



# Better Auditing for Better Contracting

Eight Recommendations to Reform the Defense Contract Audit Agency and other Federal Government Audit Departments

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By Pratap Chatterjee

March 2012



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# Introduction and summary

The federal government needs to strengthen auditing of the \$530 billion in taxpayer money that is awarded annually to contractors in order to make sure that the public gets value for dollars spent.<sup>1</sup> The agency with the greatest share of this work is the Defense Contract Audit Agency, which despite its name and location within the Pentagon is responsible for the lion's share of auditing government contracts. The Defense Contract Audit Agency recovered \$2.7 billion in 2010, but it could increase this substantially if it was fully and properly staffed and given more funding together with sufficient authority and independence.

Three years ago, as many as 30,000 audits of government contracts a year were conducted annually.<sup>2</sup> That number has now plunged to 10,000 audits per year despite the fact that the dollar value of contracts issued has remained steady. The time taken to check up on proposed prices before a contract is awarded now stands at 72 days, up from 28 days only two years ago.<sup>3</sup> These dramatic changes were spurred on by a series of reports by the Government Accountability Office, the investigative arm of Congress, that suggested the auditors were doing their work too quickly, and in the process failing to document their work in accordance with government auditing guidelines.

DCAA responded to these criticisms by emphasizing additional work documentation, but now questions are being raised if the agency isn't placing too much emphasis on following questionable practices that add little to the quality of audits, to the detriment of conducting hard hitting audits. "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," said Sen. Claire McCaskill (D-MO) at a recent congressional hearing on fixing the existing auditing system.<sup>4</sup>

The Defense Contract Audit Agency is in charge of auditing all military contracting, about \$367 billion or 70 percent of all government contracting in fiscal year 2010.<sup>5</sup> In addition, an astonishing 76 percent of civilian audits were also

performed by the agency in 2009, according to data collected by the staff of the Subcommittee on Contracting Oversight of the Senate Committee on Homeland Security and Governmental Affairs.<sup>6</sup>

The Defense Contract Audit Agency is proud of its work—with good reason. In the past the agency has claimed a return on investment as high of \$50 for each dollar spent,<sup>7</sup> although that number has gone down over the years to \$5.10 per dollar today, according to the agency’s own estimates.<sup>8</sup> That is to say for every dollar that the government spends on the agency today, it generates five times as much in recovered funds and lowered costs.

The Defense Contract Audit Agency has also come under fire from whistleblowers, who complain that the agency is not doing a good enough job. And it’s not just angry workers: The agency first faced attacks in congressional hearings for an obsession with “metrics” or finishing as many audits as possible in the shortest possible time but contractors are now berating the agency for taking too long.

In response to the critical GAO report and Congressional hearings, the Defense Contract Audit Agency has attempted difficult shifts in its bureaucratic culture over the past three years. However, many believe that these changes have not been for the better, but have actually lessened oversight of government contractors. In particular, DCAA now seems to be focusing on fewer contracts, and this is clearly not good enough. Consequently this paper recommends that Congress should strengthen this federal auditing system by:

- Hiring more qualified auditors at the Defense Contract Audit Agency and other agencies with auditing responsibilities, such as the Department of Energy
- Giving auditors authority to subpoena contractor records, which they cannot do now
- Naming and shaming companies that do not have adequate financial systems
- Withholding 10 percent of contractor fees if they do not have adequate business systems in place to create a financial incentive to improve accounting systems
- Moving to risk-based audits and random checks rather than excluding certain types of contracts such as limiting proposal audits to fixed-price contracts over \$10 million and cost-type contracts over \$100 million, as is now the practice

- Completing pricing reviews within a set number of days so that the contracting agencies can issue contracts in a timely manner
- Providing the Defense Contract Audit Agency with its own independent general counsel so that it does not face a conflict of interest by relying on the Pentagon's lawyers
- Evaluating whether the Defense Contract Audit Agency should report directly to Congress rather than to the Pentagon as is presently the case.

In the pages that follow, this report will profile the different reasons audits by the Defense Contract Audit Agency sometimes fail, and what's been done to correct these failures in the past. This analysis will put in perspective the important set of detailed recommendations that conclude this report.

# Background: Contract audit failures

When a federal government agency decides that it needs to buy something from a private contractor, it turns to one of its employees known as a contracting officer who draws up a “request for proposals” under the guidelines specified in the Federal Acquisition Regulation. The contracting officer may ask auditors for assistance in pricing the contract and conducting negotiations depending on the nature of the contract. These audits, depending on the agency involved, may be conducted by auditors from three sources—the inspector generals of the respective agency, the Defense Contract Audit Agency, or public accounting firms.

