be happy to answer any questions that you have.

Senator McCASKILL. Thank you very much. Mr. Hoe.

TESTIMONY OF E. SANDERSON HOE,¹ PARTNER, MCKENNA, LONG, AND ALDRIDGE, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. HOE. Madam Chairman, my name is Sandy Hoe, and I am a partner at the law firm McKenna Long and Aldridge LLP. I am pleased to be here to testify before you today on behalf of the United States Chamber of Commerce.

As you indicated in your opening statement, I have been practicing government contract law on behalf of the contractor community for more than 37 years.

Today's hearing is very important to the government contractor community. Contractors understand and accept that by providing goods, supplies, and services to the Federal Government in ex-

¹The prepared statement of Mr. Hoe appears in the appendix on page 98.

change for taxpayer funds, they are agreeing to contract auditing requirements.

The need for such audits is not being questioned. How the audits are conducted is something on which the contractor community has definite views.

Of the three auditing organizations who have appeared here today, the Government Accountability Office, the Inspector General, and the DCAA, government contractors interface most frequently with the DCAA.

There are a number of concerns that the government contracting community has as it works with the DCAA, and you have heard many of these issues before, such as the length of time it takes to complete an audit and the quality of the audits themselves.

There are, however, more recent issues facing the contractor community. The first is the role that the auditor is taking in relation to the contracting officer. Both traditionally and by law, contracting officers have exercised authority to make decisions regarding the implementation and performance of government contracts.

Recently, however, there is evidence that the auditing community may be usurping some of the contracting officers' role. Let me provide you with a specific example from the Department of Defense.

On January 4 of this year, DOD published a memorandum assigning new roles for the Defense Contract Management Agency (DCMA), which houses the administrative contracting officers for the Department of Defense, and the DCAA regarding forward pricing rates for contracts.

The memorandum provides that contracting officers shall adopt the DCAA's recommended rates. This is a significant change of policy and conflicts with current law.

Under current law, contracting officers have the authority to administer contracts, taking advice from auditors, lawyers, and technical experts.

Industry does not see the wisdom of separating this one auditing function from the contracting officer who otherwise is the final arbiter for the government on all contract matters. We believe this change could cause problems in the future.

Another issue that concerns industry today is DCAA's recent stridency in its application of regulations during the conduct of audits. Some in the industry have noticed a sharp upturn in DCAA's reluctance to engage in the discussion of audit issues when they arise through the performance of an audit.

The Federal Acquisition Regulation cost principles and other cost and price compliance regulations are relatively explicit but still cannot and do not cover every circumstance that may arise. Judgment often is necessary in applying the regulations to resolve issues.

Unfortunately, since 2008 and 2009, DCAA seems to have lost its appetite for analyzing of the intent of a regulation versus its literal interpretation.

Once DCAA it has applied the literal language, it seems little moved by any argument that the result reached is nonsensical or could not have been what the drafters intended.

This has confounded some in the contractor community who believe that the goal of the regulations and of government contracting generally is to reach correct and rational results.

I would like to end my statement with an idea for improving government contracting. Consider that an audit can have at least two perspectives and, Madam Chairman, you mentioned this in your comments earlier.

An audit can be forward looking where the intent is to identify steps to ensure that a contractor's system, policies, and procedures will comply with government contract requirements.

A contract audit also can be backward looking where its purpose is to test the contractor's actual compliance with the contract and regulatory requirements.

The first is affirmative, seeking to assure future compliance. The latter is more investigative and often associated with the concept of rooting out fraud, waste, and abuse.

Each one is important but the first could be referred to as the carrot, as the affirmative emphasis by the government and the contractor on getting things right up front; and the other, the stick.

Both will give a contractor incentive to be in compliance, as, Senator McCaskill, I believe you noted earlier. However, we believe the carrot is much more likely to achieve the goal.

And by analogy from the manufacturing sector, there is a saying that you cannot inspect your way to a quality product. It is a phrase that is often heard. The lesson from this is that quality needs to be built into a product up front.

Inspecting quality after the fact is far less effective, and I think that lessons from the manufacturing industry can provide some lessons for the auditing community.

Thank you again for inviting me to testify and I look forward to any questions you may have.

Senator McCASKILL. Thank you, Mr. Hoe. Mr. Schwellenbach.

TESTIMONY OF NICK SCHWELLENBACH,¹ DIRECTOR OF INVESTIGATIONS, PROJECT ON GOVERNMENT OVERSIGHT

Mr. SCHWELLENBACH. Chairman McCaskill, thank you for inviting me today to testify on ways to improve contract auditing including the possible benefits of an independent contract audit agency.

This hearing is an important step. We need an independent and muscular contract audit agency that protects the taxpayer. We believe that there should be an independent Federal Contract Audit Agency (FCAA).

This is not a new idea but has been around since at least the 1980s when DCAA whistle blower George Spanton exposed serious problems at DCAA. In 2009, the GAO laid out recommendations for congressional consideration.

This included, in the long term, possibly creating an FCAA. While some knowledgeable insiders tell us that the location of the agency is not a key issue, POGO believes an FCAA that conducts most contract auditing for the entire Federal Government makes

¹ The prepared statement of Mr. Schwellenbach appears in the appendix on page 105.

sense, and I believe the statistics that your staff prepared today I think bear that out to some extent.

While DOD contracts and contract proposals still represent the bulk of DCAA's work, the DCAA has evolved since its inception in 1965 to become a de facto FCAA.

There are several reasons why this happened. Contracting has greatly grown outside of the DOD. DCAA has deep institutional knowledge of contractors and utilizing the DCAA may be cheaper for organizations than hiring or training their own cadre of contract auditors.

DCAA provides a critical check on contractors. It helps insure that we pay reasonable prices and spots attempts by contractors to charge unallowable costs.

DCAA estimates that it saves slightly more than 5 dollars for 1 dollar invested in it. It is, however, horribly understaffed given its workload.

For example, during the early 1990s, it had more than 2,000 more employees than it currently does while there is a greater amount of contracting now.

Non-DOD agencies can request DCAA services if they are willing to pay. This is a disincentive to utilize DCAA. If adequately and centrally funded, an FCAA would remove this disincentive.

There are other possible benefits to an FCAA, the most significant being independence. Currently, the DCAA reports to the DOD Comptroller. Along with the GAO, we have some reservations whether this structure ensures adequate independence.

Furthermore, it is apparent to us that the DCAA Office of General Counsel is not independent. Its attorneys are evaluated by the Defense Legal Services Agency (DLSA).

A similar independence problem previously existed with the Pentagon IG; and in 2008, the IG Reform Act gave the Pentagon IG its own independent General Counsel. We think this has some relationship with the unwillingness of DCAA to issue subpoenas to contractors, and I can get into that later.

But in the meantime, we need to improve DCAA as much as possible, and we are concerned about its current direction. You only have to read the hundreds of comments posted on the government executive website by people claiming to work at DCAA to understand that some part of its workforce is deeply angry with its direction.

As I mentioned, DCAA has not issued a subpoena to a contractor in over two decades despite long-standing access to records problems they have faced from contractors. And we believe this is an indication that it is risk adverse.

We are also concerned with the tenfold increase in the proposal review threshold at DOD. You mentioned earlier, Madam Chairman, that pre-award audits are highly important, especially in negotiating better deals for the taxpayer.

Essentially, DOD has cut out DCAA from performing many of those pre-award audits. An audit often with the smaller contract proposals is where they find the biggest amount of questioned cost as a percentage of the proposal.

Without the help of DCAA auditors, contracting officers may not be armed with the knowledge they need to negotiate the best deal for the taxpayer.

We also understand that whistle blowers who testified before the full Committee in 2008 feel they have not received adequate and public recognition from agency leadership.

There is also a belief by some within the DCAA that there is not enough accountability for the deletion of audit findings or the gagging of a whistle blower. Bad managers must be held accountable, and DCAA's promotion process needs to emphasize merit.

And I will quickly conclude here.

Besides creating a FCAA, there are opportunities to strengthen contract auditing. DCAA should have its own general counsel. While the staffing increase of 500 auditors is a step in the right direction, they need, perhaps, a larger workforce.

DCAA needs more transparency. Little is known about what it does and we believe some reporting could be made public or to the Congress.

We would also like to see more transparency with how contracting officers handle DCAA recommendations. Often DCAA auditors find large amounts of questioned costs or unallowable costs; but at the end of the day, it is up to the contracting officer to actually sustain those findings.

Congress also needs to take a look at how the role of contract auditors has been systematically reduced over the last two decades, and I would also take a look at the complaint system at the DCAA. Is it working?

Contract auditors provide a great return on investment and save far more money than they cost. We believe an FCAA makes sense; but even if DCAA remains within DOD, it needs to be strong as possible.

And I am open to questioning.

Senator MCCASKILL. Thank you very much. Thank all three of you.

I think legitimate points have been raised by both Mr. Hoe and Mr. Schwellenbach. I see validity in some of the points you have made; and being fairly knowledgeable about the situation at DCAA, I do think that I understand why maybe some of the points that you are bringing up, Mr. Hoe, have surfaced.

Let me talk for a minute about your testimony, Mr. Hoe. It is very hard for me. I will expose my bias right now. I think that the independence of an auditor, by definition, does not produce warm and fuzzy relationships between auditors and those people who are being audited. The biggest lie that was ever told to me as we went into a state agency to audit was, gosh, we are glad to see you.

Mr. HOE. I have heard that, too.

Senator MCCASKILL. It is not a pleasant experience because human nature makes one feel very defensive when they are being audited. In fact, a lot of the good work that audits do gets lost because the auditee is too busy being defensive and is not in the right place to get the constructive criticism that comes inevitably with an audit.

I guess my problem with, let me talk about two things. The DCMA directive as it relates to DCAA. I mean is it not true that

the contracting officers have an ongoing relationship with the contractors that sometimes impact their ability to see everything clearly as it relates to some of the behavior of the contractors?

Mr. HOE. Senator McCaskill, In my experience, which goes back a number of decades now, it has been the rare circumstance, if I was even aware of a single circumstance, where I believe that the contracting officer was co-opted by the contractor with whom he was dealing as a contracting officer.

Senator MCCASKILL. I do not think you spent much time in Iraq then.

Mr. HOE. I have not spent time in Iraq.

Senator MCCASKILL. Clearly, it is the best example I can think of. Logistics Civil Augmentation Program (LOGCAP) by and large, there was a co-opting of the contracting officers. In fact, the contracting officers on the ground generally were just the low man on the totem pole that were handed a clipboard and had no training, had no capability of even asking a question like why in the world are we monogramming the towels in a cost-plus contract.

Those are the kinds of things that went on there. You understand that.

Mr. HOE. Oh, yes, I do, and I do understand that a large part of the analysis that explains Iraq was the need to get into the country quickly, to set up quickly, to provide contract services.

Senator MCCASKILL. I do not think that explains monogramming the towels, Mr. Hoe.

Mr. HOE. Excuse me.

Senator MCCASKILL. I do not think that explains monogramming the towels. That is not consistent with getting in there quickly. That is consistent with running up the price to maximize the amount of money the contractor was being paid, .

We could sit here all day. I mean I guess what I am saying is I do not want businesses to feel like they are being punished for doing business with the Federal Government.

But it is hard for me from where I sit in this Subcommittee and the work we have done to think that we are being so aggressive with our auditing that they believe that it is no longer a place they want to do business. I mean I guess I have to tell you it is hard for me to think that.

Mr. HOE. I do not think the solution to the problem that you state is necessarily to take away the authority that contracting officers have held for decades and decades, if not a century, in handling government contracts.

Contracting Officers, currently by law as well as by tradition, are the central clearinghouse, if you will, for all aspects of contracting and, of course, contracting involves not just cost accounting, billing, estimating, and so forth, it involves performance and full compliance with many other socio-economic provisions.

All of that currently filters through a single source, the contracting officer, and I think there is good reason for that. There may be, with further thought, some reason to separate out some portion of the audit function, but it would be a very unique circumstance and I think it would be an unfortunate assessment of what contracting officers are and what they do.

There are problems, there were problems, and probably currently exist problems, as you say, in Iraq and Afghanistan and some of those areas. I do not think that is representative of the entirety and history of Federal Government contracting.

Senator McCASKILL. I will not belabor the point. I think there is a fine line between cooperation and being co-opted, and I think independence, an auditor always has to err on the side of not being co-opted which means maybe a little less cooperation.

I am not sure that the contracting officers traditionally, particularly in the Department of Defense, have taken that. Their independence is not something that was front and center like it is with an auditor's.

So if we are talking about pricing information, I will look into what we talk about today and make sure I understand what has occurred and make sure it is lawful.

But I like the idea that auditors are telling contracting representatives what the prices should be in my book that is good news.

Mr. HOE. If I may, Madam Chairman, that assumes the questions related to audited costs or prices up front on the fixed-price contract are quite clear.

I do not think that is a true picture of the situation. There are many areas, as I mentioned in my opening statement, of regulations that state certain standards or principles for the allowability of a cost or the accounting for a cost that create a good bit of debate and discussion amongst the auditors, the contracting officers, and the contractors that goes on every day.

Often the outcome is not precisely what one party or another stated at the beginning. It is the result of a negotiation, and contracting officers hold the role of the party negotiating on behalf of the government.

They certainly do, and they are commanded by the Federal Acquisition Regulation to take input from their advisors, which include the auditors, the lawyers, the technical people.

That all ought to come through the contracting officer. It is the contracting officer who centralizes all those facts, all those considerations, and renders a final judgment.

If the view is to take a different tact going forward, I think it deserves some debate.

Senator McCASKILL. Some discussion.

Mr. HOE. Yes.

Senator McCASKILL. Fair enough.

Ms. Franzel, you talked about preventative controls. I think this is a huge point that needs to be made here. I think that accounting system reviews, invoice reviews, all of the things are incredibly important.

Do you think the right balance is being struck now between time being spent on those measures versus the time we spend on auditing?

Ms. FRANZEL. I think that we do need to evaluate this both from the contract management side of the house as well as the auditing side of the house because if contract management or contracting officers are not doing their job then a huge preventive mechanism is being lost.

There are also certain types of audits that have great value as a preventive mechanism. And rather than waiting for the detective mechanism, we have seen examples in agencies where because the final billing rates, indirect billing rates were never determined, the contractors were actually booking payables on their financial statements to the government because they knew they owed the government money and there is a backlog in these audits.

If this could have been handled properly up front, these types of problems would not be occurring.

But I want to emphasize that this is really on both sides of the house. The contracting officers need to do their jobs properly and implement the appropriate preventive controls over their responsibilities.

And then the audits, I think there is certainly room for taking a look at the different types of audits that are being conducted—where do we get the best bang for the buck?

It is not always going to be a one size fits all though. Some contractors are very risky for unique reasons, and for those contractors, it may be best to go in and do an after-the-fact audit to try to recover certain fraudulent charges.

So everybody needs to be working diligently on this but there is certainly benefit for those detective audits.

Senator MCCASKILL. I believe the number is \$55 billion in improper payments at the Department of Health and Human Services (HHS). Does that sound right?

Ms. FRANZEL. I think that is about right, yes. The government-wide total is \$125 billion, and I think HHS is a very large chunk of that.

Senator MCCASKILL. I will make one bold statement here. That would never happen in the private sector, ever, ever, ever happen in the private sector.

We would not let that money go out the door as we have without putting more preventative controls in place up front, and it is very hard to get the government's attention about improper payments because it is not like it impacts anybody's bottom line.

It does not impact profit margin. It does not impact their discussions with the bank. It does not impact anything of that.

So I think that we need to do more work in this Subcommittee about preventative measures as it relates to contracting. Maybe drill down even deeper as to what is being done in the various agencies and what is not being done, just through the lens of preventative measures before the money goes out the door because I think it is something that we have to focus on to the extent that we need to.

I know GAO has done some good work here but we have a lot more we need to be doing.

Mr. Schwellenbach, I understand, I like to say that in government we can grow when somebody has a good idea and gets enough votes.

Businesses cannot grow unless they have the revenue stream to pay for it; and if they do grow and their idea about growing does not work, they cut it.

So government is very inefficient when it relates to creating the programs. I am beyond reluctant, after looking at what happened

when we created Homeland Security and looking what happens whenever we create a new program.

We generally do not check to see if it is really duplicative. We generally do not check to see if there are any metrics, if the program is doing what is supposed to be doing very well. Job training is a great example.

Broadband deployment is another great example. We have two different agencies that are both ostensibly running broadband deployment programs, both Agriculture and Commerce.

I am really not excited about creating a new agency even if it is auditing. If there ever was going to be a subject matter I would want to create a new agency, it would be the auditing.

Why can we not make DCAA, why can we not just improve DCAA to be the main repository of auditors that agencies can go to when they need audit work done within the agencies?

Mr. SCHWELLENBACH. Madam Chairman, I think you are absolutely right. I think as GAO recognized in their 2009 report it is a risky suggestion. You could possibly make things worse. If you created a new agency, there could be a lot of up front costs.

Senator McCASKILL. And the wrong kind of competition.

Mr. SCHWELLENBACH. Absolutely.

So we do believe in a perfect world you would have an FCAA that is centrally funded, that removes the disincentive for non-DOD agencies to utilize its services.

We think obviously that would be the best of all worlds. Clearly, we have budget limitations. You yourself mentioned, we are probably entering some lean times. So why not make the system as it exists now work better, which is one thing I tried to address in my testimony.

I think there are a lot of more modest reforms such as giving the DCAA its own independent general counsel, another issue the GAO pointed out in its 2009 report. I think that could do a lot of good.

Senator McCASKILL. Like we did for the IGs?

Mr. SCHWELLENBACH. Yes, as we did for the IGs. I think that is a common sense solution. I do not think there would be much cost involved beyond what we are already paying.

There are also ways DCAA uses its workforce that perhaps need to be reviewed. I am not entirely convinced that only looking at large contract dollars is a risk-based approach.

For example, a lot of the smaller contracts involve nontraditional government contractors that may not have the internal control systems that are government-compliant in place.

So sometimes they are the riskier actors rather than the Boeings and Lockheeds of the world, not to say they have not done anything wrong which they clearly have in the past.

So I do think there are a lot of modest measures that need to be looked at. The subpoena, the lack of subpoenas over the last two decades I think is a major issue.

We know DCAA has problems with getting access to records. A few successful uses of the subpoena by DCAA could really shake up the contractor community and make them open up their books more often and reduce a lot of the issues with access to records and timeliness that currently exists.

Senator MCCASKILL. I think you are right about that. I think that we do need to begin to ask the question—has there never been an occasion that DCAA has not gotten the information it needed; and if there has been, what is the reason?

And we will propose that question for the record for Mr. Fitzgerald and his agency.

I recall vividly that it was, in fact, a lawyer at DOD who wrote the very offensive letter to the whistle blower basically telling the whistle blower that she was not allowed to speak. It was very un-American, the letter that was composed by the counsel at the Department of Defense as it related to what happened at DCAA.

Mr. SCHWELLENBACH. I would say that because that general counsel is not directly accountable to the Director of DCAA, it is more difficult to hold that general counsel accountable.

Senator MCCASKILL. Yes. We had a hard time. We have a hard time.

Let me ask. Are there any other barriers to businesses that you see, Mr. Hoe, that I need to make sure that we keep on the radar as it relates to auditing work?

Is there something we could be asking of our contractors that they do on their side of the equation that would prevent some of the less than productive interaction with the auditors?

Should we be requiring them to do more of the internal audits that then can be sampled and approved by auditors within the IG Departments of these various agencies?

Mr. HOE. Senator McCaskill, I think that is an excellent suggestion, and in fact, there are currently in place a number of programs designed to encourage, if not require, contractors to examine their own operations prior to a government auditor or investigator coming to the company to assess its systems or its performance.

The voluntary disclosure program was in existence for a number of years but is now replaced or supplanted with the mandatory disclosure requirement that is placed in new contracts and obligates contractors to come forward and disclose on their own certain acts that may rise to a certain level of malfeasance that encourages—

Senator MCCASKILL. Like looking at the competitor's fact sheet on the joint tanker competition?

Mr. HOE. Yes, very definitely.

Senator MCCASKILL. That would definitely be one.

Mr. HOE. I believe that would very definitely be one, and there are certainly others. I can say from my own experience that there are many contractors out there who, since the implementation of that program, have been raising questions with people like myself to understand what the requirements are and what kind of looking they need to do within their company, how extensive, what needs to be disclosed, and what does not rise to the level of disclosure.

It is having a substantial effect. I think, taking into account what is already in place, one would want to consider that before deciding whether there are additional affirmative steps that would be required by law or otherwise, for contractors to undertake themselves.

There are many incentives currently for contractors to look at their own systems and to make them compliant or try to make them as compliant as they can.

Senator MCCASKILL. I am sure, Ms. Franzel, you are familiar with the single audit and the way the decisions are made in terms of prioritization of audits that are done under the single audit.

And I guess, and I should have asked Mr. Fitzgerald this when he was testifying. It seems to me that the way in which States are told they must prioritize audit work for the Federal Government, that exercise would be fairly simple to implement within the Federal Government.

In other words, agencies deciding how many of their programs are what, in the single audit I think it is "A", "B" and "C" I think, is it not?

Ms. FRANZEL. "A" and "B".

Senator MCCASKILL. "A" and "B". We probably did a lot of "C"s where I was because I like doing some of the smaller programs. And "A" is the size of the program. "B" is those that are high risk for other reasons. And then if you wanted to do other programs, then it had to be in consultation and cooperation with the Federal Government signing off on it.

Do we have that kind of risk assessment going on in each agency so that in a very simple way DCAA could look at government-wide where are the big threshold programs?

But then on the other hand, where are these programs? I mean the example I like to use is weatherization under the American Recovery and Reinvestment Act (ARRA). That was a lot of money getting pumped into a program that had, up until that time, had very modest appropriations. A lot of labor involved, a lot of a shotgun-type approach across the country in how the money was used.

And even though it was not as large as say a Medicaid and Medicare program, the opportunity for lack of internal controls, the opportunity for a lot of money walking away with somebody's nephew in a pickup truck was real.

The other part of the question I want to ask is, Is anyone using the software programs that are out there right now that allow the integration of data point sets to really expose risks similar to what we did on ARRA where we contracted with a company to try to detect fraud by overlays of integrated data sets to show where there might be the most risk?

Ms. FRANZEL. Certainly. I do believe that the risk assessment function can be made better and bolstered, and I think it is being done inconsistently across agencies. So I think that is really the next big step in terms of looking at how contract audits are done and to what extent across the Federal Government.

And let me emphasize across the Federal Government because similar to the single audit for contracting, there is the cognizant agency concept. And so one contractor may actually be doing work for multiple agencies but one agency is the cognizant agency.

So what kind of communication and coordination is happening for all of the affected agencies? I think that is probably something else that can be improved and that can feed back into this risk assessment process.

And frankly if the agencies are coordinating, one would hope it would make it a little easier on the affected contractors.

So I think risk assessment is something that definitely needs to be looked at and probably improved as well as coordination across the government agencies.

Senator MCCASKILL. Is that something we could get the IG counsels to do, to do a better job of coordination of risk assessment across all agencies that would then be a document that could be a point of reference for DCAA when they get requests?

Ms. FRANZEL. Yes. That would certainly be one place. In fact, we were having this discussion at GAO, how would this coordination happen, perhaps it could be under OMB. It would have be some sort of centralized—

Senator MCCASKILL. Let us not go there.

Ms. FRANZEL [continuing]. That really it could be an IG. It could be the Council of Inspectors General on Integrity and Efficiency (CIGIE). So we do need some kind of centralized risk assessment function, I think, in coordination across agencies, and frankly, somebody or an entity to serve as technical expertise and consultation to the agencies because we have seen varying degrees of internal controls over the contracting function and the contracting officer's diligence to the preventive controls and other controls.

So there is just huge room for improvement here.

Your final question was about taking the data points that were used for the recovery monies, and I do believe that the recovery board is looking at how to get that out to agencies and use that going forward, but that is something where we need institutionalize in government going forward.

Senator MCCASKILL. Really. I have seen the software demonstrated. In fact, I believe they are using it with (SERP).

Ms. FRANZEL. It is very impressive.

Senator MCCASKILL. They are overlaying attacks versus population versus SERP money to make the assessment of whether not the SERP funds are truly getting at the cause that we want them to get at in terms of stabilizing different regions of Afghanistan.

I think that is something that we will continue to take a look at because I think technology that is available now, as long as we do not create a new agency to do this technology, if we could effectively and efficiently access the technology that is out there right now, I think we could save a lot of man-hours just by using data that is available and that can be digested, synthesized, and spit back out in a way that helps us manage risk.

I want to thank all of you today. I think we have some things to work on. I think this risk assessment government-wide is important, getting some consistency.

I think looking at some of the things we have talked about in terms of DCAA and making sure they have the independence they need if they are going to be the go-to contract agency and importantly looking at preventative measures going forward and making sure they are getting the emphasis they need so we are not trying to claw back but rather we are preventing up front.

So most Americans cannot even comprehend over \$100 billion in improper payments. That dog does not hunt. We have to figure how to get at that.

I appreciate everyone's time today, and we will continue to follow up with you because we will have a few more questions for the record.

Thank you very much.

This hearing is adjourned.

[Whereupon, at 4:28 p.m., the Subcommittee was adjourned.]

APPENDIX

Testimony of
Thomas P. Skelly
Director, Budget Service
U.S. Department of Education

Before the Subcommittee on Contracting Oversight
U.S. Senate Committee on Homeland Security and Governmental Affairs

Hearing on
“Improving Federal Contract Auditing”

February 1, 2011

Good afternoon, Chairman McCaskill, Ranking Member Brown, and distinguished Members of the Subcommittee. Thank you for the opportunity to appear before you today to discuss Federal contract auditing, and thank you for your leadership on this important issue.

My name is Tom Skelly, and I am the Director of the Budget Service for the U.S. Department of Education. Since 2008, I have also been delegated the authority to perform the functions and duties of the Chief Financial Officer (CFO). In this role, I lead the organization that provides accurate and timely accounting and financial management information, coordinates internal controls and audit follow-up, and manages contracts and acquisitions. I am proud to report that the Department’s financial statements have earned nine straight clean opinions and recognition for excellence in financial reporting from the Association of Government Accountants.

In the past, we have not had many opportunities to benefit from contract audits. In our April 2010, response to you, we identified only one external audit, and we expect only one this year. The primary reason for not having many contract audits is that most of our contracts are fixed-price, and government cost risk on that type of contract is relatively low. The Department also has many competing priorities for administrative funding. Therefore, even with cost-reimbursement contracts, we limit the use of contract audits to those situations that need a review of incurred costs, and to assist in closing out contracts.

Although the Department has one of the largest discretionary budgets, the Department also has the smallest workforce of any cabinet-level agency. Less than one percent of our annual funding is spent on administrative activities.

In fiscal year 2010, the Department had approximately 4,200 employees. This number represents a decrease of about 10 percent over the past decade, even as the workload has grown. For example, the enactment of the Ensuring Continued Access to Student Loans Act of 2008 and the Student Aid and Fiscal Responsibility Act of 2010 greatly expanded our student loan work. These loan programs and related increases in Pell Grant applications have been the main drivers of our increased work, but the Department also had a key role in the Recovery Act, through which innovative and competitive K-12 education reform efforts were expanded through such grants as Race to the Top and Investing in Innovation.

We have used contracts to perform much of the increased work involving student aid, and the dollar volume of contracts has increased. We spent approximately \$1.5 billion on contracts in fiscal year 2009 and \$1.8 billion in fiscal year 2010. Most of the increase was for student-aid processing and loan-servicing contracts. These contracts tend to require performance of high volumes of routine and similar tasks, like application processing, loan origination, and loan servicing and collection. We have contracted for these kinds of activities for three decades, and the work volume has grown dramatically in recent years.

In fiscal year 2010, only 21 percent of the contract dollars and 9 percent of the contract actions awarded by the Department were cost-reimbursement, and we are further reducing our reliance on cost-reimbursement contracts each fiscal year. Eight of the Department's top ten contracts (representing 96 percent of the spending on our largest contracts) are fixed-price. Examples of cost-reimbursement awards include contracts to analyze student achievement data from the National Assessment of Educational Progress (NAEP) and an ongoing contract with Reading Is Fundamental, Inc., to distribute inexpensive books to children and undertake other activities that promote reading and literacy.

The Department's Office of Inspector General (OIG) conducts independent audits, investigations, inspections, and other reviews of programs and operations. Part of this responsibility includes contract audits. In determining what to review, OIG considers internal risk assessments, Department requests, Congressional requests, and hotline information or other sources that contain allegations of concern.

As noted in last April's response to you about contract audits, in fiscal year 2009, OIG completed an incurred cost audit of a contract that the Department had entered into for the administration of part of the National Assessment of Educational Progress (NAEP). The purpose of the audit was to determine whether the costs incurred in fiscal year 2006 under the contract were reasonable, allowable, and allocable in accordance with the terms and conditions of the contract and applicable acquisition regulations. The approximate cost to the Department to perform this audit was \$255,123.

As a result of this audit, OIG recommended that: (1) the Department recoup unallowable costs paid to the contractor; and (2) then conduct a follow-up review of the costs not included in OIG's sample. The Department recouped \$229,723 from the contractor for the FY 2006 costs identified by OIG. In addition, the contractor disclosed during the audit that it had inappropriately billed the Department for post-retirement medical benefits during the period September 2002 through December 2007. The contractor returned to the Department \$2.7 million in April 2009 for these improper billings.

We considered several options for a follow-up audit. The OIG decided not to devote limited resources to a broader audit. The Department initiated a request to the Defense Contract Audit Agency (DCAA) for audit support to review the incurred costs not included in OIG's sample. To obtain this support, Department representatives worked with DCAA in 2010 to determine the scheduling and the cost for a follow-up audit, which was estimated to cost \$27,000. In September 2010, DCAA confirmed that the requested audit was not programmed in DCAA's schedule for fiscal year 2011. As a result, the Department contracted for audit support services. That contract includes performing the incurred cost audit, which will be conducted this year.

The Department faces challenges regarding contract audits in deciding whether they take priority over other demands for limited funds. The Department's OIG has multiple priorities, and DCAA cannot always accommodate non-DoD requests for audit support. Obtaining audit support from a non-governmental firm can be costly and time-consuming.

In conclusion, we support efforts to maximize the performance of contractors in delivering Department services. We rely on many contractors to get the work done. We believe that fixed-price contracts are the preferred option over cost-reimbursement contracts as they provide a better value to the tax payer.

Thank you, Madam Chairman and Members of the Subcommittee, for your attention to this important issue, and I would be happy to answer any questions.

TESTIMONY OF INGRID KOLB
DIRECTOR, OFFICE OF MANAGEMENT
U.S. DEPARTMENT OF ENERGY
BEFORE THE
SUBCOMMITTEE ON CONTRACTING OVERSIGHT
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
U.S. SENATE

FEBRUARY 1, 2011

Madam Chairman and Members of the Subcommittee, my name is Ingrid Kolb. I serve as the Director, Office of Management at the U.S. Department of Energy. I am pleased to be here today to discuss with you how the Department uses audit services to detect and prevent waste, fraud, and abuse in government contracts, to provide contracting officers reasonable assurance whether contractor submissions are free of material misstatement, and provide them assistance and advice in the establishment of fair and reasonable prices for products and services.

In fiscal years 2009 and 2010, the Department spent approximately \$32 billion and \$26 billion on contracts, respectively. The bulk of dollars in each year, about 80 percent, was spent under management and operating (M&O) contracts. These contracts are used to manage Department's laboratories and other government-owned or controlled facilities. The remaining portion was spent on non-management and operating contracts.

The Department's Office of Inspector General (OIG) is the auditor for management and operating contracts. In fiscal years 2009 and 2010, the Department spent approximately \$1.3 million (for 13 audits) and \$1.1 million (for 17 audits), respectively, for these OIG audits. The limited dollar amount for contract audits performed by the Department's OIG reflects the Department's Cooperative Audit Strategy, which incorporates the work of management and operating contractors' internal audit activities. The Department requires its management and operating contractors to maintain internal audit activities that perform operating and financial audits. The Department's OIG monitors the work of the contractors' internal auditors periodically to ensure their work can be relied on to the extent appropriate.

The Cooperative Audit Strategy (Strategy) was developed in 1992 by the Department's Contractor Internal Audit Council, OIG, Office of the Chief Financial Officer (CFO), and Office of Procurement and Assistance Management. The Strategy jointly leverages the resources of these organizations to maximize overall audit coverage of the Department's Management and Operating contractors. Individual roles under the Strategy are as follows: Internal Audit organizations are required to produce an annual risk-based Audit Plan and Audit Report, an allowable Cost Audit, and an audit of subcontractor costs. In all cost audits, auditors ensure adequate coverage and test items for allowability, meeting contractual limitations or ceilings and requirements to have Contracting Officer's prior approval. All questioned costs are reported to the appropriate Departmental Contracting Officer and are described in the annual Audit Report.

The M&O Contractor produces an annual Statement of Costs Incurred and Claimed (SCIC) that contains line items summarizing the amount of costs incurred and claimed by the contractor for reimbursement by the Department and that attests that costs incurred are allowable, contractor internal controls are adequate, and work of Internal Auditors meets standards and can be relied on.

DOE's OIG auditors conduct SCIC audits in which they review the quality of Internal Audit's work and whether the OIG can rely on that work, whether Internal Audit conducted or arranged for audits of its subcontractors when costs incurred were excessive and whether previously identified questioned costs and internal control weaknesses that impacted allowable costs have been adequately resolved.

The DOE CFO provides expert guidance on the adequacy of the contractor's financial management system and approves plans for new financial management systems or system upgrades.

The DOE Office of Procurement and Assistance Management provides guidance on the Strategy and audit-related contract clauses for inclusion in contracts.

In the summer of 2009, the DOE OIG published two reports evaluating the effectiveness of the Cooperative Strategy—one covering seven NNSA M&O Contractors and the other covering 17 non-NNSA M&O Contractors. The reports found that the contractors had,

for the most part, effectively implemented the requirements, and as a whole, the Strategy was meeting its overall goal of improving accountability in the Department. In both reports, the OIG made suggestions for improvements and stated that it will monitor the contractors' compliance with the requirements of the Strategy in future assessments.

The Defense Contract Audit Agency (DCAA) has traditionally been the primary auditor for non-management and operating contracts. In fiscal years 2009 and 2010, the Department spent approximately \$9.8 million (for 376 audits of varying types) and \$9.4 million (for 273 audits of varying types), respectively, on contract audits performed by DCAA. The Department typically obtains the following pre-award and post award audit services from DCAA: financial condition/capability reviews; accounting system surveys; forward pricing proposal audits; incurred cost audits; management systems reviews; internal control reviews; cost accounting standards compliance reviews; equitable adjustment proposal reviews; termination settlement reviews; and progress payments reviews. The majority of services are for incurred cost audits. DCAA has provided excellent service in the past and remains our primary source of audit service for non-M&O contracts. DCAA has had challenges with an increasing workload and fewer resources which have caused us some concerns in the past several years. The Department's ability to obtain cost-incurred audits was diminished and, for some DOE procurement sites, caused a backlog of contract closeouts. Other DCAA audit support such as that relating to forward pricing proposals has also declined, which has impacted the Department's ability to negotiate fair and reasonable prices in a timely fashion. In early January of this year, due to shared concerns over the Agency's capacity to meet

expected demand for audit services, senior officials of the Department, along with those of three other civilian agencies, met with the Defense Contract Audit Agency director to explore ways to utilize the Agency's services more efficiently. The meeting was productive, and future meetings are planned to help streamline the ordering process and better identify the products we are seeking as well as to better understand the capabilities of DCAA to support our needs. I believe ongoing dialogue with DCAA will go a long way towards allowing us to maximize its capabilities while identifying service gaps that can be met through other measures.

In response to the increased workload associated with the American Reinvestment and Recovery Act (the Act) and the corresponding expected increase in demand for DCAA audit services around the Government, the Department conducted a competitive procurement to obtain supplemental contract audit services. A private sector accounting firm was awarded the contract in May, 2010, to provide audit services related primarily to financial assistance awards under the Act. The contract also provides for full contract audit services. To date, the contractor's performance has been timely and satisfactory, and we expect to increase our use of contract audit services.

I would like to note, however, that the services provided by DCAA and the audit contractor are not "apples to apples." DCAA generally strives to provide a complete audit, whereas we have been using the audit contractor primarily to provide contract-specific information to Contracting Officers to assure they can make timely, sound

business decisions. The quality of services provided by both DCAA and the contractor has been high, however, the range of services provided by DCAA is much broader. We intend to utilize our audit contractor where necessary to help our Contracting Officers receive the information necessary for them to make sound business decisions. This has generally been on the less complex actions; however we may ultimately use audit contractors for more complex reviews.

The Department of Energy will continue to use DCAA's audit service. At the same time, however, the use of an audit contractor has proven very successful, and we expect that such auxiliary private sector support will continue to be yet another effective "tool" for accomplishing our acquisition function.

The Department does not see a need for the creation of a Federal Contract Audit Agency. The challenges we have recently faced in obtaining contract audits from DCAA appear to reflect a diminished capacity at DCAA, not an inherent weakness in the Federal contract audit construct. As long as increased capacity is added at DCAA to serve our needs, we don't see a real benefit that would justify the cost of creating a new entity.

Again, thank you for this opportunity to testify before the Subcommittee. This completes my prepared statement. I would be happy to answer any questions you may have.

STATEMENT OF HON. BRIAN D. MILLER
INSPECTOR GENERAL, GENERAL SERVICES ADMINISTRATION
BEFORE SENATE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS, AD HOC SUBCOMMITTEE ON CONTRACTING
OVERSIGHT



FEBRUARY 1, 2011

Madame Chair, Ranking Member Brown, and distinguished members, I want to thank you for the opportunity to testify on the importance of contract audits in detecting and preventing fraud, waste, and abuse in government contracts. I also want to express my thanks for your continued support of Inspectors General and for the Subcommittee's strong commitment to oversight.

The Office of Inspector General (OIG), General Services Administration (GSA), relies heavily on its auditing function to fulfill its mission to detect and prevent fraud, waste, and abuse in federal contracts.

The OIG identifies and prevents a significant amount of procurement-related misconduct. Additionally, the OIG has expanded collaboration and increased cross-agency efforts to reduce fraud, waste, and abuse in contracting through its involvement with the former National Procurement Fraud Task Force and the Attorney General's current, comprehensive Financial Fraud Enforcement Task Force.

I will outline the OIG's major contract audit functions and results as well as some current contract oversight challenges.

I. Scope of Contract Audit Work

GSA is the Federal Government's primary acquisition agency. It was created to centralize the procurement of commonly used goods and services for the Government. GSA leverages about \$66 billion of procurement annually, and also contributes to the management of about \$500 billion in U.S. Federal property. GSA is home to the largest interagency contracting program in the Federal Government, the Multiple Award Schedules (MAS). In fiscal year (FY) 2010 sales for this program were \$38.9 billion with 18,396 contracts. In addition, GSA received \$5.5 billion in American Recovery and Reinvestment Act (ARRA) funds for public building construction projects.

Because of the volume of GSA's acquisition buying power, GSA's OIG plays a crucial oversight role in detecting and preventing fraud, waste, and abuse.

A. Four Main Types of Contract Audit Work

One of the OIG's most important oversight mechanisms for scrutinizing procurement is contract auditing. We define contract auditing as the examination of the books and records of a company doing business with GSA. We have approximately 140 auditors and analysts performing audits and reviews. The Office of Audits devotes between 50 and 60 percent of its direct audit hours specifically to contract reviews.

We perform several different types of contract audit work. These include pre-award and post-award MAS reviews, claim audits, and providing assistance to the Department of Justice (DOJ) on False Claims Act cases.

We conduct pre-award reviews before a contract is awarded, and post-award reviews after a contract is awarded. The OIG devotes most of its contract audit time to conducting pre-award MAS reviews, which are used to provide information to GSA contracting officers for use in contract negotiations. By providing information on the proposal, such as whether the information provided by the contractor is current, accurate, and complete, we enable the contracting officer to negotiate better terms. However, the information we provide is solely for the contracting officer to use as he/she sees fit and is not in any way binding.

We also perform audits after the MAS contract is awarded (post award reviews) to verify that the vendors have complied with their contractual obligations. These audits determine if the MAS vendors have billed their GSA customers in accordance with the pricing, terms, and conditions of the contract. Again, however, we provide recommendations to the agency, which then decides whether or not to implement those recommendations. Both types of reviews can find significant irregularities that could indicate fraud. As appropriate, we refer these to OIG investigations and/or the DOJ.

The OIG provides significant audit assistance to the DOJ on False Claims Act cases. The False Claims Act provides for liability for triple damages and a penalty per claim for anyone who knowingly submits or causes the submission of a false or fraudulent claim to the Federal Government. The Act allows for a private citizen, known as a "relator," to bring a lawsuit on behalf of the United States, where the citizen has information that the named defendant has knowingly submitted or caused the submission of false or fraudulent claims to the United States. These are referred to as "*qui tam*" cases. While some cases in which we are involved are based solely on *qui tams*, many others involve issues that we identified and referred to DOJ during our pre- and post-award reviews.

A claim audit is an examination relative to the contractor's assertion of monetary damages resulting from alleged Government-caused delays and disruptions. The purpose of the audit is to evaluate the quantum (amount of monetary adjustment) and to determine if the claimed costs are allowable, allocable, and reasonable, supported by accurate and complete information, and

in accordance with the contract provisions and cost principles set forth in the Federal Acquisition Regulations (FAR). The majority of claims result from construction, and we anticipate a substantial volume of work in ARRA construction claims.

B. Additional OIG Audit Functions

Another main audit function of the OIG is internal auditing, defined as reviewing the various programs and processes within GSA. To complement our audits, we have established an Office of Forensic Auditing to detect procurement fraud. Forensic auditing utilizes audit, investigative, legal, and technical skill sets to collect, analyze, and evaluate evidentiary material concerning potential fraud. We have identified and referred for investigation several individuals for potential crimes such as wire fraud, theft, and misrepresentation.

II. Effectiveness and Success

The OIG has employed contract audits to great success. Over the last two years, the OIG has conducted reviews of 200 contracts that have estimated values of nearly \$25 billion. Our preaward reviews and claims have identified \$1.1 billion in potential cost avoidances and our post-award reviews have identified \$33 million in questioned costs. Based in large part on our contract audit work, twenty three False Claims Act cases have been settled during the last two years for a total of over \$400 million.

Audits and reviews of federal contracts can be long and very complex; some take years along with perseverance and extensive resources to complete. The results we have achieved are a testament to the expertise, skill, and capability of our auditors and the OIG. Recent False Claims Act settlements illustrate that our work is vital to the integrity of the contracting process and the economy of the acquisition programs. Below are some examples of recent, noteworthy results that were based in large part on our audit efforts.

- Our review of EMC, a large information technology vendor with MAS volume of \$100 million per year, led to an \$87.5 million settlement. Our audit found that EMC had not made full disclosure of its commercial pricing practices to GSA, was not offering GSA pricing comparable to its best commercial customers, and was not complying with its GSA MAS contract requirements. For example, EMC was supposed to conduct a price comparison to ensure that the government received the lowest price provided to any of the company's commercial customers making a comparable purchase for each government order under the contract. However, our auditors found that EMC knew that it was not capable of conducting such a comparison, and so EMC's representations during the negotiations – as well as its subsequent representations to GSA that it was conducting the comparisons – were false. Agency contracting officials supported the preaward review position, and did not renew EMC's MAS contract. In addition to our review results, which we referred to the DOJ, a *qui tam* was filed alleging that information technology vendors such as EMC were engaged in an illegal kickback scheme designed to influence the government to purchase specific company's products. We provided substantial support and resources to the DOJ in pursuing this case.