All requests for proposals (if public and valued at over \$25,000) are supposed to be made available on a website called FedBizOps. Many of the contracting opportunities posted to FedBizOps require an audit to support the negotiated price. Typically the contract types for which audit assistance may be required fall into three categories:

- Fixed-price contracts where the contractor provides supporting cost or pricing data to establish the reasonableness of price
- Time-and-materials contracts based on fixed, per-hour labor rates
- Cost-reimbursable contracts where a contractor submits invoices for allowable costs incurred

Cost-reimbursement contracts, often known as “cost-plus” contracts, provide that a contractor gets paid for all allowable costs plus a percentage of the estimated cost of performance as profit.

In the hierarchy of these three contract types, time and material contracts are considered to be the most risky, followed by cost-reimbursement contracts, and finally fixed-price contracts. Each one of these contract types has several variations, which may further add to the risk assumed by the government and/or the contractor.

Once an agency awards a contract it falls to the contracting officer to monitor the contractor's performance. Sometimes this function is delegated to an administrative contracting officer or a contracting officers representative.

Auditors work with contracting officers before, during, and after a contract is signed to try to ensure that the price paid is fair and reasonable, and that the taxpayer gets the benefit of the bargain that was negotiated. Auditors can be asked to evaluate costs and prices during contract negotiations, particularly with so-called no bid, or sole-source, contracts. The auditor might also review an individual contractor's internal systems such as billing, labor costs, and quality control.

After a contract starts, and through the final closeout, auditors can review invoices of incurred costs to ensure that a contractor's claims can be justified under government regulations.

The Defense Contract Audit Agency audits the vast majority of contracts for the simple reason that the Department of Defense spends roughly 70 percent of all federal contracting dollars. A recent study by the Senate Subcommittee on Contracting Oversight showed that 76 percent of all civilian agency audits and a total of 89 percent of all federal contracting audits are also done by the Defense Contract Audit Agency. Some agencies are almost wholly reliant on the agency for contract auditing. The Department of Health and Human Services, for example, has the highest percentage of civilian agency audits performed by the Defense Contract Audit Agency, roughly 90 percent.<sup>9</sup>

Some government agencies use their own inspectors general instead of the Defense Contract Audit Agency. The General Services Administration, which buys products and services for use by other federal agencies, estimates that its inspector general spent \$58 million and recovered \$1.2 billion in fiscal 2009 and 2010, a cost savings of almost 20 to 1. The Department of Education inspector general spent \$255,123 to audit a 2006 contract with the National Assessment of Educational Progress and recovered \$2.93 million for the taxpayer in improper billings and unallowable costs, a savings of almost 12 to 1 compared to the cost.<sup>10</sup>

A few government agencies use public accounting firms, although this is relatively rare. Just 92 out of the 17,000 contract audits performed during 2009 were performed by these firms. Here's one example: The Department of Energy hired the big auditing firm KPMG in May 2010 to audit financial assistance awards under the American Recovery and Reinvestment Act of 2009. Ingrid Kolb, the



director of the office of management at the Department of Energy, says that the department undertook this unusual step because it was worried that the Defense Contract Audit Agency had a major backlog—what she described as “challenges with an increasing workload and fewer resources.” Kolb noted that even though her department was happy with the public accounting firm, the services provided were not “apples to apples” and that she preferred to use the Defense Contract Audit Agency for more “complex” audits.<sup>11</sup>

The consequences of a negative audit finding can range from the determination of a simple unallowable cost to serious criminal charges. In the case of poor billing procedures, such as a failure to produce timesheets, auditors can first ask the contractor to fix the problem by issuing a so-called statement of condition and recommendation, or declare that a contractor has “inadequate” procedures, which can delay or halt payment to the contractor.<sup>12</sup>

A finding of a poor business system (such as a property management or an accounting system) could also result in a similar automatic hold on full payments until the problems are resolved. Conversely, a company with good business systems is allowed to engage in “direct billing,” which means they are paid in full without the need for an audit of each invoice.

Auditors are also supposed to track down evidence of fraud, waste, and abuse such as “unsupported” costs (inadequate documentation to justify the charge) or “questioned” costs (costs that appear to be too high for the work done) or “disallowed” costs (costs that are contrary to the contract or rules governing cost charging). In any of these cases, an auditor issues a “Form 1” that automatically results in a “withholding” of payments. If the contractor can justify an expense, then the withholding is removed.<sup>13</sup> If criminal behavior (such as bribery) is suspected, then an auditor can issue a “Form 2000” and refer the matter to the Federal Bureau of Investigation or the Defense Criminal Investigation Service, a unit of the Department of Defense.<sup>14</sup>

If an auditor’s criticism is found to be valid, then the federal government can deny payment. Typically, some 70 percent of the Defense Contract Audit Agency’s withholds are “sustained.” That percentage dropped dramatically in Iraq, provoking sharp criticism that the military commands were caving in to the contractor or political pressure.<sup>15</sup>

How often contracts are audited varies from agency to agency. In 2009, federal agencies performed roughly 17,000 contract audits, according to the Senate

Subcommittee on Contracting Oversight. This works out to one audit for every \$489.3 million spent on contractors. The precise amount varies from agency to agency. One audit is conducted for every \$24.7 million spent on contractors by the Pentagon to one for every \$2.5 billion dollars spent at the Department of Justice.<sup>16</sup>

Federal auditors perform these routine tasks on as many risky contracts as possible in order to catch the most likely instances of waste, fraud, and abuse and make sure that taxpayers get value for money. Businesses often grumble about the bureaucracy but as we will see in the next section, even these audits miss significant problems.