- In 2004, Hewlett Packard (HP), a large MAS information technology vendor, was named in a *qui tam*. Subsequently, in 2007, HP notified GSA and the DOJ that it was not in compliance with the price reduction clause and other contract requirements. It offered to pay GSA less than \$2 million to settle the issue. Our auditors reviewed the information provided by HP, including the commercial discounting disclosures made by HP prior to the award of its GSA contract, and found these disclosures were inaccurate and resulted in the government customers paying more for HP products than they would have had HP disclosed accurate information. Our analysis of the data showed the damages to the Government were considerably more than the \$2 million calculated by HP. We worked closely with the DOJ, and the company and the Government reached a \$55 million settlement.
- An audit of another MAS contractor, Comstor (a.k.a. Westcon), identified that this vendor had a business arrangement with another company (Cisco) to sell Cisco's goods. Cisco, a large information technology company, did not sell its products directly to the Government under its own MAS contract. Instead, Cisco sold to GSA through a third party distributor, Comstor. As part of this arrangement, both Cisco and Comstor were required to disclose discounting information to GSA. Our auditors found that Cisco and Comstor knowingly provided incomplete information to GSA contracting officers during negotiations in regard to Comstor's contract with GSA, which resulted in defective pricing of Cisco products and submission of false claims to the United States. We referred this matter to the DOJ, and the company agreed to pay the government \$48 million to resolve these contract fraud allegations.
- Audits of Fastenal, a national hardware store distributor, identified significant contract compliance issues, including with the accuracy of commercial sales practices and the price reduction clause. We worked closely with the DOJ to pursue our findings, and Fastenal agreed to pay \$6.25 million to resolve allegations that it (1) did not provide current, accurate and complete information about its commercial sales practices, including discounts afforded to other customers during negotiations and (2) failed to comply with the price reduction clause of its contract, when it overcharged Government customers and improperly assessed delivery and sales tax charges on Government sales.
- We also have identified a growing concern regarding the use of unqualified labor on MAS contracts. We find that once the qualifications for labor categories have been established the contractor does not always follow these requirements. In a recent audit of ManTech Advanced Systems International we found that the vendor billed a person as a scientist that required a bachelor's degree plus two years of experience or a high school degree with four years of experience. While the person had a bachelor's degree, his experience did not appear relevant to the position of scientist, in that the company counted work at a department store and a grocery store as experience. ManTech has already provided refunds/credits to the government in the amount of \$285,000. Our work in this area is on-going.

- The largest contract fraud settlement in which we have been involved is NetApp for \$128 million. NetApp is a computer storage and data management solutions company that had MAS contracts to sell hardware, software, and storage management services. Based on a *qui tam*, we conducted extensive audit work to assist the DOJ. Our audit work contributed significantly to the settlement, which resolved allegations that NetApp knowingly failed to provide GSA with current, accurate and complete information about its commercial sales practices, including discounts offered to other customers, and that it knowingly made false statements to GSA about its sales practices and discounts. The settlement also resolved allegations that NetApp knowingly failed to comply with the price reduction clauses by failing to pass on to the Government greater discounts that it gave to its commercial customers.
- A final example illustrates the results we have achieved in the construction area and demonstrates how long a case may take. Morse Diesel International, Inc. (a.k.a. MDI, AMEC), started as an audit of a \$2.5 million change order proposal for the removal of hazardous waste at the St. Louis Courthouse in 1995. While reviewing the bond cost for the change order, our auditors were provided with a bond invoice that did not match the invoice that was included in the GSA contract file. The key fraud issue was that the GSA contracting officer would not approve payment of the bond without proof of payment and MDI submitted a "paid" invoice that indicated the bond was paid months before the invoice was actually dated. The auditors verified that the invoice was not paid as of the date shown on the invoice that MDI provided to the contracting officer and that the submitted "paid" invoice was false. We also reviewed other MDI contracts and discovered similar issues with the San Francisco Customs House and Sacramento Courthouse. During the following four years, several additional audits of MDI claims, change orders, and payments (over \$25 million in value) uncovered other illegal acts on all three of these projects. The case resulted in two criminal convictions - one in 2000, in St. Louis for a false statement where the company paid a \$500,000 fine and one in 2001, in Sacramento for major fraud against the Government where the company paid a \$689,000 fine. The DOJ became involved in 1999 and we worked on the case until final settlement in 2009. In total there were recoveries, avoidances, and forfeitures of \$113.1 million.

III. Ensuring Quality in the Contract Auditing Process

The above examples attest to the quality of OIG audit efforts. The efficiency of the GSA OIG was recognized by the Government Accountability Office (GAO) when it reported a dollar return of \$19.33¹ for every dollar invested in the GSA OIG. We also have developed substantial expertise in the areas we audit, both through formal and on-the-job training, and we continually work to expand and reinforce that training. We also continually seek improvement and adjust as circumstances change, such as the passage of ARRA. Regular peer reviews reinforce compliance with applicable standards. Put simply, we are proud of the work we do.

¹ Appendix 1. Government Accountability Office, *Inspectors General: Actions Needed to Improve Audit Coverage of NASA 33-35* (GAO 09-88, December 2008).

We are also aware that, to be effective, we must protect our independence. We understand that a perceived lack of auditor independence at certain other agencies has prompted a suggestion for the creation of a new Federal Contract Audit Agency. At the outset, we firmly believe that the GSA OIG is the only audit entity needed at GSA. We also believe that developing and strengthening the audit divisions of the cognizant Offices of Inspector General (OIGs) would provide a better solution. OIGs are already familiar with each agency's subject matter and would be in a better position to become familiar with the distinctive characteristics of the contracts of each agency and develop the requisite expertise in each agency's contracts. Furthermore, the OIGs already have an existing and independent framework and structure within which to perform this work.

IV. A Current Contract Oversight Challenge

Obtaining prompt access to contractor records is essential for audits to perform contract reviews. However, the OIG has on occasion encountered difficulties in obtaining prompt and complete access to contractor records, needlessly delaying audit work.

Contractors in several cases have refused to disclose requested records during pre-award reviews, citing various regulatory clauses and asserting that they are not legally obligated to disclose the requested information. Currently we conduct pre-award reviews under the auspices of the contracting officer. If the contracting officer does not fully support the OIG's efforts, the contractor has an incentive to delay and try to obtain a contract before the OIG review can be completed.

Auditors, acting under the authority of the audit clause in the contract, have spent inordinate amounts of time trying to obtain contractor records. These delays can continue throughout an audit. Although auditors eventually obtain the requested documents by repeated requests and perseverance, the initial lack of cooperation and transparency causes significant delays and costs taxpayers money in additional administrative costs. Short of issuing a subpoena for the records, with the attendant paperwork and delay that could cause, we believe that legislation that specifically stated the OIG had access to those records would provide leverage we could use to more efficiently obtain these records.

Such barriers to information rightly owed to OIGs can hijack what has proven to be an effective contract oversight mechanism to the detriment of the Federal Government and the American Taxpayer.

V. Recommendation

We propose a legislative remedy to this challenge. Adopting clear, statutory language allowing OIGs to obtain contractor records would provide an effective tool for us in our contract audits.

The American Recovery and Reinvestment Act of 2009, Pub. L. 111-5 (Recovery Act), grants OIGs authority to examine records on contracts and grants awarded using Recovery Act funds. This provision in the Recovery Act eliminates any doubt about the OIGs' authority to review records.

I suggest expanding and extending this provision through an amendment to the Inspector General Act as follows:

Section 6 of the Inspector General Act, 5 U.S.C. App. 3, is amended—

By adding at the end of subsection (a) the following:

(10) Whenever in the judgment of the Inspector General it is necessary in the performance of the functions assigned by this Act, (a) to examine any records of any contractor or grantee, and of its subcontractors or subgrantees, or any State or local agency administering a contract, that pertain to, or involve transactions relating to, the contract, subcontract, grant, or subgrant.

Appendix 1: Government Accountability Office, *Inspectors General: Actions Needed to Improve Audit Coverage of NASA 33-35* (GAO 09-88, December 2008).

Appendix I: Monetary Accomplishments Reported in OIGs' Semiannual Reports to the Congress for Fiscal Year 2007

Federal agency	IG total budgetary resources	Monetary accomplishments	Dollar return on IG's budget ^a
1 Social Security Administration	\$92,000,000	\$4,802,207,264	\$52.20
2 General Services Administration	58,000,000	1,121,385,515	19.33
3 Department of Transportation	71,000,000	1,086,688,396	15.31
4 Department of Education	50,000,000	639,389,462	12.79
5 Department of Health and Human Services	285,000,000 ^b	3,537,923,000	12.41
6 Department of Housing and Urban Development	121,000,000	1,347,799,879	11.14
7 Office of Personnel Management	19,000,000	188,856,301	9.94
8 Department of Defense	221,000,000	2,083,836,000	9.43
9 Department of Veterans Affairs	74,000,000	670,200,000	9.06
10 Department of Justice	89,000,000	754,357,601	8.48
11 Department of Labor	73,000,000	561,849,158	7.70
12 Small Business Administration	21,000,000	130,177,723	6.20
13 Federal Deposit Insurance Corporation	26,000,000	116,280,993	4.47
14 Agency for International Development	51,000,000	193,342,475	3.79
15 Department of the Interior	43,000,000	142,527,564	3.31
16 Department of Energy	42,000,000	99,409,187	2.37
17 Department of Commerce	23,000,000	51,736,992	2.25
18 Department of the Treasury	19,000,000	40,257,085	2.12
19 Environmental	54,000,000	92,792,457	1.72

	Protection Agency			
20	Corporation for National and Community Service	7,000,000	11,974,636	1.71
21	Department of State	34,000,000	52,500,036	1.54
22	Tennessee Valley Authority (TVA)	16,000,000 ^c	15,854,105	0.99
23	Department of Agriculture	91,000,000	81,412,378	0.89
24	Department of Homeland Security	128,000,000	100,916,585	0.79
25	Railroad Retirement Board	7,000,000	5,179,515	0.74
26	Treasury Inspector General for Tax Administration	135,000,000	54,902,108	0.41
27	National Aeronautics and Space Administration	34,000,000	12,103,809	0.36
28	Nuclear Regulatory Commission	10,000,000	495,065	0.05
29	Export-Import Bank of the United States	2,000,000	na ^d	na ^d
30	Central Intelligence Agency	na ^d	na ^d	na ^d
Total		\$1,896,000,000	\$17,996,355,289	\$9.49

Testimony
of
Patrick J. Fitzgerald
Director, Defense Contract Audit Agency
before the
Subcommittee on Contracting Oversight
Senate Committee on Homeland Security and Governmental Affairs
on
Improving Federal Contract Auditing
February 1, 2011

Chairman McCaskill, Senator Brown, and members of the Subcommittee, thank you for the opportunity to appear before you today. I am pleased to provide you with an overview of DCAA's contract audit mission and responsibilities. I will also discuss the role DCAA plays in performing contract audits for agencies other than the Department of Defense.

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 the necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting, thereby protecting the taxpayer's interest. Our charter was intentionally developed to permit DCAA to provide these same contract audit services to other Federal agencies.

To carry out its mission, DCAA has about 4,725 employees and 114 field audit offices around the world. More than 85 percent of DCAA's personnel are auditors. And of those auditors, 29 percent hold advanced degrees and 28 percent are Certified Public Accountants (CPAs). In FY 2010, DCAA performed over 11,700 audits covering \$228 billion in proposed or claimed contractor costs. These reviews recommended reductions in proposed or billed costs of \$13.7 billion (referred to as questioned costs); and \$20.2 billion in estimated costs for which the contractor did not provide sufficient information to explain the basis of the estimated amounts (referred to as unsupported costs). In any one year, DCAA audits between 8,000 and 9,000 different contractors.

DCAA Contract Audit Effort

To support the Secretary of Defense's initiatives 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 and contract management organizations; they work closely with DCAA throughout the contracting process.

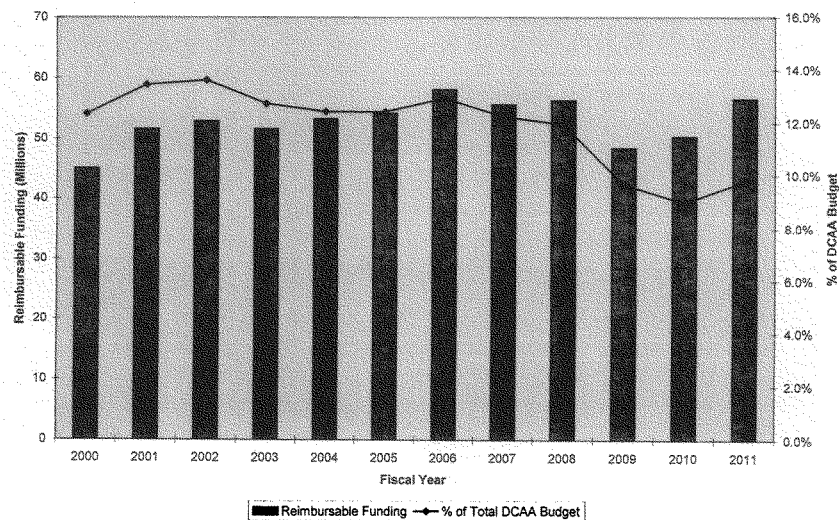
The type and extent of DCAA audit work varies based on the type of contracts awarded. DCAA typically performs audits of contractors' bid proposals when cost data is provided and contracting officials determine the need for audit services. These audits are performed prior to contract award in accordance with the Federal Acquisition Regulation for both fixed-price and cost-reimbursable contracts to assist the contracting officer in negotiating a fair and reasonable price. DCAA audit services are generally limited to those procurements under Federal Acquisition Regulation Part 15 (Contracting by Negotiation). During FY 2010, DCAA conducted 4,380 audits of contractor proposals covering \$182 billion and reported cost questioned of about \$12.2 billion. Of the 4,380 proposal audits, 390 were conducted for civilian agencies and these reviews resulted in exceptions of more than \$870 million. After contract award, audit effort is concentrated on cost-reimbursable and time-and-material contracts. These types of contracts pose an increased risk of overspending, often with little incentive for the contractor to control costs. As a result, there is continual audit effort on these contract types from award to final closeout and payment. This effort is concentrated on audits of contractor business systems, provisional payments; and annual testing of contract costs for compliance with contract terms.

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.

DCAA Effort at Civilian Agencies

DCAA has performed contract audits for civilian agencies since its inception in 1965. The type and scope of DCAA's efforts at civilian agencies are very similar to the audits we perform for the Department of Defense. Over the last several years, the percent of DCAA's total budget devoted to reimbursable work has ranged from 9 to 13 percent and the total reimbursable funding has ranged from \$45 to \$58 million.

DCAA Reimbursable Funding



In an average year, DCAA provides audit services to more than 30 civilian agencies. However, DCAA's reimbursable effort is heavily weighted toward just a few civilian agencies. A breakdown of DCAA's FY 2010 reimbursable effort is shown below:

Reimbursable Organization	Percent of Total DCAA Reimbursable Effort
NASA	33.0%
Department of Energy	19.1%
Foreign Military Sales	14.4%
Department of Health and Human Services	8.2%
Department of Homeland Security	5.0%
Department of State	4.6%
Remaining Civilian Agencies	15.7%

When performing contract audits, DCAA provides the same professional services to civilian agencies as it does to the DoD acquisition community. The current reimbursable rate DCAA charges civilian agencies is \$113.84 per hour.

DCAA audit services for civilian agencies can be grouped into two general categories. The first are requests pertaining to contractors where DCAA has a continuing presence. The second are audit requests for contractors not currently being audited by DCAA.

Audits at Contractors with a Continuing DCAA Presence. DCAA normally performs all contract audit services at contractors where DCAA maintains an active presence. This usually means the contractor has an active DoD contract. In FY 2010 nearly 90 percent of the contractors we audited were engaged in some type of DoD work. Using DCAA for contract audit services at these locations is a cost effective use of Government resources and provides assurance that a comprehensive audit is accomplished.

Audits at Contractors without a Continuing DCAA Presence. Audit requests at contractors without a continuing DCAA presence are handled on a case-by-case basis. The following criteria are used in determining whether to accommodate or decline the audit request:

- Is the requested service compatible with DCAA's contract audit services?
- Would the acceptance or refusal to perform the work result in duplicative audit activity?
- Can the work be performed within Agency resources?

During the past year, DCAA has developed a risk-based approach to performing contract audits. This approach has allowed DCAA to focus on the highest-risk areas with the biggest payback to the U.S. taxpayer. DCAA uses this risk-based approach when performing reimbursable audit effort. In general, this has meant DCAA has expended more resources in the forward pricing area (audits of contractor proposals) at the expense of resources devoted to the incurred cost area.

In addition, recent changes to the way DCAA performs audits means we are performing more comprehensive, high-quality audits, which include additional transaction testing and ensuring our audits comply with Generally Accepted Government Auditing Standards (GAGAS). While these changes have resulted in audits that take longer to complete, we believe the changes have resulted in an increase in audit quality. The additional audit procedures ensure the acquisition community is getting the best possible product. DCAA has applied these same changes to the way we perform reimbursable audits.

Recommendations to Strengthen Civilian Contract Audits

Over the past several months, the Department of Defense has taken steps to implement several initiatives that have improved contracting processes and related contract oversight. It is my opinion that the implementation of similar initiatives on a broader Federal level would provide similar benefits as discussed further below.

Contractor Business Systems. Business systems and related internal controls are an essential part of any organization and are vital to protecting the Government's interest and preventing contractor overpayments. DCAA generally provides the contract audit oversight of contractor business systems to assist the contracting officers as they negotiate and administer contracts. The Department has committed to improve DoD's oversight of contractor business systems and published proposed business system rules on January 15, 2010, and again on December 3, 2010, in the Defense Federal Acquisition Regulations Supplement (DFARS). The proposed rules define and establish criteria for each contractor business system and implement compliance mechanisms (specifically percentage withholds) when deficiencies are discovered. We are encouraged that the proposed rules will increase transparency by providing Defense contractors a clear understanding of what is required of them, while also improving the audit and administrative oversight activities. We believe that similar rules, if implemented to apply to all reimbursable Government contracts, would provide similar improvements beyond DoD.

Process for Adjudicating Audit Findings. Recognizing the importance of the DCAA's mission and the audit services provided for the benefit of the taxpayer, I believe that audit findings should receive full consideration during the contract negotiation process. One of my first actions as Director of DCAA was to engage with the Director, Defense Procurement and Acquisition Policy, to formulate a DoD process that ensures the taxpayer receives the full benefit of DCAA's audit services. On December 4, 2009, DoD issued a detailed adjudication policy. This provides a process for DCAA to elevate differences of opinion on contract audit matters when the contracting officer responsible for dispositioning DCAA audit findings and recommendations does not agree with the audit findings and/or recommendations. In addition, subsequent to the issuance of the DoD adjudication policy, Mr. Charlie Williams, Director,

Defense Contract Management Agency (DCMA), and I have committed our Agencies to aggressively target contractual opportunities to recover millions of taxpayer dollars by dispositioning outstanding audit findings. I believe that if a formalized adjudication policy existed for all Government contract audits, similar taxpayer benefits could be achieved.

Risk-Based Audit Requirement Approach. Another way to strengthen audit coverage across the Federal Government is to have a risk-based audit approach identifying the high-risk contract actions requiring audit resources. During the past several months, my staff has been working with Defense Procurement and Acquisition Policy to revisit the Department's reliance on DCAA audits to ensure that those audits are focused on the areas of the greatest risk to the Department, the warfighter and the taxpayer. DCAA audit requirements have grown significantly over the past several years. This has created a need to reassess the DCAA audit workload and priorities with the Department to ensure that the level of risk justifies the need for an audit as opposed to a lesser service (for example, cost/price analysis). One such example relates to the thresholds for seeking DCAA audits of contractor forward pricing proposals to provide goods and/or services to the Department. The Department's analysis revealed that the DoD threshold for requiring a DCAA audit was significantly lower than necessary, resulting in the ineffective use of DoD and DCAA audit resources. As a result, Sub-section 215.404-2(c) of the Defense Federal Acquisition Regulation's Procedures, Guidance, and Information was revised on September 17, 2010. It increased the audit thresholds for negotiated contracts to \$10 million for fixed-price contracts and \$100 million for cost-reimbursable contracts, commensurate with the associated risk. For the proposals under the revised thresholds, DCMA will provide cost- and price-analysis services to assist the contracting officer achieve fair and reasonable contract pricing. These revisions help the Department to ensure that DCAA focuses

its scarce audit resources on those areas of greatest risk. Again, I believe that these same initiatives should be considered by other Departments. Appropriate thresholds for audits should be established based on risks, to ensure that scarce audit resources are applied to those areas which pose the greatest risk to the taxpayer.

Finally, I know that the hearing today will examine the issue of creating a new Federal Contract Audit Agency. I do believe that DCAA, as it is currently positioned in the Department of Defense, does have sufficient organizational independence to perform high quality audits to accomplish its mission. In addition, the Department has taken steps to ensure DCAA's audit findings are given full consideration during negotiations through a formal adjudication process. And I would be remiss if I did not acknowledge the enormous support provided by the Comptroller's office over the last year. This support included a significant increase in DCAA resources (about 500 additional auditors over the past 2 years) and Department support for the many quality initiatives undertaken by DCAA.

Closing

In closing, I would like to say that civilian agencies are an important part of DCAA's contract audit effort. Let me assure you that we are committed to providing civilian agencies with high-quality audits that protect the interests of the American taxpayer. Over the past year, DCAA has implemented many initiatives to improve the quality of our audits and improve the work environment for our talented workforce. In response to the several external reviews, DCAA has made significant cultural changes such as issuing a new strategic plan and improving strategic communications both within the agency and with our external stakeholders. To assist in developing our workforce, we are overhauling our training programs as well as making changes to our hiring and promotion policies. In addition, DCAA has also issued several audit policy

changes to facilitate the performance of high quality audits. In summary, we have changed the way DCAA does audits by using a more collaborative and comprehensive approach to contract auditing. As we go forward, we intend to work towards achieving a proper balance between DCAA resources and the workload to enable us to address the growing incurred cost backlog, while continuing to improve the performance of quality audits.

I appreciate the opportunity to testify before you today and I will be glad to respond to your questions.

United States Government Accountability Office

GAO

Testimony before the Subcommittee on
Contracting Oversight, Committee on
Homeland Security and Governmental
Affairs, U.S. Senate

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CONTRACT AUDITS

Role in Helping Ensure Effective Oversight and Reducing Improper Payments

Statement of Jeanette M. Franzel
Managing Director

Accompanied by Gayle L. Fischer
Assistant Director
Financial Management and Assurance



GAO-11-331T



Highlights of GAO-11-331T, a testimony before the Subcommittee on Contracting Oversight, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

Agencies across the government are increasingly reliant on contractors to execute their missions. With hundreds of billions of taxpayer dollars at stake, the government needs strong controls to provide reasonable assurance that these contract funds are not being lost to improper payments (fraud and errors), waste, and mismanagement.

Effective contract oversight, which includes effective internal controls throughout the contracting process, is essential to protecting government and taxpayer interests. *Standards for Internal Control in the Federal Government* provides the overall framework for internal control, which includes the control environment, risk assessment, control activities, information and communication, and monitoring.

Contract auditing is a control mechanism intended to provide those responsible for government procurement with financial information and advice relating to contractual matters and the effectiveness, efficiency, and economy of contractors' operations.

Today's testimony describes the (1) contracting cycle and related internal controls, (2) Defense Contract Audit Agency (DCAA) and its role in performing contract audits for the Department of Defense (DOD) and other federal agencies, and (3) risks associated with ineffective contract controls and auditing.

GAO's testimony is based on prior reports and testimonies, as listed at the end of this statement.