# Recent audit failures

In 2008 after receiving whistleblower complaints, the Government Accountability Office launched an inquiry into 14 Defense Contract Audit Agency audits that were conducted between 2003 and 2007 at three agency offices in southern California. A first report from GAO found that in every single one of the 14 audits, DCAA staff did not have the backup documentation to support their own draft conclusions, as is required under generally accepted government auditing standards known as GAGAS.<sup>17</sup>

A follow-up GAO report examined another 69 DCAA reports done between 2004 and 2006 from around the country to see if there were systemic problems. This investigation found 64 of the 69 had “serious problems” and even the remaining five “had compliance problems.”<sup>18</sup> These findings sent up alarm bells in Congress, which had typically looked to the auditors to make sure that taxpayer money was not being wasted.

The GAO reports discovered three broad type of problems: poor quality work, a failure to report bad contractors, and an overreliance on limited audits. Let’s examine each in turn.

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## Poor quality work

Defense Contract Audit Agency auditors, for example, spent 2,292 hours auditing one specific contract in Iraq held by Parsons Corporation, a construction company from Pasadena in southern California, worth \$516 million. The auditors reported to have discovered \$89 million in unsupported and questioned costs, but when GAO examined the audit, they found that the DCAA staff “did not perform sufficient work” to support their opinions, arguing that the auditing of the contractors unsupported costs was slipshod and open to challenge.

Similarly, DCAA auditors checked just 12 of some 22,000 transactions conducted between May and July 2005 by one of the top five military contractors (the company was not identified in the report). In 20 out of 22 audits reviewed, the agency did not test to see if the company had submitted duplicate invoices. In 6 out of 9 audits reviewed, DCAA did not check if the company had separated out “allowable and unallowable” costs.

Finally, at one major military contractor, the agency gave the company a clean bill of health after interviewing just two employees instead of examining the company’s actual accounting system.

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### Failure to report bad contractors

Here are just three examples of over 80 audit reports examined by GAO that covered contracts issued between 2003 and 2007. In the first case, Interstate Electronics Corp., a military satellite display manufacturer, was discovered to have a faulty billing system in 2005. This faulty system caused it to overbill the government by at least \$246,000 on one occasion (later refunded by the contractor) and potentially another \$3.5 million in another instance. Despite being notified of these problems, the Pentagon allowed Interstate Electronics to continue “direct billing,” which meant the company was automatically paid in full without additional scrutiny when it turned in its invoices without prior scrutiny.<sup>19</sup>

In the second case, William French, a Defense Contract Audit Agency supervisor in Iraq, ordered a staffer to sign an audit conducted on Parsons Corp. The order was issued after Parsons complained that the auditor “did not fully understand its new policies and procedures” on accounting controls. The company was given an “adequate” opinion in August 2006.<sup>20</sup>

Five months later, Parson’s repair work on the Iraqi police headquarters was found to have “plumbing failures and electrical fires” and eventually all the company’s work in Iraq was canceled in 2007.<sup>21</sup> The Defense Contract Audit Agency finally withdrew Parson’s clean audit in December 2008 after the GAO investigation. Despite this finding against his oversight work, French was promoted to Western Regional Quality Assurance Manager for DCAA, and then to branch manager at the Pasadena office that audits Parsons.<sup>22</sup> (French did not respond to requests for comment on the GAO charges)<sup>23</sup>

In the third case, Paul Hackler, a Defense Contract Audit Agency supervisory auditor, examined billing practices at a \$835 million custom-designed manufacturing plant built by a Boeing Inc. subsidiary in Decatur, Alabama, in the mid-1990s to produce 40 Delta IV rockets per year.<sup>24</sup> The original idea behind the plant was to put up satellites to serve the nascent cell phone industry. The venture failed when cell phone operators decided to use land-based towers instead.

In 2005 the Air Force Space and Missile Systems Center agreed to pay a monthly retainer to Boeing to maintain a satellite launch capability. Even though the government was typically just buying one rocket every couple of years, Boeing's financial managers seemed to have decided to recoup some of the original costs by charging inflated fees. An auditor also discovered that Boeing might have overpaid salaries totaling \$11 million.<sup>25</sup>

“Despite our documented objections, upper management instructed us to issue an audit that failed to report numerous violations and the Air Force awarded Boeing \$270 million of past losses,” Hackler later testified to Congress.<sup>26</sup>

Defense Contract Audit Agency managers also “replaced the supervisory auditor and auditor, and the new staff worked together to modify working papers and change the draft audit opinion from ‘inadequate,’ to ‘inadequate in part,’ and, finally, to ‘adequate,’” he added. Boeing later settled this case without admitting to these allegations or any liability.

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## Over-reliance on limited audits

Sometimes other agencies besides the Department of Defense have relied too heavily on the Defense Contract Audit Agency in order to reduce their own workload. In such cases, the fault for failures may lie with the buying agency rather than with DCAA.

The Department of Energy, for example, recently justified paying out between \$40 million and \$60 million a month to engineering and infrastructure giant Bechtel Corp. to build a waste treatment plant at the Hanford nuclear site in Washington state, claiming that the Defense Contract Audit Agency had issued a clean audit of Bechtel's billing systems. The Department of Energy conducted little supervision over the project, which gradually ballooned from an 11-year-long \$4.3 billion project starting in 2000 to a 20-year, \$12.2 billion project now scheduled to end in 2019.<sup>27</sup>

A GAO study later found that the DCAA audit of Boeing's billing systems that the Department of Energy relied upon was a cyclical report done every three years for the company as a whole and not on the actual project. The failure to do proper supervision "exposed the hundreds of millions of dollars spent annually," according to the GAO, "to an unnecessarily high risk of improper payments."<sup>28</sup>

# The problems: Metrics, records, experience, and independence

Why is the Defense Contract Audit Agency doing a poor job? Four reasons stand out.

- Pressure to complete audits as quickly as possible, resulting in a mad metrics meltdown
- Lack of access to proper records, making it hard for auditors to do their jobs
- Lack of qualified personnel, resulting in reduced capacity to do sufficient audits
- Lack of independence and authority, making the agency susceptible to pressure from contractors and high-ranking officials

Some of these problems stem from the history of the agency. A year after DCAA was created in 1965, it had 3,662 staff in charge of auditing \$21.5 billion in contracts.<sup>29</sup> Over the last four decades, DCAA's oversight of contract dollars expanded over four-fold (after adjusting for inflation) to a high of \$501 billion in proposed or claimed contractor costs that generated 30,352 audits in 2008.<sup>30</sup>

Initially the agency expanded to cope with the workload, doubling in size by the early 1990s to over 7,000 staff.<sup>31</sup> But following the advent of the Clinton administration's Re-Inventing Government initiative, the number of Defense Contract Audit Agency audit staff was slashed and plummeted to a low of 3,526 in 2003. Staff cuts were reversed following the explosion in contracting that took place in the last decade, and stood at 4,725 staff by mid-2011.

In the last two years, following the criticism of fast and sloppy auditing by DCAA by the GAO, the agency dramatically slowed down the number of audits it conducts from over 30,000 in 2008 to just 17,000 in 2009 and to 10,000 in 2010, with the agency now abandoning more audits than it completes.<sup>32</sup>

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## Mad metrics meltdown

Here's how this happened. In the 1990s, the Defense Contract Audit Agency first came under severe criticism because it had a backlog of audits, some of which were seven years old. Bill Reed, then director of DCAA, ordered sweeping changes in how the agency conducted audits in order to catch up and to comply with the prevailing sentiment that the federal government had become over-bureaucratic and bloated.<sup>33</sup> A senior auditor from California who worked at DCAA explained what happened: "We basically closed out outstanding audits of procurement dollars by looking the other way."<sup>34</sup>

Next, Reed ordered his staff to focus on performance "metrics," which he narrowly defined as the speed at which audits were completed. "To put it bluntly, cheaper, faster, better," his successor April Stephenson would recall later.<sup>35</sup> Multiple layers of supervision and management were created such to ensure that staff completed even the most complex of audits in less than 30 days. In fact, auditors complained that they spend more time tracking their efficiency under the new "Defense Management Information System" than conducting auditing, defeating the whole purpose of working better.<sup>36</sup>

A former senior auditor at DCAA summed up the process in an online posting on Government Executive's website:

*"Typically, a budget will be anywhere from 24 to 40 to 80 hours, depending on the complexity of the job. Every auditor spends at least half of the time just setting up the shell—formatting what will be done. The written report takes anywhere from 8 to 24 hours to write. What little time that is left to do the audit is typically 4 to 16 hours. Of course, one should not find anything wrong - there goes the elapsed days and or \$/hr. metrics ... Only an idiot will blow the budget for an assignment and get a red light for missing those great "metrics." Only punishment will be received for "failing" to do what the mgmt. wants—the GREEN LIGHT."<sup>37</sup>*

Another wrote in to say: "Mad Metrics Meltdown! The application of engineering and factory floor measurements to professional activity is a lazy, risk-averse, anti-intellectual crutch of poor management."<sup>38</sup>