View GAO-11-331T or key components. For more information, contact Jeanette M. Franzel at (202) 512-9471 or franzel@gao.gov.

February 1, 2011

CONTRACT AUDITS

Role in Helping Ensure Effective Oversight and Reducing Improper Payments

What GAO Found

The contracting cycle consists of activities throughout the acquisition process, including preaward and award, contract administration and management, and ultimately the contract closeout. Strong internal controls contain a balance of preventive and detective controls appropriate for the agency's operation and help ensure an effective contract oversight process. Preventive controls—such as invoice review prior to payment—are controls designed to prevent improper payments, waste, and mismanagement, while detective controls—such as incurred cost audits—are designed to identify improper payments after the payment is made. While detective controls identify funds that may have been inappropriately paid and should be returned to the government, preventive controls help to reduce the risk of improper payments or waste before they occur.

DOD accounts for the largest share of federal contract spending. DCAA was established in 1965 in response to studies which identified the need for consistency in contract audits at DOD. DCAA serves 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 closeout of contracts and subcontracts. The majority of DCAA audits focus on cost-reimbursable and other nonfixed-price contracts, which pose the highest risk to the government.

Reported federal contract obligations—which have increased by \$100 billion in real terms since fiscal year 2005, from \$435 billion to \$535 billion in fiscal year 2010—poses significant risk if effective contract oversight is not in place. GAO's work has identified contract management weaknesses, significant problems with federal agency controls over contract payments, and internal control deficiencies throughout the contracting process, including contract auditing. GAO also found audit quality problems at DCAA offices nationwide, including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision.

DCAA and the other federal agencies mentioned in GAO's testimony have completed some actions and have actions under way to address GAO's recommendations. GAO made 17 recommendations to DOD and the DOD Inspector General (IG) to address the weaknesses it identified at DCAA. DOD and DCAA have taken a number of actions on these recommendations, including revising DCAA's mission statement, appointing a new DCAA Director and a Western Region Director, establishing an internal review office to perform periodic internal evaluations and address hotline complaints, initiating outside hiring, strengthening its audit quality review function, and providing training on auditing standards. DCAA has actions under way on other recommendations. DOD IG has expanded its oversight of DCAA's audit quality control process. In addition, the Centers for Medicare and Medicaid Services (CMS) have completed actions on two recommendations and expect to complete actions on all but one of the remaining 16 recommendations by March 31, 2011. Department of Energy official's stated that actions have been complete on all 11 GAO recommendations. GAO is following up to confirm.

United States Government Accountability Office

Madam Chairman and Members of the Subcommittee:

Thank you for the opportunity to be here today to discuss the role that contract audits can serve in contract oversight processes and helping to reduce the risk of improper payments. The purpose of contract auditing is to assist in achieving prudent contracting by providing those responsible for government procurement with financial information and advice relating to contractual matters and the effectiveness, efficiency, and economy of contractors' operations. With reported federal contract spending topping the \$500 billion mark annually, effective contract oversight, which includes effective internal control throughout the contracting process, is essential to protecting the government and taxpayer interests. The *Standards for Internal Control in the Federal Government* provide the overall framework for establishing and maintaining internal control and for identifying and addressing areas at greatest risk of fraud, waste, abuse, and mismanagement.¹

Today, I will describe the (1) contracting cycle and the general nature of internal controls that should be in place, (2) Defense Contract Audit Agency (DCAA) and its role in performing contract audits, and (3) risks associated with ineffective contract controls and auditing. I will conclude by outlining some potential actions that could improve the effectiveness of DCAA and its role in performing contract audits for the Department of Defense (DOD) and other federal agencies.

In preparing this testimony, we relied on the work we performed during our DCAA engagements,² as well as our extensive body of work on federal agency contract management. More detail on our scope and methodology is included in each issued product. Our audit work was conducted in accordance with generally accepted government auditing standards

¹ GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-213.1 (November 1999).

² GAO, *Defense Management: Widespread DCAA Audit Problems Leave Billions of Taxpayer Dollars Vulnerable to Fraud, Waste, Abuse, and Mismanagement*, GAO-10-163T (Washington, D.C.: Oct. 15, 2009); *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).

(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.

The Contracting Cycle and Internal Controls

The contracting cycle consists of activities throughout the acquisition process, including preaward and award, contract administration and management, and ultimately the contract closeout. Generally, prior to contract award, an agency identifies a need; develops a requirements package; determines the method of acquisition; solicits and evaluates bids or proposals; determines the adequacy of the contractor's accounting system for billing purposes; and ultimately negotiates a price and contract terms, resulting in the contract awards. After contract award, the agency performs activities related to contract administration and management. Contract administration and management involves monitoring the contractor's performance as well as reviewing and approving (or disapproving) the contractor's requests for payments. As discussed in more detail later in this statement, there are various types of contract audit activities that can occur in the preaward and award, and administration and management phases of a contract. The contract closeout process involves verifying that the goods or services were provided and that administrative matters are completed, including a contract audit of costs billed to the government and adjusting for any over- or underpayments based on the final invoice. Effective contract oversight includes effective internal control throughout the contracting process.

Internal Control

Generally, the government manages its risk, in part, through establishing effective internal controls, which includes performing oversight activities. *Standards for Internal Control* provides that to be effective, an entity's management should establish both a supportive overall control environment and specific control activities directed at carrying out its objectives.³ As such, an entity's management should establish and maintain an environment that sets a positive and supportive attitude towards control and conscientious management. A positive control

³ *Standards for Internal Control* cover the control environment, risk assessment, control activities (policies, procedures, techniques, and mechanisms that enforce management's directives), information and communication, and monitoring (performance assessments and audits).

environment provides discipline and structure as well as a climate supportive of quality internal control, and includes an assessment of the risks the agency faces from both external and internal sources. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives and help ensure that actions are taken to address risks. The standards further provide that information should be recorded and communicated to management and oversight officials in a form and within a time frame that enables them to carry out their responsibilities. Finally, an entity should have internal control monitoring activities in place to assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

Control activities include both preventive and detective controls. Preventive controls—such as invoice review prior to payment—are controls designed to prevent improper payments (errors and fraud),⁴ waste, and mismanagement, while detective controls—such as incurred cost audits—are designed to identify errors or improper payments after the payment is made. A sound system of internal control contains a balance of both preventive and detective controls that is appropriate for the agency's operations. While detective controls are beneficial in that they identify funds that may have been inappropriately paid and should be returned to the government, preventive controls such as accounting system reviews and invoice reviews help to reduce the risk of improper payments or waste before they occur. A key concept in the standards is that the cost of control activities should not outweigh the benefit. Generally, it is more effective and efficient to prevent improper payments. A control activity can be preventive, detective, or both, based on when the control occurs in the contract life cycle.

⁴ Improper payments are defined in the Improper Payments Information Act of 2002 as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It also includes any payment to an ineligible recipient or ineligible service, duplicate payments, payments for services not received, and any payment for an incorrect amount.

Contract Types and Related Risks

Agencies may choose among different contract types to acquire goods and services.⁵ This choice is the principal means that agencies have for allocating risk between the government and the contractor. The choice of a contract type will also impact the types of internal control and contract auditing activities needed to help protect the government's interests and reduce the risk of improper payments. Contract types can be grouped into two broad categories: fixed-price contracts and nonfixed-price contracts, such as cost-reimbursable contracts and time and materials (T&M) contracts. Although the *Federal Acquisition Regulation* (FAR) places limitations on the use of cost-reimbursement and T&M contract types, these contract types may be used to provide the flexibility needed by the government to acquire the large variety and volume of supplies and services it needs. The three types of contracts place different levels of risk on the government and the contractor. For example,

- For fixed-price contracts, the government agrees to pay a set price for goods or services regardless of the actual cost to the contractor. A fixed-price contract is ordinarily in the government's interest when the risks involving the project and the project's price are minimal or can be predicted with an acceptable degree of certainty and a sound basis for pricing exists, as the contractor assumes the risk for cost overruns.
- Under cost-reimbursement contracts, the government agrees to pay those costs of the contractor that are allowable, reasonable, and allocable to the extent prescribed by the contract. Consequently, the government assumes most of the cost risk. The contractor is required to provide its best effort to meet contract objectives within the estimated cost. If this cannot be done, the government can provide additional funds to complete the effort, decide not to provide additional funds, or terminate the contract. Cost-reimbursement contracts may be used only when the contractor's accounting system is adequate for determining costs applicable to the contract and appropriate government surveillance during contract performance will provide reasonable assurance that efficient methods and effective cost controls are used.⁶ In order to determine if the contractor has efficient methods and effective cost controls, contracting officers and other

⁵ Agencies may acquire goods and services under contracts with private entities or they may enter into interagency agreements (interagency acquisitions) to acquire goods and services from other federal agencies, which may acquire the goods and services under contracts with private entities.

⁶ 48 C.F.R. §§ 16.104(h), 16.301-3(a).

contracting oversight personnel may perform reviews of various contractor systems, as well as a comprehensive review of contractor invoices to determine if the contractor is billing costs in accordance with the contract terms and applicable government regulations. In addition, the establishment of provisional and final indirect cost rates helps to ensure that the government makes payments for costs that are allowable, reasonable, and allocable to the extent prescribed by the contract.

- For T&M contracts, the government agrees to pay fixed, per-hour labor rates and to reimburse other costs directly related to the contract, such as materials, equipment, or travel, based on cost. Like cost-reimbursement contracts, the government assumes the cost risk because the contractor is only required to make a good faith effort to meet the government's needs within a ceiling price. A T&M contract may be used only if the contracting officer prepares a determination and findings that no other contract type is suitable and if the contract includes a ceiling price that the contractor exceeds at its own risk.⁷ In addition, since these contracts provide no positive profit incentive for the contractor to control costs or use labor efficiently, the government must conduct appropriate surveillance of contractor performance to ensure efficient methods and effective cost controls are being used.

As discussed in more detail later in this statement, most contract audit activity is focused on cost-reimbursable and other nonfixed-price contracts, due to the higher risks to the federal government.

DCAA's Origin and Contract Audit Role

Audits of military contracts can be traced back to at least the World War I era. Initially, the various branches of the military had their own contract audit function and associated instructions and accounting rulings. Contractors and government personnel recognized the need for consistency in both contract administration and audit. The Navy and the Army Air Corps made the first attempt to perform joint audits in 1939. By December 1942, the Navy, the Army Air Corps, and the Ordnance Department had established audit coordination committees for selected areas where plants were producing different items under contracts for more than one service. On June 18, 1952, the three military services jointly issued a contract audit manual that later became the DCAA *Contract*

⁷ 48 C.F.R. § 16.601(d).

*Audit Manual (CAM).*⁸ The CAM has been regularly updated over the years and is still in use today.

In May 1962, Secretary of Defense Robert S. McNamara instituted "Project 60" to examine the feasibility of centrally managing the field activities concerned with contract administration and audit.⁹ An outcome of this study was the decision to establish a single contract audit capability within DOD and DCAA was established on June 8, 1965.¹⁰ At that time, DCAA's mission was to perform all necessary contract audits for DOD and provide accounting and financial advisory services regarding contracts and subcontracts to all DOD components responsible for procurement and contract administration. DCAA was placed under management control of the Under Secretary of Defense (Comptroller), where it remains today. Other audit organizations, including the DOD and other federal agency Inspectors General (IG), the Special IGs for Iraq and Afghanistan, and the military service audit agencies also have a role in the oversight of federal contracts.

DCAA consists of a headquarters office at Fort Belvoir, Virginia, and six major organizational components—a field detachment office, which handles audits of classified contracting activity, and five regional offices within the United States. The regional offices manage field audit offices (FAO), which are identified as branch offices, resident offices, or suboffices. Resident offices are located at larger contractor facilities in order to facilitate DCAA audit work. In addition, regional office directors can establish suboffices as extensions of FAOs to provide contract audit services more economically. A suboffice depends on its parent FAO for release of audit reports and other administrative support. In total, there are currently 382 DCAA offices, including 114 FAOs, throughout the United States and overseas. At the end of fiscal year 2010, DCAA employed about 4,700 staff, of which 85 percent are auditors, at DCAA's various offices throughout the United States, Europe, the Middle East, and in the

⁸ DCAA, *Contract Audit Manual (CAM)* DCAAM 7640.1.

⁹ Project 60 also resulted in consolidation of the military services' contract management activities under the Defense Contract Management Agency (DCMA), formerly the Defense Contract Management Command (DCMC) within the Defense Logistics Agency. On March 27, 2000, DCMC was established as DCMA under the authority of the Under Secretary of Defense (Acquisition, Technology, and Logistics).

¹⁰ DOD, *General Plan: Consolidation of Department of Defense Contract Audit Activities into the Defense Contract Audit Agency* (Feb. 17, 1965).

Pacific to perform audits and provide nonaudit services in support of contract negotiations related to approximately 9,000 contractors.

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 and other federal agencies' contracting and contract payment functions. FAR subpart 42.1, "Contract Audit Services," and DOD Directive 5105.36, *Defense Contract Audit Agency (DCAA)*, establish DCAA as the department's contract audit agency¹¹ and set forth DCAA's responsibilities.

FAR 42.101 prescribes contract audit responsibilities as submitting information and advice to the requesting activity, based on the analysis of contractor financial and accounting records or other related data as to the acceptability of the contractors' incurred and estimated costs; reviewing the financial and accounting aspects of contractor cost control systems; and performing other analyses and reviews that require access to contractor financial and accounting records supporting proposed and incurred costs.

DOD's acquisition life cycle includes many contract and administrative activities. As illustrated in figure 1, these activities fall into three contract phases—preaward and award, administration and management, and closeout—that involve several activities and numerous types of audits. DCAA and other federal agencies are not consistent in their definitions of contract audits and reviews and other federal agencies generally do not perform the full range of audits that DCAA performs. While the majority of DCAA's audit effort supports the DOD contract community, in fiscal year 2010, based on DCAA records, about 12 percent of DCAA's audit hours were used to respond to other federal agency requests for contractor audits. DCAA performs audit services for other federal agencies on a fee-for-service basis. Appendix I contains information on DCAA audits and nonaudit services provided by DCAA in support of contracting and contract payment.

¹¹ DODD 5105.36, paragraph 4.2, reissued on January 4, 2010, to include DCAA's new mission statement.

Figure 1: Relationship of Contract Phases, Contract Events, and DCAA Audits

Contract phases	Contract events	Audit activities
Preaward and award	Proposal	Full proposal
	Contract negotiations	Rate review
	Contract award	Financial capability
		Preaward accounting survey
		Initial Disclosure Statement review
		Other
Administration and management	Contract performance	Provisional billing rates
		Progress payments (fixed price and fixed price incentive fee contracts only)
		Earned value management system (if required)
		Other requested special audits
		Annual incurred cost reviews (flexibly priced contracts only)
		Audits of contractor internal control systems
		Cost accounting standard (CAS) compliance
		Paid voucher reviews
Closeout	Contract physically complete	Overpayment review
		Final price submissions (fixed price incentive fee contracts)
	Contract closed	Contract audit closing statement (cost type and time and materials contracts)
		Termination

Source: GAO analysis of DCAA information.

The majority of DCAA audits focus on cost-reimbursable and other nonfixed-price 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 is generally not promised a completed deliverable or service at a set price. 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 nonfixed-price contract.¹² Audits of estimating system controls support negotiation of fair and reasonable prices.¹³ Also, billing system audits support decisions to authorize contractors to submit invoices

¹² FAR §§ 16.104(h) and 16.301-3(a)(1).

¹³ DCAA, *Contract Audit Manual (CAM)* 5-1202.1.a and *Defense Federal Acquisition Regulation Supplement (DFARS)* § 215.407-5.

directly to DOD payment offices for payment without government review.¹⁴ 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.

Risks of Ineffective Contract Controls and Auditing

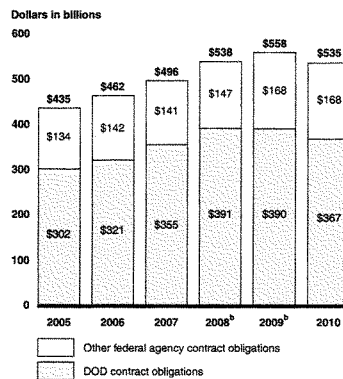
Agencies across the government are increasingly reliant on contractors to execute their missions. In fiscal year 2010, federal agencies reported obligating approximately \$535 billion on goods and services—more than double the amount obligated at the start of the last decade in real terms. Our analysis of Federal Procurement Data System–Next Generation (FPDS-NG) contract obligations¹⁵ determined that although federal contract spending increases have slowed and decreased slightly in recent years, over the past 5 years federal contract spending has increased by \$100 billion.¹⁶ As illustrated in figure 2, the sheer size of federal contract spending poses significant risk if effective processes, controls, and oversight are not in place. DOD accounts for approximately 70 percent of the federal government's FPDS-NG reported annual contract spending—\$367 billion in fiscal year 2010—and other federal agencies accounted for \$168 billion in contract spending. With hundreds of billions in taxpayer dollars spent on government contracts, strong contract oversight is essential.

¹⁴ FAR § 42.101 and DFARS § 242.803.

¹⁵ The obligation amount generally is the amount of the contract award, such as the firm-fixed price or estimated value of cost reimbursements for a particular fiscal year.

¹⁶ Our analysis is based on contract actions over \$25,000 adjusted for fiscal year 2010 inflation factor.

Figure 2: DOD and Other Federal Agency Contract Obligations Related to Actions over \$25,000 for Fiscal Years 2005 through 2010^a



Source: GAO analysis of unaudited obligations data from the Federal Procurement Data System.

^aContract obligations are adjusted for inflation using the fiscal year 2010 Gross Domestic Price Index.

^bDOD's reported obligations in fiscal year 2008 and 2009 reflected an approximately \$13.9 billion adjustment to correct an error made in fiscal year 2008.

GAO's work has shown that agencies confront several interrelated challenges, including separating wants from needs; executing acquisition programs within available funding and established time frames; using sound contracting arrangements with appropriate incentives and effective oversight; assuring that contractors are used only in appropriate circumstances and play proper roles; and sustaining a capable and accountable acquisition workforce. In addition, since 1997, we have reported that the nonacquisition workforce, such as contracting officer representatives and unit leaders, also have a role in contract management and must be trained.

These challenges have contributed to GAO's designating contract management as a high-risk area at DOD, the Department of Energy, and the National Aeronautical and Space Administration. Weapon system acquisition is also designated as a high-risk area at DOD. Governmentwide, GAO also designated the management and use of interagency contracting

as high risk. Other agencies face many of the same challenges. Collectively, these challenges expose hundreds of billions of taxpayer dollars to potential risks of improper payments, waste, and mismanagement.

**Contracting Control
Weaknesses Identified in
GAO Work**

Our work has identified significant contract management weaknesses, problems with federal agency controls over contract payments, as well as weaknesses in contract auditing.¹⁷ We have identified internal control deficiencies that have occurred throughout the contracting process and phases. These weaknesses and deficiencies increase the risk of improper payments, and fraud, waste, abuse, and mismanagement. For example, we found:

Department of Energy (DOE). DOE's internal controls over payments to its Waste Treatment Plant (WTP) contractor did not provide reasonable assurance against the risk of improper payments, particularly given the WTP project's substantial inherent risks.¹⁸ Several factors combine to pose an inherent risk to the government of improper payments on this project, including the size and complexity of this one-of-a-kind nuclear construction project, the multibillion-dollar cost and schedule overruns the project had already experienced, and the substantial volume of transactions billed by the contractor to DOE on each invoice. Despite these risks, in fiscal years 2005 and 2006, DOE performed little or no review of the contractor's invoices or supporting documents for \$40 million to \$60 million billed by the contractor to DOE each month. The need for close, ongoing review of invoiced transactions and support is particularly compelling given that the contractor's invoices provided little detail as to the items purchased, contrary to FAR and contract requirements. However, DOE officials chose instead to rely primarily on DCAA's review and approval of the contractor's corporatewide financial systems, which DOE officials believed allowed them to rely on the contractor's systems with little or no DOE oversight. In addition, DOE relied primarily on the contractor to review and validate subcontractor charges without having a process in place to assess whether the contractor was properly carrying out its subcontractor oversight

¹⁷ See list of related products at the end of this testimony.

¹⁸ GAO, Hanford Waste Treatment Plant: Department of Energy Needs to Strengthen Controls over Contractor Payments and Project Assets, GAO-07-888 (Washington, D.C.: July 20, 2007).

responsibility. DOE's heavy reliance on DCAA and the contractor, with little oversight of its own, exposed the hundreds of millions of dollars it spent annually on the WTP project to an unnecessarily high risk of improper payments. Our July 2007 report made 11 recommendations to improve DOE's oversight of and accountability for WTP expenditures. DOE officials advised us that they have completed action on all 11 recommendations. We are currently following up to confirm DOE's actions.

Centers for Medicare and Medicaid Services (CMS). We evaluated CMS's Medicare Modernization Act (MMA) program contracting activity and found that CMS did not fulfill critical contractor oversight responsibilities, such as reviewing contractors' indirect cost rate information and assessing the adequacy of the contractors' accounting systems, thereby increasing risks of fraud, waste, and abuse not only to CMS but to other federal agencies that may use the same contractors.¹⁹ Specifically, we identified numerous questionable payments totaling nearly \$90 million that represented potentially improper, unsubstantiated, or wasteful payments. For example, we found payments for costs that did not comply with the terms of the contract or applicable regulation, such as costs for unapproved labor categories, costs exceeding contract indirect rate ceiling amounts, and travel costs in excess of allowable limits. In other cases, we were unable to obtain adequate documentation, such as vendor invoices or time sheets, to support costs billed. In addition, we identified payments for which risks in CMS's contracting practices resulted in potential waste. In some cases, due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. Our November 2007 report made nine recommendations to the Administrator of CMS to improve internal control and accountability in the contracting process and related payments to contractors. CMS completed actions to develop agency-specific policies and procedures for the review of contractor invoices and create a centralized tracking mechanism that records the training taken by personnel assigned to contract oversight activities. In addition, CMS officials advised that CMS has recovered \$2.8 million, deemed \$7.5 million in questioned payments to be proper, and anticipate the remaining questioned cost will be found to have been proper after

¹⁹ GAO, Centers for Medicare and Medicaid Services: Internal Control Deficiencies Resulted in Millions of Dollars of Questionable Contract Payments, GAO-08-54 (Washington, D.C.: Nov. 15, 2007).

indirect rate audits are complete. We are continuing to follow up on CMS's progress in addressing the remaining seven open recommendations.