For staff who were serious about their work, there was only one way to complete the auditing. "Unless I'm willing—and I have been—to work on my own time on weekends, I can't finish the audits within the certain hours and I don't—and at the



end, when my performance gets rated, my supervisor will run through a summary of the audits I completed during the year and how much a percentage I ran over the budget. And if I ran more than 10 percent, I got dinged,” said Diem Thi Le, a senior auditor in the Santa Ana office of DCAA in southern California with 20 years of experience at the agency.<sup>39</sup>

Auditors who finished quickly and met the metrics got promoted faster. Defense Contract Audit Agency whistleblowers say that the system effectively encouraged auditors to ignore waste, fraud, and abuse because finding fault with a contractor would slow down their audits and cause them to miss their metrics. Big military contractors quickly learned that they could easily exert pressure on DCAA auditors to give them a clean bill of health rather than lose a promotion for being late in meeting their quota.<sup>40</sup>

Supervisors also discouraged auditors from submitting fraud reports unless they have complete proof, even though one of the tasks of the auditor is to report suspicious behavior for further scrutiny by federal criminal investigators.<sup>41</sup>

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### Lack of access to records

In theory, auditors can issue a subpoena to demand records from contractors in order to check if there has been any fraud, waste, or abuse. As far back as 1983, veteran Defense Contract Audit Agency auditor and whistleblower George Spanton underlined the need for access to records at a hearing in Congress. “I defy any auditor to be to do a professional audit without the records, no matter how minimal the limitations. The one record he does not see could be the one that make the entire audit worthless,” he said.<sup>42</sup>

Just a few years later, the courts ruled against DCAA’s subpoena power in a case against the Newport News Shipbuilding and Dry Dock Company. On February 11, 1987, the agency asked Newport News to produce “federal income tax returns, financial statements, and related documents” in relation to a Navy contract. Newport News claimed that “the documents contain subjective information that is not useful in verifying direct or indirect costs” and not “negotiations, pricing and performance” information. In 1990 courts ruled in the company’s favor, stating that DCAA “lacked statutory authority.”

The court ruling had a chilling effect. For 20 years the Defense Contract Audit Agency has never issued another subpoena or forced contractors to produce records, according to an internal memo written by then-DCAA director April Stephenson in 2009.<sup>43</sup> Indeed, a September 2009 GAO report on DCAA “identified numerous instances where requests for contractor records were not met” and that there was “no evidence” that DCAA supervisors took “enforcement action, as set out in DCAA policy.”<sup>44</sup>

This problem is particularly acute with “no-bid” contracts where the federal government relies heavily on a single source to provide goods or services and does not have the benefit of competition to ensure that the taxpayer is getting the best price. While the government is theoretically protected under the Truth in Negotiations Act, which requires contractors to certify that the cost and pricing data is “current, accurate and complete,” some companies don’t always tell the whole truth about their costs, and DCAA auditors have limited means to figure that out.

The only way to determine if the company is not overbilling on a fixed-price contract, for example, is to examine company records. This inability to investigate whether or not the contractors are providing accurate data has been a major hurdle for auditors ever since the Newport News ruling, but the Pentagon has failed to remedy this situation. On September 11, 2009, an exasperated April Stephenson, then director of DCAA, sent an internal memo to her bosses proposing that the law be changed “to expand DCAA’s access to contractor records required to accomplish our mission” to all “audits, records, reviews, documents, papers, recommendations or other material” of contractors and sub-contractors.<sup>45</sup>

The Stephenson memo, which was unearthed by the Project On Government Oversight, in July 2011, was never acted upon by the Pentagon. Others in the contract auditing community support her position. “Such barriers to information ... can hijack what has been proven to be an effective oversight mechanism,” said Brian Miller, the General Services Administration inspector general, in recent testimony before Congress. “Adopting clear, statutory language allowing OIGs (offices of the inspectors general) to obtain contractor records would provide an effective tool for us in our contract audits.”<sup>46</sup>

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## Lack of qualified auditors

Shortly before he retired, Bill Reed was fond of showing his staff a PowerPoint slide that claimed that the cost of a DCAA audit was \$116.24 per hour in 2006 compared to the Big Four audit firms such as KPMG and Price Waterhouse, which billed an average of \$162.81.<sup>47</sup>

But in reality, DCAA's costs were lower for one simple reason—it had far fewer qualified auditors than the Big Four allowing it to pay lower salary costs. In 2011 Patrick Fitzgerald, the director of DCAA, estimated that just 28 percent of his staff were qualified CPAs compared to a Big Four rate of closer to 50 percent.<sup>48</sup>

The Defense Contract Audit Agency is also unusual in that many of its managers and supervisors are not qualified CPAs, yet they are required to sign off on audits, a practice that would be illegal in the commercial world. This practice has caused dissent in the ranks of the staff that are qualified to sign off on audits in public practice but prohibited at the agency, sending a signal that loyalty was promoted over competence.<sup>49</sup>

“By permitting non-CPAs to manage CPAs in audit work, DCAA culture has turned the established auditing profession on its head,” a 20-year veteran of DCAA in northern California says. “It is the equivalent of a novice directing a journeyman on how to build a house or conduct any other trade or profession that has developed and refined its purposes and standards over the centuries.” He estimated that in one year audits of \$2.8 billion of the \$4 billion were put under the responsibility of non-CPAs supervisors at the Peninsula branch office just south of San Francisco.<sup>50</sup>

The GAO also discovered that one DCAA office, located at Northrop Grumman Corp.'s offices in El Segundo, California, asked inexperienced trainees who had no proper supervision to conduct at least 18 complex “forward pricing” audits even though they had never done a single audit before in their lives. (The 18 audits were part of a larger pool of 62 problem audits for contracts worth over \$6.4 billion.)<sup>51</sup>

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## Lack of independence and authority

In the 1990s, Defense Contract Audit Agency management started to offer more support to contractors and to military buyers like the Air Force and the Navy, possibly compromising its audit independence. The agency has also buckled to pressure from contractors to back off on certain issues such as advice on prices and reporting fraud.

Under the label of “re-inventing government,” for example, which took place under the Clinton-Gore administration, the Defense Contract Audit Agency, led by Bill Reed, started to copy some of the more questionable practices of the Big Four commercial audit firms who were offering “consulting” services to Fortune 500 companies on how to “manage” their taxes and accounting systems.

DCAA, for example provided consulting services via “financial liaison auditors” to work at various major military commands such as the U.S. Air Force and U.S. Army while simultaneously creating “integrated product teams” where DCAA auditors would work with contractors and government procurement officers to make joint decisions on how best to speed up awards of contracts involving the contract requirements, design, source selection, and auditing.<sup>52</sup> At one point DCAA launched a scheme called the Contractor Risk Assessment Group that permitted reduced audit oversight for companies in return for a system of self-regulation.<sup>53</sup>

The practice of “consulting” by certified auditors in the commercial world ceased following the Enron Corp. scandal, which led to the collapse of the big accounting firm Arthur Anderson and the passage of the Sarbanes-Oxley Act in 2002, which prohibited the practice. But the Defense Contract Audit Agency continued similar practices until 2008, when a series of damning GAO reports led DCAA to dismantle the program.<sup>54</sup>

Government auditors also are expected to provide an assessment of proposed prices (known as “forward prices”) during contract negotiations, in order to prevent contractors from charging too much for specific items or labor categories. While contracting officers are not required to comply with the advice of auditors, this advice provides a good check and balance and ensures that the taxpayer gets a fair price.

The office of Defense Procurement and Acquisition Policy sent out a memo on January 4, 2011, to make clear that the contracting officers should indeed follow the cost or prices recommended by the Defense Contract Audit Agency.<sup>55</sup>

Contractors launched a major pushback because they realized that this would disrupt the cozy relationship between the Pentagon buyers and sellers. “This clearly continues the ongoing diminishment in the discretion and prerogatives of contracting officers, who now are reduced to “rubber-stamping” DCAA’s determinations,” wrote John W. Chierichella and Ryan E. Roberts, who work on government contracting for the law firm Sheppard Mullin.<sup>56</sup>

Lawmakers disagree. “I like the idea that auditors are telling contracting representatives what the prices should be. You know, in my book, that’s good news,” said Sen. Claire McCaskill (D-MO) at a recent congressional hearing. “I think that there is just a fine line between cooperation and 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’m not sure that contracting officers traditionally—particularly in the Department of Defense have taken that, their independence is not something that is front and center like it is with an auditor.”<sup>57</sup>

Auditors are also expected to report any suspicious activity that indicates possible fraud by filling out a Form 2000 and giving it to DCAA management. Reporting such activity, however, can slow down audits, and certain managers have been accused of discouraging this practice, according to a report from the Center for Public Integrity.<sup>58</sup>

One example of this was a leaked January 2008 memo written by a Defense Contract Audit Agency branch manager who refused to pass on a fraud report. “It is my conclusion that there is not a sufficient basis for suspicion of fraud or other irregularity, therefore, I will not forward a copy of the Form 2000 to Headquarters,” the manager wrote.<sup>59</sup>

While there is no data to show how widespread this problem is, DCAA management issued a memo in February 2009, to clarify the rules noting that: “No attempt should be made to dissuade an auditor from completing and submitting a DCAA Form 2000.”<sup>60</sup>

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## Attempts to fix the problems

By the end of September 2008, April Stephenson, who was then director of the Defense Contract Audit Agency, announced a number of changes—18 out of 19 of the metrics were to be scrapped while Webmetrics (a staff performance management software program) was shut down.<sup>61</sup>

A new set of 11 new “standards,” which included 8 measurable “metrics,” was announced. “The key to successful performance measures is to measure the right performance,” Stephenson wrote. “The wrong type of behavior and/or results may occur if the wrong performance measures are used, or if the correct performance measures are used improperly.” She appointed Karen K. Cash,

DCAA's assistant director for operations, to follow up on staff complaints, which were invited via an anonymous website.