As a result of the contracting weaknesses we found in the MMA program, GAO was asked to evaluate CMS's internal controls over its contracting activities.²⁰ Based on our audit, we found pervasive deficiencies in CMS's internal controls over contracting and payments to contractors. The internal control deficiencies occurred throughout the contracting process phases. These deficiencies were due in part to a lack of agency-specific policies and procedures to ensure that FAR requirements and other control objectives were met. CMS also did not take appropriate steps to ensure that existing policies were properly implemented nor maintained adequate documentation in its contract files. As a result of our work, we estimated that at least 84.3 percent of FAR-based contract actions made by CMS in fiscal year 2008 contained at least one instance in which a key control²¹ was not adequately implemented. We also estimated that at least 37.2 percent of FAR-based contract actions made in fiscal year 2008 had three or more instances in which a key control was not adequately implemented. The high percentage of deficiencies indicated a serious failure of control procedures over FAR-based acquisitions, thereby creating a heightened risk of making improper payments or waste. Our October 2009 report made nine additional recommendations to the CMS Administrator to develop and implement policies and procedures to ensure that FAR requirements and other control objectives are met. We have obtained documentation on CMS's actions and are in the process of validating this information. CMS officials told us they expect to complete actions on all but one of our recommendations by March 31, 2011.

Ineffective Contract Auditing

In 2009, we reported on audit quality problems at DCAA offices nationwide, including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision. In addition, DCAA's management environment and quality assurance structure were based on a production-oriented mission that put DCAA in the role of

²⁰ GAO, Centers for Medicare and Medicaid Services: Deficiencies in Contract Management Internal Control Are Pervasive, GAO-10-60 (Washington, D.C.: Oct. 23, 2009).

²¹ We determined a control to be "key" based on our review of the standards for internal control as well as the FAR, *Health and Human Services Acquisition Regulations*, and agency policies and whether inadequate implementation would significantly increase the risk of improper payments or waste.

facilitating DOD contracting without also protecting the public interest.²² We found serious quality problems in the 69 audits and cost-related assignments we reviewed.²³ For example, 65 of these assignments exhibited serious noncompliance with generally accepted government auditing standards (GAGAS) or other deficiencies similar to those found in our investigation,²⁴ including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision. DCAA has taken action on many of our recommendations but continues to experience significant audit quality problems across offices in all DCAA regions.

As a result of our work, DCAA rescinded over 80 audit reports because its underlying audit evidence was outdated, insufficient, or inconsistent with reported conclusions and opinions. Those rescinded audits had been issued to support decisions on contract pricing and awards and impacted the planning and reliability of hundreds of other DCAA audits, representing billions of dollars in DOD expenditures. 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 *Cost Accounting Standards* (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.

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 DCAA's agencywide audit failures we identified. 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.

²² GAO, DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform, (GAO-08-468) (Washington, D.C.: Sept. 23, 2008).

²³ 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.

²⁴ GAO-08-557.

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 cited in the audit reports.

Unsupported opinions. Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions, which are relied on for 2 to 4 years, and sometimes longer. The lack of sufficient support for those audit opinions 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. For example, we found that:

- For many controls, DCAA did not perform any testing at all. For example, audits of contractor accounting systems focus on a review of the adequacy of contractor policies and procedures. At least six of the nine accounting audits we reviewed did not include procedures for confirming contractor segregation of allowable and unallowable cost.
- DCAA issued an “adequate” opinion on the accounting system for a major DOD contractor, indicating that system controls were effective, after performing only a walkthrough of the accounting process and interviewing two employees.
- In billing system audits we reviewed, DCAA auditors often tested only two, three, or sometimes five transactions to support audit conclusions on contractor systems and related internal controls. Twenty of the 22 billing system audits we reviewed did not include tests to identify duplicate invoices.
- In one audit, DCAA auditors reported on the adequacy of a contractor’s billing system based on tests of only four vouchers—all issued on the same day.
- In an audit of controls over indirect and other direct cost for a business segment of one of the top five DOD contractors, DCAA auditors tested only 12 out of about 22,000 transactions processed from May through July 2005.

Similarly, the 32 cost-related assignments we reviewed 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 and services. We identified the following problems with these assignments.

- **Paid voucher reviews.** Under the direct-bill program, contractors may submit their invoices directly to the DOD disbursing officer for payment without further review. DCAA performs annual testing of paid vouchers (invoices) to determine if contractor voucher preparation procedures are adequate for continued contractor participation in the direct-bill program.²⁵ For the 16 paid voucher assignments we reviewed, we found that DCAA auditors failed to comply with DCAA *Contract Audit Manual* (CAM) guidance.²⁶ Auditors generally did not identify the population of vouchers, did not create sampling plans, and made a small, nonrepresentative selection of as few as one or two invoices for testing to support conclusions on their work. Based on the limited work that was performed, the auditors concluded that controls over invoice preparation were sufficient to support approval of the contractors' direct billing privileges. This is of particular concern because we determined that Defense Finance and Accounting Service (DFAS) certifying officers rely on DCAA voucher reviews.
- **Overpayment assignments.** DCAA performs overpayment assignments to verify that contractors have billing procedures and internal controls in place to identify and resolve contractor billing errors and overpayments in a timely manner. We found that auditor judgments about the population and selection of transactions for these assignments did not provide a representative universe for testing and concluding on contractor controls over billings and payments received. As a result, this work does not provide reasonable assurance that contractors have adequate controls in place to identify and correct overpayments and billing errors and make appropriate, timely refunds and adjustments.

²⁵ DCAA does not perform paid voucher reviews during the year that it performs an audit of the contractor's billing system internal controls.

²⁶ CAM 6-1007.

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- **Incurring cost audits.** The purpose of incurred cost audits is to examine contractors' cost representations and opine on whether the costs are allowable, allocable to government contracts, and reasonable in accordance with the contract and applicable government acquisition regulations.²⁷ For the four incurred cost audits we reviewed, we found that the auditors did not perform sufficient, detailed testing of claimed indirect and direct costs. As a result, the scope of work performed was not sufficient to identify claimed costs, if any, that were not adequately supported or unallowable costs, if any, that should have been questioned.

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. For example, in fiscal year 2008, DCAA performed approximately 30,000 audits with 3,600 auditors. This workload substantially contributed to the widespread audit quality problems we identified. While DCAA has increased its staff to about 4,700, of which about 85 percent are auditors, and reduced the number of reports issued in fiscal year 2010 to about 10,000. Based on routine audit follow-up work, we have determined that DCAA has allocated resources to the highest risk contracts but not yet fully completed actions on a risk-based audit approach, with consideration of resources and auditing standards, that is effective in protecting taxpayer interest. In addition, DCAA has not yet resolved fundamental weaknesses in its strategic plan, metrics, and human capital practices that had a detrimental effect on audit quality. In addition, DCAA and the Defense Contract Management Agency (DCMA) identified as part of their current cost recovery initiative that there is a significant backlog of *Cost Accounting Standards* (CAS) cost impact issues requiring disposition and resolution by administrative contracting officers. According to DOD Inspector General officials, these CAS issues represent billions of dollars of unresolved audit findings and the 6-year statute of limitations is running out on many of them.

Considering the large number of DCAA audit reports issued annually and the reliance the contracting and finance communities place on DCAA audit conclusions and opinions, effective and reliable contract audits are necessary to protecting the public interest.

²⁷ CAM 6-102.

In our 2009 report, we made 17 specific recommendations to DOD and the DOD Inspector General (IG) to improve DCAA's management environment, audit quality, and oversight. DOD and DCAA have taken a number of actions on our recommendations, including revising DCAA's mission statement, appointing a new DCAA Director and a Western Region Director, establishing an internal review office to perform periodic internal evaluations and address hotline complaints, initiating outside hiring, expanding its audit quality review function, and providing training on auditing standards. While DCAA has initiated actions on our other recommendations, as discussed in our report, DCAA will need more time to complete those actions. Those include achieving changes in its management environment and culture, developing a strategic plan that links to performance metrics and a human capital strategic plan, developing a well-supported risk-based contract audit approach, obtaining outside expertise on auditing standards to assist in revising its contract auditing policies and procedures, and providing guidance on sampling and testing for the various types of audits it performs. DOD IG has expanded its oversight of DCAA's audit quality control process.

Our 2009 report also offered some potential actions for strengthening the organizational effectiveness of DCAA and the contract audit function in the federal government. These potential actions would require further study as well as congressional action, and include actions intended to (1) increase DCAA's authority and independence, (2) provide for additional reporting and oversight of audit results, and (3) evaluate whether certain organizational changes to DCAA could strengthen its independence and improve audit quality. We have reprinted the detail of these options in appendix II.

Madam Chairman and Members of the Subcommittee, 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 Jeanette M. Franzel at 202-512-9471 or franzelj@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 Gayle Fischer, Assistant Director; F. Abe Dymond, Assistant General Counsel; Omar Torres, Auditor-in-Charge; and Yiming Wu, auditor.

Appendix I: DCAA Audit and Nonaudit Services

Table 1 lists several audit and nonaudit services performed by the Defense Contract Audit Agency (DCAA) during the three phases of the contracting process—preaward and award, contract administration and management, and closeout—and cites the statutory and regulatory provisions that authorize or establish the need to have DCAA perform the service. DCAA audits also support the contract payment process both directly and indirectly. For example, audits of contractor-incurred cost claims and voucher reviews directly support the contract payment process by providing the information necessary to certify payment of claimed costs.¹ Other audits of contractor systems, including audits of contractor internal controls, CAS compliance, and defective pricing, indirectly support the payment process by providing assurance about contractor controls over cost accounting, cost estimating, purchases, and billings that the agency may rely upon when making contract decisions, such as determinations of reasonable and fair prices on negotiated contracts. For example, an accounting system deemed to be adequate by a DCAA audit permits progress payments based on costs to be made without further audit.²

¹ Disbursing officers are authorized to make payments on the authority of a voucher certified by an authorized certifying officer, who is responsible for the legality, accuracy, and propriety of the payment. 31 U.S.C. §§ 3325, 3521(a), and 3528(a).

² FAR § 32.503-4.

Table 1: Examples of DCAA Audit and Nonaudit Services.

Contract phase and assignment	Audit and nonaudit services	Contracting support	Payment support	
			Direct	Indirect
Preaward and award phase:				
Accounting system*	Audit: DCAA determines adequacy of the contractor's accounting system prior to award of a cost-reimbursable or other flexibly priced contract. FAR § 16.301-3(a)(1).	X		X
Contractor accounting disclosure statements	Audit: DCAA reviews the contractor's Disclosure Statement for adequacy and CAS compliance and determines whether the contractor's Disclosure Statement is current, accurate, and complete. DCAA also reviews Disclosure Statements during the postaward phase if contractors revise them. FAR §§ 30.202-6(c), 30.202-7 and 30.601(c).	X		X
Estimating system*	Audit: DCAA determines adequacy of contractor estimating systems. FAR § 15.407-5 and DFARS § 252.215-7002(d), (e).	X		X
Contract price proposals and forward pricing proposals ^b	Audit: DCAA examines contractor records to ensure that cost or pricing data are accurate, current, and complete and supports the determination of fair and reasonable prices. 10 U.S.C. §§ 2306a and 2313 (DOD) and 41 U.S.C. § 254d (other agencies); FAR Subpart 15.4 (esp. FAR § 15.404-2(c)) and § 52.215-2(c); and DFARS § 215.404-1.	X		X
Financial liaison advisory services*	Nonaudit: DCAA Director establishes and maintains liaison auditors and financial advisors, as appropriate, at major procuring and contract administration offices. These services are also provided during the postaward phase, as needed. DODD 5105.36, paras. 7.1.1 and 5.9.	X		X
Postaward/administration and management phase:				
Internal control system audits (generally)	Audit: DCAA reviews the financial and accounting aspects of the contractor's cost control systems, including the contractor's internal control systems. FAR § 42.101(a)(3) and DFARS § 242.7501.	X		X
Billing system audits*	Audit: DCAA determines adequacy of contractors' billing system controls and reviews accuracy of paid vouchers. DCAA uses audit results to support approval of contractors to participate in the direct-bill program. FAR § 42.101 and DFARS § 42.803 (b)(i)(C).	X	X	
Purchasing system review ^b	Audit: DCAA determines adequacy of a contractor's or subcontractor's purchasing system. FAR Subpart 44.3.	X		X
Progress payments ^b	Audit: DCAA verifies amount claimed, determines allowability of contractor requests for cost-based progress payments, and determines if the payment will result in undue financial risk to the government. FAR §§ 32.503-3, 32.503-4, and 52.232-16.	X	X	
Incurred cost claims*	Audit: DCAA determines acceptability of the contractors' claimed costs incurred and submitted by contractors for reimbursement under cost-reimbursable, fixed-price incentive, and other types of flexibly priced contracts and compliance with contract terms, FAR, and CAS, if applicable. FAR §§ 42.101, 42.803(b), and DFARS § 242.803.	X	X	
Billing rates and final indirect cost rates*	Audit: DCAA establishes billing rates for interim indirect costs and final indirect cost rates. FAR §§ 42.704, 42.705 and 42.705-2 and DFARS § 42.705-2.	X	X	

Contract phase and assignment	Audit and nonaudit services	Contracting support	Payment support	
			Direct	Indirect
Defective pricing ^a	Audit: DCAA determines the amount of cost adjustments related to defective pricing. See above authorities to audit contractor cost and pricing data and FAR § 15.407-1.	X		X
CAS compliance ^a	Audit: DCAA determines contractor and subcontractor compliance with CAS set forth in 48 CFR § 9903.201 and determines cost impacts of noncompliance. FAR §§ 1.602-2, 30.202-7, and 30.601(C).	X	X	
Other specially requested services	Audit and nonaudit services: DCAA conducts performance audits and other audits based on requests from DOD components and requests from other federal agencies. DOD Directive 5105.36, Sec. 5.	X		X
Paid voucher reviews ^a	Nonaudit services: DCAA reviews vouchers after payment to support continued contractor participation in the direct bill program. CAM 6-1007.6; FAR § 42.803; DFARS § 242.803; DODD 5105.36, paras. 5.4 and 5.5; and DOD Financial Management Regulation (FMR), vol. 10, ch. 10, para. 100202.	X	X	
Approval of vouchers prior to payment ^f	Nonaudit: DCAA reviews and approves contractor interim vouchers for payment and suspends payment of questionable costs. FAR § 42.803; DFARS § 242.803(b)(1)(B); DOD Directive 5105.36, paras. 5.4 and 5.5; and DOD FMR vol. 10, ch. 10, para. 100202.	X	X	
Overpayment reviews ^a	Nonaudit services: At the request of the contracting officer, DCAA reviews contractor data to identify potential contract overpayments. FAR §§ 2.605, 52.216-7(g), (h)2.	X	X	
Closeout phase:				
Contract closeout procedures and audits ^a	Audit: DCAA reviews final completion vouchers and the cumulative allowable cost worksheet and may review contract closing statements. DFARS § 242.803(b)(1)(D).	X	X	

Source: GAO analysis.

^aIndicates DCAA audit and nonaudit services covered in this audit.

^fIndicates types of audits covered in our prior investigation (GAO-08-857). We reviewed progress payment and contract closeout audits that related to audits in our earlier investigation or this audit where the auditors considered the evidence in those audits.

Appendix II: Potential Legislative and Other Actions for Strengthening DCAA and the Contract Audit Function

In our September 2009 report,¹ we identified certain legislative and other actions, such as authorities and protections similar to those granted to federal agency Inspectors general (IG) in the IG Act, and changes in organizational placement, that could enhance Defense Contract Audit Agency (DCAA) effectiveness and independence.² Successful management initiatives for cultural and organizational change in large private and public sector organizations can often take several years to accomplish. We caution that changing DCAA's organizational placement without first correcting fundamental weaknesses in mission and the overall management environment would not assure effective audits.

Short-term Legislative Actions

In addition to DCAA management reforms already under way and our additional recommendations, our 2009 report identified certain legislative protections and authorities under the IG Act that could enhance DCAA's effectiveness. Legislation would be needed in order to grant DCAA such protections and authorities.

Leadership. The IG Act provides for the President to appoint the IG, with Senate confirmation, at many federal agencies.³ Under the act, Congress must be notified in advance of removing the IG, and only Congress can eliminate the office of an IG. Currently, the head of DCAA is appointed and can be removed by the Secretary of Defense. Further, DCAA was created and can be reorganized or reassigned by departmental order without notice. IG Act protections Congress could grant to DCAA would therefore include (1) Senate confirmation of a presidentially appointed DCAA Director⁴ and (2) removal of the DCAA Director conditioned on congressional notification.⁵ Specifically, the act provides that an IG may be removed from office by the President and any removal is to be reported to both Houses of Congress 30 days prior to the removal. In addition to these IG Act protections, Congress could build additional provisions into legislation, to include the following:

¹ GAO-09-468.

² Codified in an appendix to Title 5 of the United States Code (hereafter 5 U.S.C. App.)

³ The IG Act also requires the heads of many "designated federal entities" to appoint an inspector general for each entity. 5 U.S.C. § App. 8G.

⁴ 5 U.S.C. App. § 3(a).

⁵ 5 U.S.C. App. § 3(b).

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- Requirements that the DCAA Director possess the appropriate professional qualifications. For example, provisions for appointment of the DCAA Director could require selection from among individuals who possess demonstrated ability in managing and leading organizations, specific accounting or auditing background, general knowledge of contract management, and knowledge of and extensive practical experience in financial management practices in large governmental or business entities.
 - A mandate permitting the DCAA Director to hold a renewable term appointment of between 5 to 7 years. Legislation should provide that the DCAA Director can be removed only for cause or other stated reasons. These protections would allow the head of DCAA to provide stability and continuity of leadership that span presidential administrations and prevent removal except for cause or other disclosed reasons.
 - Conflict of interest provisions for the DCAA Director and other key staff in addition to those provisions currently in law. This would be intended to ensure that selection of the audit agency head would not involve a "revolving door" situation between contractors and the contract audit agency.

Access to independent legal counsel. The IG Act provides for independent legal advice for IGs rather than requiring the use of agency legal counsel.⁶ Currently, DCAA relies upon DOD legal counsel.⁷ DCAA officials told us that the DCAA Director has not always been apprised of legal decisions by DOD counsel that have impacted DCAA operations. Further, according to the DCAA Director, the lack of independent counsel led to a situation where DOD attorneys provided questionable legal counsel to a DCAA field office supervisor without the DCAA Director's knowledge. Obtaining independent legal counsel would avoid conflicts of interest between DOD and DCAA, thereby helping to improve DCAA's effectiveness.

Budget. The IG Act requires separate budgets for Offices of Inspector General (OIG) within agency budgets, allowing Congress to review IG

⁶ 5 U.S.C. App. § 8F(4)(A).

⁷ Section 893(g) of the Ike Skelton National Defense Authorization Act for Fiscal Year 2011 requires the Secretary of Defense to ensure that DCAA has sufficient legal resources and expertise to conduct its work in a manner that is consistent with audit independence.

budget requests separately. DCAA currently does not have this protection. IGs that are appointed by the President with Senate confirmation receive a separate appropriation, preventing agencies from reprogramming IG funds to other programs and activities. However, there is currently little visibility over DCAA's budget because it is funded under the Operations and Maintenance, Defense-wide appropriation, which includes numerous DOD agencies, such as the Defense Contract Management Agency (DCMA), the Defense Logistics Agency, the Defense Finance and Accounting Service, and some buying command activities. Therefore, DCAA's share of annual appropriations is subject to reprogramming, sometimes without congressional notification. According to the DCAA Director and documentation provided by the Director and Office of Comptroller/CFO, in the past, DOD has reprogrammed funding between DCAA and other DOD activities on numerous occasions. Because these reprogrammings were below the \$15 million threshold for congressional notification, Congress did not have notice of these funding decreases at the time they occurred. For fiscal year 2009, DOD reprogramming increased DCAA's funding by \$3.5 million. Legislation similar to the IG Act could grant DCAA a separate budget⁸ to provide visibility and protections from reprogramming of funds to other agency priorities.

Increased authority and independence. Legislation could strengthen DCAA's audit authority by providing the same level of access to records and personnel available to IGs.⁹ Currently, DCAA has statutory access to certain records related to cost-type contracts or those that contain cost and pricing data, but not to contractor personnel. As a result, DCAA's subpoena power is limited to certain records and does not cover contractor personnel. While we recognize that DCAA auditors have ongoing discussions with contractor personnel, they do not have statutory authority to compel contractor officials to meet with them and submit to interviews. IGs have authority, including subpoena power, to access all records, reports, audits, reviews, documents, papers, recommendations, or other material available that relate to programs and operations for which the IG has responsibilities. Further, IG subpoena authority extends beyond access to records and documents in that IG auditors can administer or take an oath in order to obtain information. Our discussions with DCAA auditors and reviews of audit documentation identified numerous

⁸ 5 U.S.C. App. § 6(f)(1).

⁹ 5 U.S.C. App. § 6(a)(1), (4), and (5).

instances where requests for contractor records were not met.¹⁰ Obtaining increased access to contracting companies, especially their staff and documentation, would be an important provision to improve the effectiveness of DCAA audit staff.

Reporting and oversight of audit results. The IG Act provides for semiannual reports to the agency head and appropriate committees of Congress summarizing results of significant audits and investigations.¹¹ DCAA currently has no external reporting requirement, reducing opportunities for oversight and transparency. Congress could mandate some form of external DCAA reporting in legislation similar to the IG Act. Moreover, DCAA does not currently provide copies of its audit reports to other federal agencies that use the same contractors that DOD uses. According to the DCAA Director, DCAA's appropriations are specific to DOD contractor audits, and unless federal agencies request and reimburse DCAA for audit services, DCAA cannot provide them with copies of its audit reports even though these reports may cover their contractors. Legislation could also expressly allow DCAA to provide audit results to other agencies, a step that would improve its visibility and effectiveness for the government as a whole.

Legislation to grant DCAA similar protections and authorities as those provided in the IG Act could enhance reform efforts that are already under way. Although we found that a lack of DOD Comptroller/CFO and IG oversight has impaired DCAA's effectiveness, DOD has begun work to provide improved oversight of DCAA's operations. In August 2008, the DOD Comptroller/CFO conducted a "tiger team" review of DCAA's audit quality assurance program, and DOD approved a more comprehensive Defense Business Board (DBB) study. The new DOD Comptroller/CFO recognized the need for DCAA oversight and on March 16, 2009, approved the charter for a DCAA Oversight Committee. Committee members include the Auditors General of the Army, the Navy, and the Air Force; the DOD Director of Defense Procurement and Acquisition Policy; and the DOD Deputy General Counsel for Acquisition and Technology. The committee held its first meeting in early April 2009. During May 2009, the DCAA Oversight Committee members reviewed selected DCAA audits and visited

¹⁰ As noted previously, in these cases, there was no evidence that DCAA supervisors elevated the issue to management or to procurement officials to initiate enforcement action, as set out in DCAA policy.