Stephenson also sat down with the Defense Business Board (a Pentagon advisory board set up by Donald Rumsfeld composed of senior executives from major military contractors) to seek their advice. The board quickly came up with several vague suggestions such as creating a new business plan, centralizing management, and hiring an ombudsperson.<sup>62</sup>

A little less than one year after the new metrics were announced, April Stephenson went before the Senate to announce that her agency had undertaken “50 specific improvement actions” and had more planned over the next few years. Staff “feedback was favorable as most employees reported that they did not feel pressure to meet the performance measures on individual assignments,” she said.<sup>63</sup>

But whistleblowers continued to write into *Government Executive* to say that the changes were “cosmetic” and that “the new performance measures have been either ineffective or enforced sporadically.” The magazine reported that “auditors presented documents and e-mails indicating that they still are being pressured to hand in their work prematurely.”<sup>64</sup>

The whistleblowers have been successful in persuading others that DCAA was not spending enough time auditing each separate contract. But instead of continuing to improve auditing on contracts that were traditionally subject to audit, the Pentagon has responded by having DCAA work on auditing fewer contracts and by substantially shrinking the pool that it is subject to audit. On September 17, 2010, the agency raised the threshold for checking up on fixed-price contracts from \$700,000 to \$10 million and from \$10 million to \$100 million for cost-plus contracts. In order to make up for the contracts that would no longer be audited, the agency proposed that it would help contracting officers to determine “fair and reasonable” prices during negotiations.<sup>65</sup>

Today it appears that the Defense Contract Audit Agency has been thrown into reverse gear, with complaints starting to emerge that the agency is taking too long to complete work. For instance, the agency estimated that a typical “contractor pricing review” took 28 days to complete in 2008, but two years later the average time for the very same work took 72 days. “Some of our audits take longer because we are doing a more comprehensive job,” said Patrick Fitzgerald, the new DCAA director, in an interview with *Government Executive* magazine. “If there are other

factors that are causing us to take longer, we need to do a deep dive on those and try to figure out how mitigate or to alleviate them.”<sup>66</sup>

The Defense Contract Audit Agency has already chalked up new failures because of this slowdown. One recent example is Columbus, Ohio-based Mission Essential Personnel, LLC, which was awarded an initial five-year-contract by the Department of Defense’s U.S. Intelligence and Security Command (worth up to \$414 million to provide 1,691 translators in Afghanistan in September 2007 that was later expanded dramatically to support the tens of thousands of soldiers that the Obama administration was surging into the country.<sup>67</sup> The private company employed 6,800 translators in Afghanistan and billed \$629 million in revenue in 2010 alone, a dramatic increase from its tiny 2005 revenues of \$6.7 million.<sup>68</sup>

In July 2010 the Commission on Wartime Contracting discovered that the Defense Contract Audit Agency had failed to conduct a single business systems audit for Mission Essential Personnel. Asked to explain this failure, DCAA Director Patrick Fitzgerald explained that the contract grew quicker than expected. “Are we behind the curve? Yes. We should have been in there quicker,” he told the commissioners at a hearing in Congress. “Our experience has shown that when contractors grow that fast, the procedures, processes, and systems have trouble keeping up with that growth, increases the risk to the U.S. government.”<sup>69</sup>

Yet a series of confidential government reports written by contracting officers in Afghanistan in 2009 and 2010 that were later obtained by the Associated Press showed that Mission Essential Personnel’s billing systems were already failing.<sup>70</sup> An AP article quoted the internal reports that alleged that the company had no idea what units the linguists were working with or if they were even showing up for work. “MEP’s inability to track their linguists continues to be a problem,” a report written in late 2009 claimed. “Despite MEP’s acknowledgment of this issue little has been done to correct the problem.” Another military report said: “MEP’s linguist accountability completely collapsed ... following months of deterioration.” It got worse: translators who had returned to the United States continued to be paid according to another report written in late summer of 2010.

Part of the problem was that translators could log into Mission Essential Personnel’s computer system from anywhere in the world and submit fake timesheets. “MEP does not have in place an effective, systemic method of insuring that their U.S.-hire linguists are actually at their duty location performing the services they are being contractually paid to do,” the report said.<sup>71</sup>

The company says it has since fired the translators that were cheating. In a statement to the Associated Press, Mission Essential Personnel said the military had never alerted the company of “any linguist accountability problems.”

Yet, the question remains: Had the Defense Contract Audit Agency done a full audit of the company’s billing systems and labor management practices between 2005 and 2010, it is possible that this problem could have been caught earlier.