¹¹ 5 U.S.C. App. § 5(a).

a DCAA field office. The committee is continuing to assess DCAA actions on recommendations in these reports and identify any gaps for further action. DCAA has already taken numerous actions to respond to our initial investigative report as well as DOD Comptroller/CFO and DBB recommendations.

Longer-term actions

In the longer term, Congress could consider changes in DCAA's organizational placement. However, moving DCAA as an organization or establishing a new federal contract audit agency would require careful analysis and planning before implementation. For example, numerous governmentwide acquisition management reform efforts are currently under way that could impact the contract audit function. These efforts include congressional oversight and reform legislation and Presidential direction on developing governmentwide guidance for reviews of existing contracts to identify contracts that are wasteful, inefficient, or otherwise unlikely to meet agencies' needs, and to formulate corrective action in a timely manner, as well as interest group studies.

Depending on the outcome of the various contract reform initiatives and the successful implementation of DCAA management reforms, Congress may also want to consider increasing the efficacy of these reforms by establishing an independent governmentwide contract audit agency. The creation of a statutory governmentwide contract audit agency could enhance contract auditor effectiveness and independence by placing the audit agency outside DOD and other federal agencies that make procurement and contract management decisions. Centralizing the contract audit function and mandating its use by all federal agencies also could provide for consistent audit coverage and bring efficiencies and economies of scale to the contract audit process across the government. However, our 2009 report cautioned that this would likely entail significant costs and operational and accountability considerations and would be an extremely costly option involving significant infrastructure and reorganization and would require substantial planning and analysis before deciding whether to proceed and how to implement any changes. Some of the issues that would need further study and analysis include the following:

Governance. Governance is the framework of rules and practices by which a governing body, such as a board of directors, ensures accountability, fairness, and transparency in the entity's relationship with all of its stakeholders, including management, employees, and government. In order to improve governance and accountability at federal

agencies, a variety of laws covering a range of management and administrative practices and processes have been enacted. Consideration of such provisions for a governmentwide contract audit agency should include application of general laws related to funds control, performance and financial reporting, accounting and internal control systems, human resources management, and recordkeeping and access to information, among others. Further, governance issues unique to a contract audit agency, such as its relationships to agency contracting officers and the Congress, should be assessed.

Scope of Work. Scope of work considerations would include roles, responsibilities, and relationships of the governmentwide contract audit agency and IGs with regard to contract audits. Another consideration would be whether the new agency would be available for consultation as an outside expert on federal agency preaward issues. In addition, a determination would need to be made on the handling of fraud referrals. For example, the central new agency could have an investigative division or it could refer potential contract fraud to federal agency IGs for further investigation.

Funding. Congress would need to determine how to fund the new contract audit agency. For example, funding could be provided through appropriations or from reimbursement by federal agencies. This decision would likely be tied to decisions on the governmentwide contract audit agency's mandate and scope of work and any realignment of contract audit resources.

Further study and analysis of this potential action would involve input from the federal agency IGs and agency contracting and finance communities as well as government contractors and public interest groups. Numerous additional issues would potentially be identified and require substantial time and cost for effective consideration and resolution.

Related GAO Reports and Testimonies

High-Risk Series	<p><i>DOD's High-Risk Areas: Actions Needed to Reduce Vulnerabilities and Improve Business Outcome</i>, GAO-09-460T, Washington, D.C.: March 12, 2009.</p> <p><i>High-Risk Series: An Update</i>, GAO-09-271, Washington, D.C.: January 2009.</p>
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TESTIMONY OF

E. SANDERSON HOE
PARTNER, MCKENNA LONG & ALDRIDGE

ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

BEFORE THE SENATE SUBCOMMITTEE ON CONTRACTING OVERSIGHT
OF THE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS

HEARING ON "IMPROVING FEDERAL CONTRACT AUDITING"

February 1, 2011

Madame Chairwoman, and distinguished members of the Contracting Oversight subcommittee, thank you for inviting me to testify. My name is Sandy Hoe and I am a partner at the law firm of McKenna Long and Aldridge. I have been practicing government contract law on behalf of the contractor community for more than 37 years. Today, I am testifying on behalf of the United States Chamber of Commerce. The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region.

I understand the focus of today's hearing is government contract auditing and how it can be improved. I have been asked to address the challenges and experiences that government contractors have encountered with respect to audits and actions that could mitigate those challenges. First, let me affirm that government contractors understand and accept that by providing goods, supplies and services to the federal government in exchange for tax payer funds, they are agreeing to contract auditing requirements not found in the private marketplace. Specifically, they recognize the necessity of auditing by their customer. There are sound public policy reasons for contract audits. The need for such audits is not being questioned. How the audits are conducted is something on which the contractor community has definite views.

Of the three auditing organizations present today, the U.S. Government Accountability Office ("GAO"), the Defense Contracting Auditing Agency ("DCAA") and the Inspectors General at various agencies, government contractors interface most frequently with the DCAA. The DCAA is an agency within the Department of Defense, under the authority of the Under Secretary of Defense (Comptroller). Its primary function is to perform contract audits for the Department of Defense and other government agencies at the request of military and civilian

acquisition organizations and the Defense Contract Management Agency ("DCMA"). In this role, DCAA audits approximately 9,000 contractors each year. In addition to performing contract audits, the DCAA also provides accounting and financial advisory services to Department of Defense Components responsible for procurement and contract administration.

I. CURRENT AUDIT ISSUES IMPORTANT TO CONTRACTORS

A. Role of the Auditor Versus the Contracting Officer

Recent developments have raised concern within the contractor community that auditors are being granted primacy over contracting officers ("COs") in making certain contract decisions. Both traditionally, and by law, contracting officers have exercised authority to make decisions regarding the implementation and performance of government contracts.

A January 4, 2011 Defense Procurement and Acquisition Policy ("DPAP") memorandum identifying steps taken to mitigate "DCMA/DCAA overlap" cited a policy change related to Forward Pricing Rate Recommendations ("FPRR") and Forward Pricing Rate Agreements ("FPRA"). It stated: "where DCAA has completed an audit of a particular contractor's rates, DCMA shall adopt the DCAA recommended rates as the Department's FPRR position." According to the memorandum, DCMA already has coordinated a draft policy reflecting this change. This action, however, conflicts with a uniform body of regulations and judicial decisions that place the final determination for items such as forward pricing rates squarely upon the shoulders of the contracting officer.

The FAR mandates that the corporate administrative contracting officer ("CACO") is unilaterally responsible for determining a contractor's proposal and billing rates, and for determining whether to accept an FPRA as being in the government's interest, or, alternatively,

to issue an FPRR.¹ Decisional authority has further established that DCAA's role is to be advisory, and that the contracting officer may exercise discretion in deciding whether to follow DCAA audit recommendations. ELS Inc., B-283236, et al., 99-2 CPD ¶ 92, 1999 WL 993094 (Oct. 25, 1999); see also OAO Corp., B-228599.2, July 13, 1988, 88-2 CPD ¶ 42, at 6 ("DCAA audits are only advisory; the degree to which they are used is a matter for the contracting officer to decide"). This balance of authority is appropriate, given the contracting officer's authority to administer contracts and "make related determinations and findings," FAR § 1.602-1; § 2.101, as well as the contracting officer's "wide latitude to exercise business judgment" in requesting and considering the advice of audit specialists. FAR § 1.602-2.

The January 4 DPAP memorandum indicates that contracting officers will apparently now issue final rates as determined by DCAA without the contractor having the opportunity to demonstrate to the Administrative Contracting Officer ("ACO") why such rates may be unreasonable. Unless the contractor elects to contest the rates by submitting a claim under the Contract Disputes Act ("CDA"), it will, at a minimum, lose the ability to recoup the lost amounts allocated to fixed price contracts based upon the DCAA-determined rates. This approach would be unfair to contractors and directly conflict with established regulatory law.

The Chamber is also concerned with reports of Inspectors General encroaching on the role of the contracting officer. In a specific instance, during negotiations of a contract for a commercial item, the Inspector General's auditor repeatedly inserted themselves into the discussions between the contracting officer and the offeror and actually participated in the

¹ See FAR § 42.302 (negotiation of forward pricing rate agreements designated to the contract administration office), § 42.704 (the contracting officer shall establish billing rates for several categories of contractors including those business units of a multidivisional corporation under the cognizance of a CACO), § 42.1701 Administrative Contracting Officer ("ACO") responsible for FPRA or issuance of an FPRR in the absence of an FPRA), § 2.101 (ACO unilaterally sets the FPRR).

negotiation calls. In fact, after the company accepted the contracting officer's offer on the pricing, terms and conditions of the contract, due to pressure from the IG, the contracting officer called back and withdrew the offer. In the end, negotiations for the commercial item took 18 months. While this is one example of a difficult negotiation, stories of this type of interference are becoming more common.

B. Stridency in Application of Regulations

Some in industry have noted a sharp upturn in DCAA's reluctance to engage in rational discussion of audit issues since 2008 and 2009 about the same time when the Congress and the GAO demanded improvements to DCAA. While DCAA took many specific and warranted actions in response to the criticism, a less tangible response has been for DCAA to take a no risk approach to addressing audit issues.

The FAR cost principles and other cost and price compliance regulations are relatively explicit, but still cannot and do not cover every circumstance that may arise. Judgment often is necessary in applying the regulations to resolve issues. Unfortunately, since 2008/2009, DCAA seems to have lost its appetite for analysis of the intent of a regulation versus its literal application. Once it has applied the literal language, DCAA seems little moved by any argument that the result reached is nonsensical or that it could not have been what the drafters intended. This has confounded some in the contractor community who believe that the goal of the regulations, and of government contracting generally, is to reach rational results. Combining DCAA's recent stridency with the enhanced authority it is being given for FFPA's and FFPR's produces a potentially toxic mix for contractors.

II. IMPROVEMENTS TO CONTRACT AUDITING

An audit can have at least two perspectives. An audit can be forward-looking where the intent is to identify steps needed to assure that a contractor's systems, policies and procedures will comply with government contract requirements. A contract audit also can be backward-looking where its purpose is to test a contractor's actual compliance with contract and regulatory requirements. The former is affirmative, seeking to assure future compliance. The latter is more investigative and sometimes associated with the rooting out of "fraud, waste and abuse." One is the equivalent of the "carrot" and the other the "stick." Both will incentivize a contractor to be in compliance. However, the carrot is much more likely to achieve the goal.

This is illustrated by analogy to the manufacturing sector of the economy where the saying "You cannot inspect your way to a quality product," is often heard. The lesson from this is that quality needs to be built into a product upfront. "Inspecting in quality" is far less effective. Applying this to government contracting, an emphasis on compliance upfront, through system audits, is preferable to achieving compliance through the threat of possible cost disallowances or worse, e.g., penalties or prosecutions, from backward-looking audits. Focusing more government audit resources on the front-end rather than after-the-fact is likely to bring the government a much larger return on its auditing investment.

Currently, the DCAA has procedures for conducting audits of contractor internal controls, including internal control audits of a contractor's systems in the following areas: general IT, budget and planning, purchasing, material management and accounting, compensation, labor, indirect and other direct costs, billing and estimating. See DCAA Audit Manual at Chapter 5. The DCAA Audit Manual describes the purpose for such audits as "obtaining and documenting an understanding of a contractor's internal controls and for

assessing control risk as a basis for planning related audits.” Id., at 5-101a. The manual recognizes that the effort to conduct such audits may “be offset by reduced audit effort on other related audits.” Id., at 5-101c. Carrying the “upfront” system audit function forward as the DCAA recognizes has the potential to reduce the effort later to perform after-the-fact audits of contract performance.

Placing greater audit emphasis on system compliance can only be effective, however, if the audit is performed timely. Long delays in the performance and completion of audits whether at the front end as a system audit or the backend following contract performance is detrimental to government contracting generally. In some instances, contractors have waited years to obtain an audit and closeout of final indirect rate proposals, although contractors are charged with presenting their proposals within six months of contract completion. During the period rates remain open, contractors who submit proposals particularly on fixed priced work and contracting officers are without firm guidance from previous years’ rates that completed audits would provide. This may turn out ultimately to benefit the contractor or the government. However, it need not be an impediment with timely government audits. Additionally, business needs to move forward. Having unfinished audits that have financial impact on a contractor makes planning future business activities that much more difficult.

Exposing Corruption Exploring Solutions
Project On Government Oversight

Testimony of
 Nick Schwellenbach, Director of Investigations
 Project On Government Oversight (POGO)
 before the
 Senate Homeland Security and Governmental Affairs Committee,
 Subcommittee on Contracting Oversight
 on
 "Improving Federal Contract Auditing"
 February 1, 2011

"...the time of the congress is much taken up with a variety of important matters, but the establishing of some office for auditing accounts is a matter of exceeding importance to the public interest. It is the minutia that must be gone into; the propriety of each charge examined, the vouchers looked into."

-- President George Washington, Commander-in-Chief of the Continental Armies¹

Chairwoman McCaskill and Senator Brown,

Thank you for inviting me to testify today on the importance of contract auditing across the federal government, and on ways to improve contract auditing, including the possible benefits of a proposed independent contract audit agency. I am the Director of Investigations at the Project On Government Oversight, also known as POGO. POGO was founded in 1981 by Pentagon whistleblowers who were concerned about wasteful spending and weapons that didn't work. They needed a safe way of getting that information out to Congress and the public without risking their jobs, and so we were created as the Project on Military Procurement. Over the years POGO has evolved, but we remain devoted to our roots of protecting brave truth-tellers inside the federal government, and to exposing and fixing wasteful spending.

This hearing is an important step. We need a contract audit agency that is not afraid of its own shadow. We need an independent and muscular audit agency that protects the taxpayers' interests.

We believe that there should be an independent Federal Contract Audit Agency (FCAA), as long as it is done right. This isn't a new idea: it is an idea that has been batted around since at least the

¹ Army Audit Agency, "The Evolution of Audit in the Army," <http://www.hqda.army.mil/aaaweb/history.htm>
 (Downloaded January 28, 2011)

1980s, when DCAA whistleblower George Spanton exposed serious problems at DCAA.²

While Department of Defense (DoD) contracts and contract proposals still represent the bulk of the taxpayer dollars DCAA currently examines, the DCAA has evolved since its inception to become a de facto FCAA for much of the government. There are several reasons this has occurred: both the scale of contracting³ and the type of contracting (cost type contracts and fixed price contracts where the Truth In Negotiations Act applies) that need or can benefit from DCAA's expertise have greatly grown outside of the DoD.⁴ DCAA has also become a de facto FCAA because it has developed a deep institutional knowledge of contractors, and utilizing the DCAA may be cheaper for organizations than hiring and/or training their own cadre of contract auditors.

For some time now, as the amount of contracting has grown outside of DoD, most parts of the federal government have seen DCAA as the place to go for contract auditing.

DCAA provides a critical and useful check on contractors. When it is involved, it helps ensure that we pay reasonable prices for what contractors are billing or propose to bill, and spots attempts by contractors to charge unallowable costs. DCAA estimates that it saves slightly more than \$5 for every \$1 dollar invested in it.⁵ It is, however, horribly understaffed given its workload and deserves to be strengthened and expanded. For example, during the early 1990s, it had over 2,000 more employees than it currently does—and there's a greater amount of contracting now.⁶ There was over \$530 billion in contract spending government-wide in FY 2010, although not all of it is subject to DCAA audits.⁷

In addition to DCAA, some IGs conduct contract audits on a regular basis. But their work in this area is dwarfed by that of DCAA.⁸ Non-DoD agencies can request, via their agency's IG, to utilize DCAA services if they are willing to pay for those services. This is a disincentive to utilize DCAA, as the agency must consider whether it has the funds to pay for contract audit services. In contrast, DCAA does not charge other DoD entities for their services.⁹

² Scott Eyman, "The Man Who Knew Too Much: Pratt & Whitney And The Pentagon Didn't Like What Auditor George Spanton Had To Say, But They Couldn't Shut Him Up. Now He's A Hero In The War Against Military Waste," *Sun-Sentinel*, October 27, 1985. http://articles.sun-sentinel.com/1985-10-27/features/8502170694_1_pratt-whitney-man-contracts (Downloaded January 28, 2011)

³ Defense Contract Audit Agency, "Other DCAA Functions," *DCAA Contract Audit Manual*, Chapter 15, November 30, 2010, p. 13. http://www.dcaa.mil/cam/Chapter_15_-_Other_DCAA_Functions.pdf (Downloaded January 28, 2011) (hereinafter "Other DCAA Functions")

⁴ Over the years, the use of cost-type contracts outside of DoD has grown tremendously, such as in the case of health and education research contracts.

⁵ Defense Contract Audit Agency, "DCAA Products and Services," January 11, 2011. <http://www.dcaa.mil/products.htm> (Downloaded January 28, 2011) (hereinafter "DCAA Products and Services")

⁶ Commission on Wartime Contracting in Iraq and Afghanistan, *Federal Oversight of Billions in Services Contracts*, April 19, 2010, p. 74. http://www.warimecontracting.gov/docs/hearing2010-04-19_transcript.pdf (Downloaded January 28, 2011) (hereinafter "Wartime Contracting Hearing")

⁷ USASpending.gov, FY 2010 Contracts "Prime Award Spending Data." <http://bit.ly/fRq8Wf> (Downloaded January 28, 2010)

⁸ "DCAA Products and Services"

⁹ "Other DCAA Functions"

If adequately and centrally funded, an FCAA would remove this disincentive for non-DoD agencies to utilize contract auditing.¹⁰

There are other possible benefits to pulling DCAA out from the DoD and transforming it into an FCAA, the most significant being the independence issue. Currently the DCAA reports to the DoD Comptroller, who is the Chief Financial Officer of DoD, and who in turn reports to the Deputy Secretary of Defense. We have grave reservations whether this structure ensures adequate independence for DCAA, particularly as DCAA's work often establishes issues with how DOD works with contractors.

Furthermore, it is apparent to us that the DCAA Office of General Counsel is not independent—its attorneys are evaluated by the Pentagon's Defense Legal Services Agency. It should therefore come as no surprise that some of these attorneys are responsible for the gag letter sent to one of the DCAA whistleblowers.¹¹ A similar independence problem previously existed with the Pentagon Inspector General (IG) and in 2008 the IG Reform Act gave the Pentagon IG its own independent general counsel and severed its tie to the Defense Legal Services Agency.

The FCAA Proposal

In 2009, the GAO laid out its short, medium, and long-term recommendations for congressional consideration. Those included granting IG Act-style protection to DCAA, then moving it out from under the Comptroller to report to the Deputy Secretary of Defense, and in the long-term, possibly creating an FCAA.¹²

Some knowledgeable insiders tell us that the location of the agency is not the key issue, and that the most important factor is whether this agency has reasonable professional independence and can do its job and be independent of the procurement chain of command.

Still POGO has advocated for the creation of an independent and muscular Federal Contract Audit Agency, because of the scale of contracting and because of what is being contracted out.

There have been many different proposals for an FCAA – most of which do not make sense to us or that have serious flaws. One possibility is to create an FCAA for civilian agencies, leaving DCAA for the DoD. Another idea would place an FCAA in the legislative branch or put the contract audit function back in GAO, as it was for some time. Another possibility is to give the DOD IG the responsibility for contract auditing.

¹⁰ For IGs with a robust contract audit capability, we should explore the possibility of allowing them to continue to have responsibility for this function within their agency.

¹¹ *Expediency versus Integrity: Do Assembly-Line Audits at the Defense Contract Audit Agency Waste Taxpayer Dollars?* Hearing before the Senate Committee on Homeland Security and Governmental Affairs, 110th Congress, September 10, 2008, p. 108. <http://www.gpo.gov/fdsys/pkg/CHRG-110shrg45573/pdf/CHRG-110shrg45573.pdf> (Downloaded January 28, 2011)

¹² Government Accountability Office, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform* (GAO-09-468), September 2009. <http://www.gao.gov/products/GAO-09-468> (Downloaded January 28, 2011)

If DCAA is moved, we believe that a unified FCAA that conducts most contract auditing for the entire federal government (perhaps allowing some agencies to continue to rely on their IGs, such as the GSA IG) and is based in the executive branch makes sense.

Some insiders have privately told POGO that they would perceive a civilian-only FCAA as second rate because of the prominence of DoD contracting. Two major contract audit agencies would also have duplicative administrative costs.

Putting the operational contract audit function in the legislative branch is likely a non-starter. The GAO shed most of its operational contract audit responsibilities in the 1960s and has preferred to do selective, strategic audits in consultation with and by request from the Congress.¹³

Furthermore, contract auditors' existing problems with access to records could get worse if Congress transferred them to GAO or created a separate FCAA in the legislative branch. For instance, GAO lost a case before the Supreme Court called *Bowsher v. Merck* in 1983 on its access to contractor cost records.¹⁴ The Justice Department's Office of Legal Counsel might also argue that a legislative FCAA is performing an executive branch function – and that executive branch agencies can ignore a legislative branch FCAA.

Scattering the bulk of contract audit work to IGs across the government would mean many IGs would have to build a contract audit workforce or take DCAA's. This approach would have difficulty replicating the depth of expertise that DCAA—a large, specialized agency—has developed. This would be a step backward: for instance, a more centralized approach to contract auditing within DoD was the basis for DCAA's creation.

An executive branch FCAA that covers the entire government would be somewhat like the Office of Special Counsel, a roving agency with a vast jurisdiction whose head would have to be Presidentially appointed and Senate-confirmed.

If an FCAA is well-staffed, well-led, well-trained and independent, it could potentially bring numerous benefits:

- It would have more independence and would not report to the DoD Comptroller. This would eliminate even the appearance of the external impairments that exist today;
- It would likely have more visibility throughout the federal government;
- An FCAA's audit and audit-related work across the federal government could be centrally funded;

¹³ Paul C. Light, *Monitoring Government: Inspectors General and the Search for Accountability*. Washington, DC: The Brookings Institution, 1993, p. 27. For some historical perspective, consider GAO's role in 1947, when, according to NYU Professor Paul Light, it "was a vast accounting operation... reviewing 1.5 million contracts." At the height of World War II, GAO employed nearly 15,000 people. It only has around 3,350 employees today.

¹⁴ *Bowsher v. Merck & Co., Inc.*, 460 U.S. 824 (1983). <http://openjurist.org/460/us/824/bowsher-v-merck-and-co-inc-merck-and-co-inc> (Downloaded January 28, 2011)

- An FCAA would presumably be more attuned to the nuances sometimes unique to each agency in the federal government than the DCAA is now;
- An FCAA would be better positioned than DCAA to help identify common systemic problems across agencies in contracting matters; and
- It could better deploy its resources to agencies where there are greater risks.

As much as creating a government-wide FCAA is a good idea, there are some pitfalls to be avoided. Perhaps the biggest risk would be politicization of the mission of the agency because it would be headed by a political appointee.

Despite Some Positive Changes, Deep Concerns With DCAA's Direction

As Congress weighs the pros and cons of an FCAA, we need to improve DCAA as much as possible. We are concerned about the current direction of DCAA.

I have to mention that many current and former DCAA employees and knowledgeable observers believe that companies have taken advantage of the current turmoil at DCAA.¹⁵ In addition, you only have to read the hundreds of comments posted on the *Government Executive* website by people claiming to work at DCAA to understand that there is at least some part of the DCAA workforce that is deeply angry with the direction of their agency.¹⁶ Many, if not most, of the comments hammer home the belief that the agency has become risk-averse. Of course, contractors want DCAA to be risk-averse, and afraid to issue reports. Congress must make sure that does not happen.

Unfortunately, despite its many good auditors and cases where it defended the taxpayers' interests, there have been signs that the agency is not reaching its full potential. For instance, DCAA has not issued a subpoena to a contractor in over two decades despite long-standing access to records problems they have faced from contractors.¹⁷ That, by definition, is risk-aversion and contractors know this.

I believe the subcommittee needs to learn more about why, in FY 2010, far more assignments were canceled at DCAA than were completed, according to records POGO has obtained through the Freedom of Information Act. This is the first time this has happened for at least the past five years, and possibly ever.¹⁸

¹⁵ Richard C. Loeb, "GAO vs. DCAA – And the Winner Is? ... Contractors!" *Government Contract Costs, Pricing & Accounting Report*, Vol. 5, No. 2, March 2010. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616299 (Downloaded January 28, 2011)

¹⁶ Readers' comments, Robert Brodsky, "Defense agency raises bar for reviewing contractor cost proposals," *Government Executive*, November 1, 2010. <http://www.govexec.com/mailbagDetails.cfm?aid=46427> (Downloaded January 28, 2011)

¹⁷ Richard Lardner, "Inside Washington: Auditors go easy on contractors," *Associated Press*, November 9, 2008. http://www.usatoday.com/news/washington/2008-11-09-1290924138_x.htm (Downloaded January 28, 2011)

¹⁸ DCAA in FY2010 canceled assignments (including assignments with "no report issued") far more often than it completed assignments with reports: 16,298 assignments were canceled or "no report issued" versus 11,788

We are also concerned with the ten-fold increase in the proposal review threshold (proposal reviews are where DCAA auditors review cost data in contract proposals).¹⁹ Without the help of DCAA auditors, contracting officers may not be armed with the knowledge they need to negotiate better deals for the taxpayer. To get a sense of how some in the contractor community feel about the change, you should look at one contractor consulting firm's blog post that reports on the change in review thresholds: It has a picture of people jumping for joy.²⁰

Many auditors feel that the DCAA may bring less value to the taxpayer with this threshold change. POGO believes the change is significant, could put billions of dollars at risk, and should be reversed. Some of the essential questions are: Why did the ten-fold threshold change occur? What is the impact? Are DCAA auditors helping contracting officer saves more or less money with the threshold change?

We are concerned by the general decline in contract dollars audited and reviewed by DCAA. In particular, there has been a massive decline in the number of Truth In Negotiations Act assignments conducted by DCAA: in FY 2006 they conducted 468, in FY 2007 438, in FY 2008 348, in FY 2009 148, and in FY 2010 only 59.²¹

We understand that the whistleblowers who testified before the full committee in 2008 feel they have not received adequate and public recognition from agency leadership. There is also a belief by some within DCAA that there has not been enough accountability for the deletion of audit findings or for the gagging of a whistleblower.

One bright spot noted in a recent report by Senator Chuck Grassley (R-IA) is that DCAA has begun sending far more referrals of questionable activity to the Defense Criminal Investigative Service: up from 17 in FY 2007 to 142 in FY 2009. DCAA is sending far more than the IG's own auditors, who only passed along 9 referrals in FY 2009.²² A policy change made by the former Director of DCAA in 2009 removed many of the layers of review by DCAA managers

assignments with reports issued in FY2010, according to assignment data in the DCAA Management Information System provided by DCAA through FOIA to POGO. From FY2006 through FY2009, DCAA finished more assignments with reports issued than assignments that were canceled/no report issued, in most of those years it issued far more. For example, in FY2006, DCAA canceled (or had "no report issued") 16,690 assignments and completed 26,698 assignments where reports were issued.

Overall, there has been a massive decline in the number of DCAA reports issued. According to the database, it has gone from 26,698 assignments with reports issued in FY 2006 to 11,788 in FY 2010 with a drop every single year, but especially large decreases in FY 2009 and FY 2010.

¹⁹ Project On Government Oversight. "Pentagon Radically Reducing Oversight of Contracts Worth Tens of Billions." October 29, 2010. <http://www.pogo.org/pogo-files/alerts/contract-oversight/co-ca-20101029.html>

²⁰ Aronson LLC. "Prepare for a Decrease in DCAA Audits Thanks to New DoD Standards." November 1, 2010. <http://www.aronsonblogs.com/gcsg/?p=1528> (Downloaded January 28, 2011)

²¹ Data obtained by POGO through FOIA.

²² Senator Charles Grassley, *Oversight Review of Audit Reporting by the Department of Defense*, Office of Inspector General, September 7, 2010. <http://grassley.senate.gov/about/upload/Defense-09-15-10-Oversight-Review-of-OIG-Audit.pdf> (Downloaded January 28, 2011)

when DCAA auditors detected suspicious or irregular activity that could be indications of criminal behavior.²³

The staffing increase of over 500 auditors is another very positive sign.²⁴

Changes That Could Improve DCAA and the Role of Contract Auditing

Besides creating an FCAA, there are opportunities to improve the effectiveness of contract auditing.

The Congress recognized the need for IG's to have their own counsel, or access to another IG counsel, rather than that of the agency they are overseeing.²⁵ Similarly, the DCAA needs to have its own general counsel, who is rated by the Director or Deputy Director, and thus directly accountable to the needs of the DCAA.

DCAA needs far more auditors. In the early 1990s,²⁶ when the total amount of federal and defense contracting was lower than today, even adjusted for inflation, DCAA was significantly larger with over 7,000 employees compared to the 4,700 it has today.²⁷ DCAA has nowhere near the workforce it needs to do its job, and the backlog is getting bigger and bigger every year as a result.

DCAA needs more transparency. Unlike the GAO or the IGs, almost no audits or even the results of the audits completed by the DCAA are made public. So unlike the IGs and the GAO, you usually don't have the shaming that comes with publicity of hard-hitting audit findings, except in rare cases such as when Representative Henry Waxman (D-CA) obtained some DCAA reports critical of KBR. For the most part, it may not be appropriate for DCAA audit reports to be made public in an unredacted form because of proprietary information concerns or source selection information – but when a Top 100 contractor has inadequate internal control systems, then DCAA should start naming names. A few years ago, the past DCAA Director testified that 69 percent of Top 100 contractors had at least one deficient internal control system.

DCAA and contract auditing is only one piece of the puzzle: We would also like to see more transparency with how contracting officers handle DCAA and other contract auditors' recommendations. Are they ignoring many of the auditors' findings? When serious and significant disputes are raised by DCAA with Form 1s, how are those disputes being handled

²³ Memorandum from Karen K. Cash, Assistant Director of Operations, Defense Contract Audit Agency, to DCAA Regional Directors *et al.*, regarding Audit Alert – Reporting Suspected Contractor Fraud and Other Contractor Irregularities, February 9, 2009. [http://www.publicintegrity.org/assets/pdf/09-OTS-004\(R\).pdf](http://www.publicintegrity.org/assets/pdf/09-OTS-004(R).pdf) (Downloaded January 28, 2011)

²⁴ Robert Brodsky, "Beleaguered Defense audit agency crafts new vision for the future," *Government Executive*, July 8, 2010. <http://www.govexec.com/dailyfed/0710/070810rb1.htm> (Downloaded January 28, 2011)

²⁵ *Inspector General Reform Act of 2008* (Public Law 110-409), October 14, 2008.

²⁶ <http://www.gpo.gov/fdsys/pkg/PLAW-110publ409/pdf/PLAW-110publ409.pdf> (Downloaded January 28, 2011) and *National Defense Authorization Act for Fiscal Year 2008* (Public Law 110-181), January 28, 2008.

²⁷ <http://www.gpo.gov/fdsys/pkg/PLAW-110publ181/pdf/PLAW-110publ181.pdf> (Downloaded January 28, 2011)

²⁶ "Wartime Contracting Hearing," p. 74

²⁷ Defense Contract Audit Agency, "Staff - As of December 6, 2010," December 28, 2010. <http://www.dcaa.mil/staff.htm> (Downloaded January 28, 2011)

within DoD? In some cases when DCAA found billions in unsupported and questioned costs, DoD failed to hold the contractors accountable.²⁸

Congress also needs to take a look at how the role of contract auditors, namely the DCAA, has been systematically reduced over the last two decades by changes to the Federal Acquisition Regulation and by law. For instance, in two weeks, a contractor-sponsored workshop will be held to help contractors in war zones “get past the lack of adequate price competition and strategies to getting exemptions from the Truth in Negotiations Act (TINA)” in order to evade DCAA.²⁹ Such a workshop is not unusual and it is not surprising that contractors are looking out for their interests. But what the government has done is make it harder for the government to get the best deal for the taxpayer, while making it much easier for contractors to get the upper hand.

As mentioned earlier, something needs to be done with how proposal reviews are handled. This issue is making DCAA less relevant and less effective in protecting the taxpayer. The ten-fold threshold increase in involving DCAA auditors on proposal reviews means contracting officers are being deprived of the help DCAA auditors can give them in negotiating better prices with contractors on tens of billions of dollars worth of contract decisions.

DCAA has long had problems with access to contractor records. Access to records by DCAA is key to proving or disproving contractor claims that taxpayer dollars were spent properly. According to an Associated Press article in 2008, DCAA had not used its subpoena power in 20 years.³⁰ Congress may have a role in improving DCAA’s access to records.

I would also take a look at the complaint system at DCAA. Is it working? Are lots of complaints coming in? What are the complaints? Have the old problems been solved? What, if anything, is being done to address legitimate complaints?

Contract auditors provide a great return on investment and save far more money than they cost. With tighter budgets, we need the upfront oversight to protect money before it is awarded. We know how hard it is to put the milk back in the bottle, and DCAA’s proposal reviews, pre-award audits, and internal controls audits can protect taxpayer dollars before it is spent. We believe an FCAA makes sense, but even if DCAA remains within DoD, it needs to be as strong as possible.

²⁸ Government Accountability Office, *Iraq Contract Costs: DOD Consideration of Defense Contract Audit Agency’s Findings* (GAO-06-1132), September 2006. <http://www.gao.gov/new.items/d061132.pdf> (Downloaded January 28, 2011)

²⁹ American Conference Institute, “Performing Contracts and Subcontracts under DCAA Audit Rules: How to Satisfy Cost or Pricing Data and CAS Compliance Requirements,” *National Battlespace Contractors’ Summit on Minimizing Legal, Compliance & Security Risks*, February 16-17, 2011. <http://www.americanconference.com/Battlespace/workshop.htm> (Downloaded January 28, 2011)

³⁰ Richard Lardner, “Auditors can be easy on defense contractors,” *Associated Press*, November 10, 2008. http://www.boston.com/news/nation/articles/2008/11/10/auditors_can_be_easy_on_defense_contractors/ (Downloaded January 28, 2011)



Fact Sheet

CONTRACT AUDITS AT FEDERAL AGENCIES

Senator Claire McCaskill

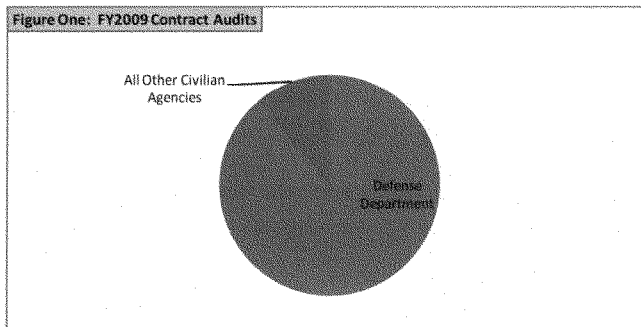
Chairman, Subcommittee on Contracting Oversight

In 2009, the federal government spent more than \$540 billion through contracts.ⁱ Contract audits are one of the key components of effective oversight of these contracts. According to the Government Accountability Office, audits of the cost and performance of government programs are "essential for government accountability to the public and transparency" about whether the government is getting value for taxpayer dollars.ⁱⁱ

The Subcommittee on Contracting Oversight has been investigating how federal agencies use contract audits to detect and prevent waste, fraud, and abuse in government contracts. In April 2010, the Subcommittee requested information from 22 federal agencies about the number and type of contract audits conducted at each agency in 2009, including whether the audits were performed by agency officials, outside contractors, or the Defense Contract Audit Agency (DCAA).ⁱⁱⁱ This fact sheet provides a summary of the Subcommittee's findings.

Significant Variation in Frequency of Contract Audits: In 2009, federal agencies conducted approximately 17,000 contract audits. On average, that amounts to one audit for every \$489.3 million spent through contracts.^{iv}

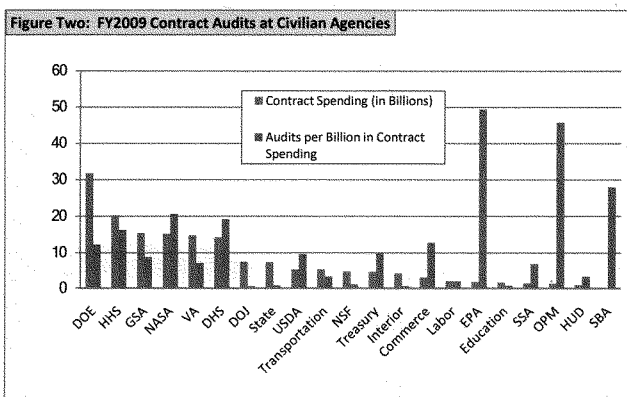
The Defense Department accounts for the majority of contract audits conducted by the federal government. In 2009, the Defense Department, which awarded approximately 70% of all contract dollars spent by the federal government, conducted approximately 89% of all contract audits. See Figure One below.



In total, the Defense Department conducted 15,136 contract audits, an average of one audit for every \$24.7 million spent through contracts. Civilian agencies conducted 1,885 audits, an average of one audit for every \$511.4 million spent through contracts.

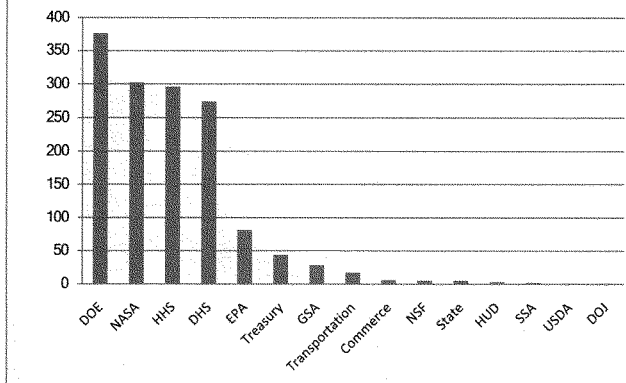
There is a significant variation among civilian agencies in the use of contract audits. The Department of Energy (DOE), which has the second highest level of contract spending after the Defense Department, conducted 389 contract audits, an average of one audit for every \$81.5 million spent on contracts. By contrast, the Environmental Protection Agency conducted one audit for every \$20.2 million; the Department of Homeland Security (DHS) conducted one audit for every \$52.2 million; the General Services Administration conducted one audit for every \$114.1 million; the State Department conducted one audit for every \$1.5 billion; and the Department of Justice conducted one audit for every \$2.5 billion.

In other words, the Defense Department conducted nearly 41 audits for every billion dollars spent through contracts, while DOE conducted approximately 12 audits for every billion. The Environmental Protection Agency conducted 49 audits; the Department of Homeland Security (DHS) conducted 19 audits; the General Services Administration conducted 9 audits; and the State Department and the Department of Justice each conducted less than one audit for every billion spent through contracts. See Figure Two below.



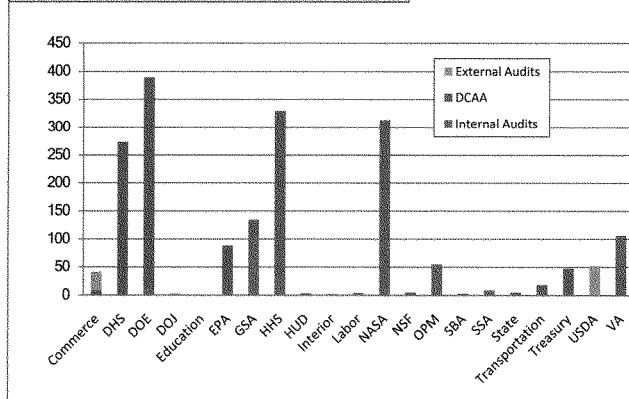
Reliance on DCAA and External Auditors to Perform Contract Audits: Many federal agencies other than the Department of Defense rely heavily on DCAA to perform contract audits. Of the 1,885 audits conducted by civilian agencies in 2009, the agencies reported that 1,441 (76%) were performed by DCAA. In 2009, the Department of Health and Human Services conducted 329 contract audits, of which 296 (90%) were performed by the Defense Contract Audit Agency. See Figure Three below.

Figure Three: FY2009 Contract Audits by DCAA for Civilian Agencies



Some agencies also rely on private contractors to supplement the audit services of the Office of Inspector General and DCAA. For example, the Department of Agriculture spent more than \$2.8 million in 2009 to acquire contract audit services from three different contractors. In total, federal agencies reported using organizations other than their Office of Inspector General or DCAA to perform 92 contract audits in 2009. See Figure Four below.

Figure Four: FY2009 Contract Audits at Civilian Agencies



Failure to Consistently Track Contract Audits: The information provided to the Subcommittee shows that there is no consistent tracking of contract audits. In addition to requesting information from federal agencies, the Subcommittee asked DCAA to provide information about the number of audits it performed for federal agencies. DCAA reported that it performed 1,161 audits for agencies other than the Defense Department in 2009. In other words, federal agencies reported that DCAA performed 280 more audits than DCAA reported to the Subcommittee.

There is no consistent pattern in difference between the information reported by DCAA and the agencies. For example, DHS reported that DCAA performed 274 contract audits for the agency, while DCAA reported that it performed only 77 audits for DHS. The Department of Transportation reported that DCAA performed 17 audits, while DCAA reported that it performed 81 audits for the Department.

ⁱ For data about contract spending, the Subcommittee relies on USASpending.gov, the government's searchable website of data relating to government contracts, grants, and other spending.

ⁱⁱ U.S. Government Accountability Office, *Government Auditing Standards: July 2007 Revision* (July 2007).

ⁱⁱⁱ The Subcommittee requested information from the Department of Agriculture, Department of Commerce, Department of Homeland Security, Department of Defense, Department of Energy, Department of Justice, Department of Education, Environmental Protection Agency, General Services Administration, Department of Health & Human Services, Department of Housing & Urban Affairs, Department of Interior, Department of Labor, National Air & Space Administration, National Science Foundation, Office of Personnel Management, Small Business Administration, Social Security Administration, Department of State, Department of Transportation, Department of Treasury, and Department of Veterans Affairs. The information provided by the Department of State does not include contract audits performed by or on behalf of the U.S. Agency for International Development.

^{iv} For all agencies other than the Department of Energy and NASA, audit numbers are based on the information received from each agency, including the agency's tally of how many audits were conducted by DCAA. Because neither the Department of Energy nor NASA could provide an individual tally for the number of audits conducted by DCAA, the Subcommittee relied on information provided by DCAA for those two agencies.

Post-Hearing Questions for the Record

Submitted to

Mr. Thomas Skelly

From Senator McCaskill

“IMPROVING FEDERAL CONTRACT AUDITING”

Tuesday, February 1, 2011, 2:30 P.M.

United States Senate, Subcommittee on Contracting Oversight,

Committee on Homeland Security and Governmental Affairs

- 1) At the hearing, I asked whether Congress should consider creating agency-wide risk-assessment requirements for contract audits.**

Q: Should agencies adopt uniform risk-assessment standards that incorporate and expand on existing audit and other internal control requirements?

Government-wide uniform risk-assessment standards could be helpful in ensuring that agencies are consistent in their identification of risk factors, though the broad range of requirements that contracts are used to perform and the associated range of complexity and risk could necessitate the development of multiple standards. Resources may also be required to implement these standards and perform the resulting audits.

Q: What key components would be most effective?

Components that could be effective fall into two categories: indicators of individual contract risk, including contract type, procurement method, and dollar value; and indicators of contractor risk, including the number of contracts held with the agency, the level of risk of those contracts, inadequate or non-compliant contractor business systems, and the length of time since the last audit or compliance review.

Q: How should such standards be established?

An interagency and interdisciplinary workgroup consisting of acquisition personnel from large and small agencies, auditors, and risk management personnel could reach out to agencies for best practices and evidence of effective use of standards, and incorporate the results into a Government-wide risk assessment tool that is useful to all agencies. The key would be to ensure that such a tool is accessible and easily employed by both professional auditors and contracting professionals, as some agencies do not have robust audit support.

- 2) The Single Audit Act requires State and local governments, tribal governments, universities, and other non-profit organizations that receive or administer grants with funding from federal agencies to conduct audits of those funds. Could an equivalent requirement for contract audits be imposed on federal agencies and departments to provide an annual account of contract audit findings? What potential advantages and**

disadvantages would such a requirement present for the agencies, IG and other auditing bodies, and the public?