The Defense Contract Audit Agency says it is working to catch up. The agency hired 500 additional auditors in 2010, and plans to add another 1,000 by 2014. “We are also working to prioritize audit workload and make sure that high-risk audits are identified and completed in a timely manner,” a Pentagon spokesperson explained, noting that the agency was working to create a new strategic plan and to re-assess the new performance measures introduced in 2008.<sup>72</sup>



# Conclusion

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## Recommendations for reform

Three years ago the Defense Contract Audit Agency came under fire for an obsession with getting through too many audits, too quickly. “We’re talking about serious sirens, bells and whistles all going off at the same time,” said Sen. McCaskill at a 2008 hearing in Congress. “I think the system is failing. The culture is broken, the performance metrics are broken, and the oversight is broken.”<sup>73</sup>

Today the opposite is true—contractors are now complaining about the auditors taking too long to determine prices. It is clear that the federal government needs more professionally qualified auditors to get the job done. “DCAA cannot always accommodate non-Department of Defense requests for audit support,” said Thomas Skelly, the director of budget services at the U.S. Department of Education, in a recent congressional testimony. “Obtaining audit support from a non-governmental firm can be costly and time-consuming.”<sup>74</sup>

In addition to a lack of qualified staff, there is also an agreement among senior auditors on some of the basic issues that whether they work at the Defense Contract Audit Agency or at the inspectors general offices at other government agencies there is a lack of access to records as well as a lack of independence and authority.

“We need a contract audit agency that is not afraid of its own shadow,” says Nick Schwellenbach, director of investigations for the Project On Government Oversight. “We need an independent and muscular audit agency that protects the taxpayers’ interests.”<sup>75</sup>

The following eight recommendations, if implemented, will help prevent waste, fraud, and abuse in contracting and safeguard taxpayer dollars:

*Hire more qualified auditors to work at the Defense Contract Audit Agency and the inspectors general offices of other government agencies*

Every year, there is a natural attrition of people retiring or taking other jobs. Rather than relying on hiring at the lowest levels and promotion by seniority, auditors with professional qualifications should be brought in to raise the ratio of professional/nonprofessional staff from one in four to one in two. All government contracts audits should only be signed by professional auditors.

*Implement former Defense Contract Audit Agency Director April Stephenson's proposal to change to the law giving the agency greater subpoena powers*

Stephenson proposed “to expand DCAA’s access to contractor records required to accomplish our mission” to all “audits, records, reviews, documents, papers, recommendations or other material” of contractors and sub-contractors.<sup>76</sup> This would allow the agency to subpoena any documents they need to do a thorough audit. Civilian agencies should follow suit.

*Enact the proposed Pentagon rule that would allow contraction officers to hold back up to 10 percent of payments if a contractor's business systems contained "deficiencies"*

These business systems include accounting, earned value management, estimating, material management, purchasing, and property management systems.<sup>77</sup> Contractors have sent in hundreds of complaints about the proposed rule, but the Pentagon should hold firm and implement it as proposed. Civilian agencies should also follow suit.

*Name the companies that have inadequate business systems*

A name and shame campaign of the top 100 contractors with inadequate internal control systems could be a powerful incentive to give the federal government the ammunition to limit payouts to companies that do not comply.

*Limiting Defense Contract Audit Agency audits of fixed-price contracts to a minimum of \$10 million and cost-plus contracts to \$100 million should be scrapped*

Allowing entire groups of contracts to escape auditing creates perverse incentives. DCAA should revert to the contract audit thresholds that were in effect prior to this change.

*Encourage contracting officers to follow the Defense Contract Audit Agency “forward pricing” recommendations*

The Pentagon should hold firm to its January 4, 2011 recommendation for government buyers to follow the advice of the auditors on what constitutes reasonable prices. It is not acceptable, however, that DCAA takes 72 days to issue an opinion on these prices. The goal should be 30 days in order to timely support contract awards. This issue may well be resolved if the agency hires more auditors.

*Ensure the Defense Contract Audit Agency is given its own general counsel to provide it with independent legal advice*

It should be noted that the Pentagon inspector general was recently provided with a general counsel for that very reason.<sup>78</sup> Inspectors general of federal agencies cannot be beholden to the senior management of their agencies if independence is to be maintained. It should be noted that such an office could also help DCAA subpoena contractors for access to records.

*Allow the Defense Contract Audit Agency to report directly to Congress*

Since the director of the Defense Contract Audit Agency reports to and is rated by the comptroller of the Department of Defense there is a perception of bias unlike the inspectors general who have much more independence and freedom in what they choose to examine.

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## About the author

**Pratap Chatterjee** is a journalist and the author of two books on military contracting - *Iraq, Inc.* (Seven Stories Press, 2004) and *Halliburton's Army* (Nation Books, 2009). He worked as a visiting fellow at the Center for American Progress from 2010 to 2011.

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