The Single Audit Act requires entities expending at least \$500,000 in Federal funds per year to retain an independent auditing firm to conduct annual audits that meet the standards established in OMB Circular A-133. One clear advantage of establishing a similar requirement for contract audits would be that it would most likely highlight the importance of contract audits, which in turn could lead to increased support for the audit function at agencies. A Single audit includes an audit of the organization's financial statement, a review of its internal control systems and a review for non compliance for the assistance programs. One challenge is to implement the requirement in a way that focuses the use of audits where there is likely to be a favorable cost-benefit. Implementing audit requirements without considering the level of risk (e.g., the size of the procurement, the nature of the requirement, the type of contract use) might result in audits that do not return significant benefit to the Government. For an agency that does mostly fixed-price contracting, incurred cost audits would not be useful on most awards, while this type of audit might prove worthwhile on large cost-reimbursement contracts, particularly at contract closeout. Audits conducted under the Single Audit Act may be conducive to a review of accounting systems and its internal controls; however, they may be less useful when the focus is on the costs of a single contract. In addition, it might be noted that the Inspector General community and GAO have in the past raised concerns about the overall quality of A-133 audits (however the Federal government and the auditing profession has taken signification actions to address audit quality issues) in its application to financial assistance, and the Act also imposes substantial cost and burden on entities receiving Federal funds. In sum, while this proposal seems worth exploring, we strongly recommend conducting a high-quality cost-benefit analysis before creating any additional requirements along these lines.



Department of Energy
Washington, DC 20585

March 22, 2011

The Honorable Claire McCaskill
Chairwoman
Subcommittee on Contracting Oversight
Committee on Homeland Security and Governmental
Affairs
United States Senate
Washington, DC 20510

Dear Madam Chairwoman:

On February 1, 2011, Ingrid Kolb, Director, Office of Management, testified regarding the Improvement of Federal Contract Auditing.

Enclosed are the answers to two questions that you submitted for the hearing record.

If we can be of further assistance, please have your staff contact our Congressional Hearing Coordinator, Lillian Owen, at (202) 586-2031.

Sincerely,

A handwritten signature in black ink, appearing to read "Brad Crowell", is positioned above the typed name.

Brad Crowell
Deputy Assistant Secretary
for Senate Affairs
Congressional and Intergovernmental
Affairs

Enclosures



Printed with soy ink on recycled paper

QUESTIONS FROM CHAIRWOMAN MCCASKILL

At the hearing, I asked whether Congress should consider creating agency-wide risk-assessment requirements for contract audits.

- Q1a:** Should agencies adopt uniform risk-assessment standards that incorporate and expand on existing audit and other internal control requirements?
- A1a:** DOE believes it would be worthwhile to investigate the efficacy of establishing Government-wide uniform risk-assessment standards that incorporate and expand on existing audit and other internal control requirements. There may be valuable insights gained if a Government-wide study were undertaken to see how uniform risk-assessment standards might improve contract auditing no matter who performs the audit.
- Q1b:** What key components would be most effective?
- A1b:** The key components of uniform risk-assessment standards that we believe would be most effective are those that take into account the agency's mission, the agency's size (in contract dollars), the dollar value of the contracts, the importance of the contracts to the agency's mission, the types of contracts, the complexity of the contracts, the history of the contractor in performing Government contracts, and past audit work performed on the contractor's contracts.
- Q1c:** How should such standards be established?
- A1c:** Such standards should be established by a Government-wide working group that includes officials representing agency IG's, DCAA, and agency procurement

executives. There should be a balance in the group between auditors and procurement professionals.

Q2: The Single Audit Act requires State and local governments, tribal governments, universities, and other non-profit organizations that receive or administer grants with funding from federal agencies to conduct audits of those funds. Could an equivalent requirement for contract audits be imposed on federal agencies and departments to provide an annual account of contract audit findings? What potential advantages and disadvantages would such a requirement present for the agencies, IG and other auditing bodies, and the public?

A2: The Single Audit Act requires that an independent auditor perform the audit in accordance with the Government Auditing Standards and must: 1) audit and provide opinions on the fair presentation of the financial statements and the schedule of expenditures of Federal awards; 2) gain an understanding of internal control over Federal programs; and, 3) audit and provide an opinion on compliance with requirements for major programs. The Single Audit Act does not include 1) cost-incurred audits; 2) approval of accounting systems; and, 3) setting of indirect rates. These activities are generally performed by DCAA or other auditors at the direct request of the government.

Either expanding the Single Audit Act or establishing an equivalent requirement or contract audits is feasible and could have several benefits, including consistency of audits across all Federal agencies, a central clearinghouse for all audits, coordinated Federal activity on audits with weaknesses and deficiencies, and potentially a decrease in some types of audits.

There may be some significant downsides however. First, such requirement would involve the creation of another large bureaucracy to oversee the efforts. Since cost-incurred audits are usually targeted to specific agency costs for companies with multiple clients, a blanket requirement to audit all Federal contract dollars in one effort could make the audit very costly and significantly delay reports. For example, small dollar value contracts, now administered and reviewed using abbreviated procedures and desk closeouts, would fall under the blanket requirement and require specific audit testing even though the amount of the contract may be immaterial.

If a more global approach is taken, the contract audit could focus more on control measures rather than specific contract compliance/cost restrictions. This would streamline the audit, provide general recommendations to various funding agencies, but might not satisfy all requirements to ensure that all contract terms are adhered to.

**Post-Hearing Questions for the Record
Submitted to
Mr. Patrick Fitzgerald
From Senator McCaskill**

“IMPROVING FEDERAL CONTRACT AUDITING”

**Tuesday, February 1, 2011, 2:30 P.M.
United States Senate, Subcommittee on Contracting Oversight,
Committee on Homeland Security and Governmental Affairs**

- 1) At the hearing, Nick Schwellenbach, Director of Investigations at the Project on Government Oversight (POGO), stated that the Defense Contract Audit Agency (DCAA) has not issued a single subpoena for production of documents in over two decades.

Q: In the past twenty years, how many requests for personal appearance, documents or information has DCAA made to businesses that have resulted in those businesses’ partial compliance or noncompliance?

Q: In the past twenty years, how many times has DCAA issued a subpoena for personal appearance of an individual, documents or information?

For each instance above, please provide the reason for issuance or non-issuance of a subpoena, the date, the party involved, and a summary of the resolution.

Answer: As part of the audit process, DCAA auditors make numerous requests for documents and information, in addition to gaining access to contractor employees for the purpose of understanding contractor costs, processes and procedures that are subject to audit. To provide context, DCAA completed over 17,000 reviews in FY 2010 and each review may result in multiple auditor requests for documents and information. Generally, contractors provide the information that our auditors require to conduct their audits. However, the issue of contractor timeliness in responding to audit requests has always been a concern as the lack of timely information wastes valuable audit resources while adding additional pressures to the procurement process and increasing the cycle time. We have issued guidance to our audit staff on those situations where the contractor’s employees have denied access to records or engaged in a “slow-roll” tactic. Our guidance outlines our expectations regarding contractor support and the process by which the auditor will elevate these issues to the contractor’s senior management officials. With the exception of the contractor information discussed below (i.e., internal audit/management reviews), our experience has shown that auditors have generally been successful in obtaining appropriate contractor information and data using the procedures outlined in our guidance. When DCAA does not receive the applicable contractor information at the time of report issuance, the audit report is appropriately qualified and/or the associated costs are reported as questioned or unsupported in the audit report.

Title 10 U.S.C. § 2313(b), authorizes the Director of DCAA to require by subpoena the production of any records of a contractor that the Secretary of Defense is authorized to audit or examine under subsection (a) of title 10 U.S.C. § 2313. It should be noted that the DCAA Director's subpoena authority does not encompass the authority to subpoena individuals. In general, the Secretary of Defense is authorized to inspect the plant and audit the records of a contractor or subcontractor performing a cost-type contract or to evaluate the accuracy, completeness, and currency of certified cost or pricing data under Title 10 U.S.C. § 2306a. As noted above, following DCAA denial of access to contractor records procedures, our audit staff has generally been successful in obtaining the information necessary to conduct our audits with the exception of gaining access to contractor internal audit/management reviews as discussed below. As a result, DCAA has not issued any subpoenas in the last 20 years.

The last two subpoenas that were issued were in the 1980's when the United States Court of Appeals, Fourth Circuit – *US v. Newport News Shipbuilding and Dry Dock Co.*, 837 F. 2d 162 (4th Cir. 1988) and 862 F. 2d 464 (4th Cir. 1988), denied enforcement of a DCAA subpoena related to internal audit material from Newport News Shipbuilding. The Court interpreted 10 U.S.C. 2313(b) to mean data subject to a DCAA subpoena should be related to negotiations, pricing, or performance of a particular contract. In this particular instance, the Court ruled that management reviews and internal audits were determined to be beyond the statutory provisions of DCAA subpoena power. Government contractors frequently use the Newport News court case as a basis for denying DCAA access to internal audit and management reviews related to Government contracts, contract costs, and the contractor's internal control over compliance with applicable Government regulations. The lack of access in this area prevents DCAA from fully assessing the contractor's management of its contracts and related costs, which are key internal management controls. To rectify the situation, DCAA has submitted a legislative proposal in connection with the 2012 legislative cycle to clarify the statutory language.

- 2) In its FY09 budget, DCAA estimated a return of \$5 dollars for every \$1 dollar invested. The GSA Office of Inspector General has estimated that it returns \$19 dollars for every \$1 dollar invested. Assuming current staffing and funding levels, how can DCAA improve its rate of return?

Answer: DCAA is not familiar with how the GSA Inspector General calculates savings. DCAA takes a very conservative approach to reporting savings and return on investment. DCAA savings do not represent potential savings or possible future savings if DCAA recommendations were implemented. DCAA only reports documented savings that have been realized based on contracting officer actions.

In most cases, DCAA savings are documented by a review of the contracting officer's Post Negotiation Memorandum (PNM) to determine the savings attributable to DCAA audits. The PNM will summarize how the contracting officer arrived at his or her final decision and whether and to what extent DCAA findings were relied upon. Also, savings resulting from our reviews of contractor operations (i.e., operation audits) are conservatively estimated as only 1 year of savings.

In addition, DCAA savings do not include monetary recoveries from investigations. For example, in FY 2010 DCAA supported more than 130 investigations which resulted in \$231 million in cost recoveries.

We do believe that there is the potential to improve our rate of return in the future. In December 2009, DoD established a formal policy for resolving disagreements with DCAA audit recommendations. The policy calls for elevation of disagreements for resolution (all the way to the Under Secretary of Defense if necessary) and should ensure that DCAA recommendations receive full consideration during contract negotiations. Also, in the last 2 completed fiscal years (2009 and 2010) DCAA's cost questioned per dollar examined essentially doubled. From 2001 to 2008 DCAA's cost questioned per dollar examined averaged just over 3 percent. In 2009 and 2010 that percentage has increased to more than 6 percent. Both the new adjudication procedures and the increase in the percentage of cost questioned should have a positive impact on DCAA's return on investment.

- 3) POGO has proposed the creation of a Federal Contract Audit Agency (FCAA) to address concerns related to DCAA's independence and capacity.

Q: What do you see as the advantages and disadvantages of POGO's proposal?

Answer: We believe that DCAA, as it is currently positioned in the Department of Defense, does have sufficient organizational independence to perform high-quality audits to accomplish its mission. In December 2009, the Department took steps to ensure DCAA's audit findings are given full consideration during negotiations through a formal adjudication process. Overall, the Department has provided extensive support to our Agency. This support included a significant increase in DCAA resources (about 500 additional auditors over the past 2 years) and Department support for the many quality initiatives undertaken by DCAA.

Perhaps the main reason to keep DCAA a part of the DoD is the fact that 85 to 90 percent of its workload is related to Defense contracts. The type of work that the Department does (e.g., sole-source and flexible-priced procurements) may require the extensive use of contract audits. Civilian agencies may not have the same type of need for contract audit expertise.

- 4) At the hearing, Sanderson Hoe questioned DCAA's authority under new January 2011 Defense Procurement and Acquisition Policy (DPAP) to establish final Forward Pricing Rate Recommendations and Forward Pricing Rate Agreements after audit and recommendation, citing the FAR's establishment of the corporate administrative contracting officer as unilaterally responsible for determining a contractor's proposal and billing rates.
- Q: Do you disagree with Mr. Hoe's argument? What gives DCAA this authority? Does this authority contravene existing FAR requirements? If not, what support do you have for this conclusion?
- Q: Would application of this authority discourage businesses' desire to contract with the federal government by limiting their remedy for perceived wrongs to submitting a time-consuming claim under the Contract Disputes Act?

Answer: We believe that Mr. Hoe has misinterpreted the intent behind Mr. Assad's January 4, 2011, memo on "Better Buying Power." As Mr. Hoe noted in his testimony, DCAA's role is advisory to the contracting officer who has the responsibility and authority to enter into agreements, including rate agreements with the contractor on behalf of the Government. Mr. Assad's memo clearly emphasizes this point. However, Mr. Assad's memo recognizes that it is not in the best interest of the Government and the taxpayer to remain in a binding rate agreement when there is more current information available, such as a DCAA audit of a more recent forward-pricing proposal prepared by the contractor. Mr. Assad's memo provides that the DCAA audit position should be the Government's point of departure as the contracting officer attempts to renegotiate a binding forward-pricing rate agreement or a specific contract based on the more current information.

- 5) Mr. Hoe also stated that pre-award audits are more effective than post-award audits for businesses because they serve a carrot instead of a stick. Do you agree?

Answer: We generally agree with Mr. Hoe's characterization of the two approaches to auditing, one being forward-looking and the other looking backward. We believe that both audit approaches are necessary to ensure that the Government and the taxpayer's interest are protected. Audits of contractor proposals prior to contract award has consistently shown that forward pricing proposals pose one of the highest risks to the Government and the taxpayer of inflated costs and prices. The vast majority of the DCAA audit exceptions are derived from audits of contractor proposals before contract award. Equally important is the additional work that we do before contract award, e.g., the Preaward Survey of Contractor Accounting System, to ensure that the contractor possesses the systems and processes necessary to accumulate, record, and bill costs on Government contracts in compliance with applicable laws and regulations. The postaward audits are necessary to ensure contractor compliance with applicable laws, regulations, and the contract terms and conditions while also serving as a significant deterrent for preventing fraud, waste, and abuse.

- 6) At the hearing, I asked whether Congress should consider creating agency-wide risk-assessment requirements for contract audits.

Q: Should agencies adopt uniform risk-assessment standards that incorporate and expand existing audit and other internal control requirements?

Q: What key components would be most effective?

Q: How should such standards be established?

Answer: As noted in my testimony, over the last several months we have been working with Defense Procurement and Acquisition Policy to revisit DoD's reliance on DCAA audits to ensure that our scarce audit resources are focused on the areas of the greatest risk to the Department, warfighter and the taxpayer. We believe that similar assessments should be made within other Departments to establish appropriate thresholds and criteria indicating potential risk

to that Department and its programs and ensure consistent audit coverage on all programs within each Department.

As noted above, establishing Department-wide, or perhaps Government-wide criteria, such as dollar thresholds for forward-pricing proposal audits as used in DoD, helps to ensure consistent audit coverage. In addition, the criteria should also consider contract- or contractor-specific information such as the type of contemplated award (i.e., cost-reimbursable or firm-fixed-price), adequacy of their business systems, and past performance. Establishing broad-based criteria would strengthen the audit oversight process, allowing for transparency and consistency across the board.

Given the risk of inflated prices associated with contractor proposals, we believe that the taxpayer would benefit from Government-wide standards that recommend audits prior to award of negotiated contracts over certain dollar thresholds, similar to those established for DoD. Threshold recommendations for proposal audits, or any other type of audit, could be incorporated into the Federal Acquisition Regulations so that they apply to all Government awards.

- 7) The Single Audit Act requires state and local governments, tribal governments, universities, and other non-profit organizations that receive or administer grants with funding from federal agencies to conduct audits of those funds. Could an equivalent requirement for contract audits be imposed on federal agencies and departments to provide an annual account of contract audit findings? What potential advantages and disadvantages would such a requirement present for the agencies, IG and other auditing bodies, and the public?

Answer: The Single Audit Act, as amended, requires each reporting entity that expends \$500,000 or more in Federal awards in a year to obtain an annual "single audit." The audit covers both the reporting entity's financial statements and Federal awards. Although, in theory, the single-audit concept could be adopted by federal agencies and departments, further study is needed to determine if the single-audit approach would provide quality audit oversight (e.g., preaward audits, monitoring during the contract, and postaward audits) at for-profit contractors. As brought up in testimony, an advantage to establishing a similar requirement for contract audits would be the potential for improving the risk-assessment process by considering program risk through an agency-wide risk-based audit approach as described in OMB A-133, (i.e., four-step major program determination). However, concerns about the quality and sufficiency of audit coverage under the Single Audit Act and the effectiveness of the single audit for oversight of indirect costs have been raised by the Council of Inspectors General on Integrity and Efficiency and the GAO. While we agree the single audit is a valuable tool, it may not be the right tool to ensure compliance with contract-specific terms and conditions when associated with contracts awarded to for-profit entities. The objective of any new requirement should be to maintain proper balances between risk and cost-effective accountability, and to help ensure the best use of available audit resources.

- 8) How will DCAA deal with the backlog of cost-incurred audits and the demand for increased preaward audits given its current resources?

Answer: As noted above and in my testimony, over the last several months we have been working with Defense Procurement and Acquisition Policy to revisit the Department's expectations of DCAA to ensure that those expectations are focused on the highest-risk areas, including incurred-cost audits. However, we view contractor preaward proposals to be one of the greatest risks to the Government and the taxpayer; therefore, we generally perform all of the preaward audits at the expense of resources devoted to incurred-cost reviews. For incurred-cost purposes, we consider the Overseas Contingency Operations contracts to be the highest priority and are focusing our available incurred-cost audit resources in this area while we work with the Comptroller to obtain the additional resources necessary to address the incurred-cost backlog. Again, this is in addition to the work that we are doing with the Department to evaluate our audit requirements.

**Post-Hearing Questions for the Record
Submitted to the Honorable Patrick Fitzgerald
From Senator Scott P. Brown**

**“Improving Federal Contract Auditing”
February 1, 2011**

1. In your testimony to the Subcommittee you stated that DCAA’s incurred cost audit backlog has quadrupled.
 - a. What exactly is the amount of backlogged audits and how much has it grown over the last two years?
 - b. What is the amount of backlogged audits for the Department of Defense?
 - c. What is the amount of backlogged audits for your reimbursable civilian agency customers?
 - d. Given your current resources, how long do you anticipate it will take to complete the audits in the backlog?

Answer: The backlog of unaudited dollars at the end of FY 2010 was \$406.0 billion. At the end of FY 2008 it was \$152.6 million for an increase of \$253.4 billion. The backlog of unaudited dollars for reimbursable civilian agency customers is about 9 percent of the total, or about \$36.5 billion (9 percent of \$406 billion). DoD represents the remaining 91 percent or about \$369.5 billion. This is an estimate and the amount for reimbursable backlog may be higher because the information identifying the effort as reimbursable is not necessarily available until the audits are ready to begin. The incurred cost backlog began increasing after the start of the Iraq war, although it stayed at a manageable level through FY 2005. From the end of FY 2005 to the end of FY 2008, the backlog increased from \$86.2 billion to \$152.6 billion, for a 77 percent increase. Over the same time period DCAA staffing remained level. DCAA staffing has grown over the past two years. Still, given our current resources, it will take at least five years to complete the audits currently in the backlog. In the meantime, the incurred cost backlog will continue to grow as new audit requirements are added. With current resources, we will not be able to make any progress on reducing the backlog unless we significantly curtail audit effort in other areas.



U.S. General Services Administration
Office of Inspector General

March 21, 2011

Honorable Claire McCaskill
Chairman
Subcommittee on Contracting Oversight
Senate Committee on Homeland Security & Governmental Affairs
601 Hart Senate Office Building
Washington, DC 20510

Dear Senator McCaskill,

Thank you again for inviting me to testify on the importance of contracting oversight at the Subcommittee's hearing on February 1, 2011. I appreciate your strong commitment to contract oversight and to Inspectors General. I am hereby responding to your post-hearing questions for the record.

You asked me whether agencies should adopt uniform risk-assessment standards that incorporate and expand on existing audit and other internal control requirements. Agency-wide standards may be useful in setting parameters or establishing guidance for risk assessments as the basis for selecting contracts to be audited. In my opinion, there are two factors that would have to be considered if agencies would be required to do this. First, flexibility in standards would be important to meet the needs of each agency. Second, resources would be needed to conduct the audits that are identified.

These factors are important because, in the case of contract auditing, one size does not fit all. Some audits are conducted because of the contract vehicle used, while others are performed because of claims against the government. Others are conducted from a preventative or compliance perspective, such as our preaward and post-award Multiple Award Schedule (MAS) reviews. Additionally, there would have to be a control point for implementing this requirement since, as the hearing showed, not all Offices of Inspector General conduct contract audits, and some contract audits are performed by others under the direction of the agency.

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I have identified three key components of risk-assessment standards that would be most effective:

- 1) criticality to the agency's mission;
- 2) contract attributes such as dollar value and contract type, and whether the need for the audit arose from special circumstances such as a claim or a quit tam; and
- 3) contractor risk such as past experiences with the contractor and the number of contracts held with the agency.

An interdisciplinary task force comprised of audit and acquisition personnel may be necessary to best capture and address the concerns of the community impacted by these new standards. Currently, the Council of Inspectors General on Integrity and Efficiency (CIGIE) and the Government Accountability Office (GAO) are the established bodies for promulgating standards and guidance related to audits.

You also asked my office to identify the advantages and disadvantages of imposing a requirement similar to the Single Audit Act on federal agencies and departments to provide an annual account of contract audit findings.

I believe that using standard risk assessment guidance and a greater sharing of contract audit findings would be beneficial. Federal agencies and departments could provide an annual account of contract audit findings and report on recurring issues and trends.

Implementation of these requirements on the federal level may present some obstacles, however. First, since contract audits are done for various purposes, the findings may not directly relate to other contracts, and there may be issues with security and proprietary data. For example, audit findings related to a contractor providing weapons systems on a cost type contract could not be readily transferred to a pre-award MAS review of that contractor providing information technology solutions. Second, it may be difficult and costly for agencies to collect and report the data, as that data would have to have consistent definitions and be widely accessible. Additionally, there would have to be a control point in each agency since not all contract audits are conducted by Inspectors General.

I would like to clarify one statement in my testimony. I stated we do not currently use DCAA and that we have used DCAA in the past a few times in relatively limited capacities, but currently my office conducts audits at GSA. That statement is correct, but to be sure there is no misunderstanding, I wanted to clarify that there may be occasions in the future, as in the past, when circumstances require us to seek limited DCAA assistance.

132

Please feel free to contact myself or Dave Farley on my staff at (202) 219-1062. I look forward to working with the Subcommittee in the future on the importance of contract oversight.

Sincerely,



Brian D. Miller
Inspector General

3

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