

Testimony

of

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before the

Commission on Wartime Contracting In Iraq and Afghanistan

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Chairman Thibault, Chairman Shays, and members of the Commission; thank you for the opportunity to appear before you today. I am pleased to provide you with an overview of DCAA's role in supporting overseas contingency operations and appreciate the opportunity to highlight some of our actions in support of the contingency contracting community as they negotiate, administer and close out contracts. As requested, I will specifically discuss DCAA's audit efforts related to prime contractor oversight of subcontract costs.

Background

DCAA is a distinct agency of the Department of Defense (DoD) that reports to the Under Secretary of Defense (Comptroller). The DCAA mission is to perform all necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting, thereby protecting the taxpayer's interest. In total, DCAA has about 4,400 employees and 111 field audit offices around the world. The Department is supporting DCAA's important work by providing increases in the Agency's workyears through FY 2015. In 2009 and 2010 DCAA's staffing increased by about 500 workyears. From 2011 through 2015 the Agency's workyears are scheduled to increase by about another 1,000 workyears.

DCAA Contingency Contracting Audit Effort Update

DCAA is responsible for providing Iraq/Kuwait/Afghanistan-related contract audit services to both DoD and other Government organizations for about 120 contractors. These contractors hold more than 300 prime contracts with contract ceiling amounts of \$93.2 billion

and funding to date of about \$77.2 billion. Under LOGCAP III and IV alone, approximately \$44 billion has been awarded through July 2010.

DCAA has supported Contingency Operations in Iraq, Kuwait, and Afghanistan since May of 2003. Since that time approximately 250 auditors have served overseas in various theaters of operations in support of Operation Iraqi Freedom and Operation Enduring Freedom, and this is in addition to the audit support provided by multiple DCAA Field Audit Offices located at contingency contractor locations in the United States. Through June 2010, DCAA has issued 3,369 reports in support of in-theater contracts, and we are expecting to issue over 120 more during the remainder of FY 2010.

To date (June 30) for FY 2010, DCAA has performed 349 audits covering \$19.5 billion in proposed or claimed contractor costs relating to Overseas Contingency Operations Contracts (OCO) contracts. These audits recommended reductions in proposed or billed costs of \$1.1 billion or roughly 5.6 percent (referred to as questioned costs), and \$3.6 billion or roughly 18 percent in estimated costs where the contractor did not provide sufficient information to explain the basis of the estimated amounts (referred to as unsupported costs). Since inception, DCAA has reported total exceptions of \$21 billion (questioned costs of \$10 billion plus unsupported costs of \$11 billion) related to our oversight efforts of in-theater contracts.

Increasing Resources Allocated to Contingency Operations

Soon after my appointment as the Director of the Defense Contract Audit Agency (DCAA) in November 2009, I identified and communicated to the DCAA workforce and the acquisition community that DCAA audit support relating to the awarding and administering of OCO Contracts is one of DCAA's top priorities. I have asked my executive team to coordinate

closely with the acquisition community to ensure we have the appropriate audit coverage for this high-risk contingency contracting and auditing environment.

As we have previously shared with the Commission, we continue to assess and increase our presence in the theater of operations as needed. Since opening the Iraq Branch Office (IBO) in May of 2003 we have covered the work in Iraq, Afghanistan and Kuwait with roughly 17 to 23 auditors all reporting through the IBO. As noted in the Commission's June 2009 interim report, DCAA had 4 auditors supporting our work in Afghanistan in the spring of 2009. We realized that the 4 auditors were insufficient to meet the increasing demands associated with the Afghanistan buildup and began to gradually increase our staffing levels to where they are today at 17 auditors. In addition, we separated the Afghanistan work from the work in Iraq and Kuwait when we established a separate Afghanistan Branch Office (ABO) in October 2009. The ABO staff of 17 in Afghanistan is in addition to the 17 working in Iraq and Kuwait for the IBO which results in a near doubling of our presence to conduct the Agency's important mission in theater. We will use some of these resources to support Task Force 2010 to assist CENTCOM in combating corruption in Afghanistan. Based on our current workload, we anticipate increasing our presence to approximately 40 auditors in the area of operations (IBO and ABO) by the end of FY 2010.

DCAA has implemented planning and coordination procedures to effectively integrate audit work between the Iraq and Afghanistan Branch Offices and the DCAA CONUS Audit Offices with cognizance of companies performing contracts in theater. In addition, we continue to assess the resources required to support CONUS audits at the three LOGCAP IV contractors, DynCorp, KBR, and Fluor. In December of 2009 we made a decision to significantly increase

our FY 2010 workyear commitment at the LOGCAP contractors. Overall we increased workyears at these three performing contractors by more than 73 percent.

Subcontract Costs – A Prime Contractor Responsibility

FAR 42.202(e)(2) clearly states that it is the prime contractor's responsibility to manage its subcontractors. Prime contractors generally rely on their estimating, purchasing and billing systems as a means to manage their subcontracts. As noted in the Commission's interim report (June 2009), adequate contractor business systems are the first line of defense against waste, fraud and abuse. In the realm of subcontracting, we find this statement to be profoundly true.

All DoD prime contractors are responsible for having an acceptable estimating system that consistently produce well-supported proposals acceptable as a basis for negotiation of fair and reasonable prices (DFARS 215.407-5-70(b)). One key characteristic of an adequate estimating system is one which addresses the prime contractor's responsibility for determining, through review and analysis, the reasonableness of proposed subcontract prices (DFARS 215.407-5-70(d)(2)(xv)). The proposal phase of a contract award involves the prime contractor's estimating and purchasing systems working together to prepare an adequate estimate of cost or price. Generally, purchasing system processes identify responsible prospective subcontractors and vendors from which subcontract proposals are obtained. The estimating and purchasing systems work in conjunction to conduct and document analyses of the subcontractor proposals to ensure the awarded subcontract price is fair and reasonable (represents the best value for the Government), regardless of whether the contemplated subcontract is sole-source, competitively awarded, or for a commercial item. After contract award, the contractors billing system works in conjunction with the purchasing system to ensure only those subcontract costs which are eligible

for payment (that is, allocable, allowable, reasonable, and in accordance with contract terms and conditions) are included in the prime contractor's billings to the Government.

As I previously mentioned, DCAA has reported total exceptions of \$21 billion related to our oversight efforts of in-theater contracts. Although an exact number is not known, a significant portion of the total audit exceptions relate to proposed and incurred subcontract costs. Under the LOGCAP contract we estimate that subcontract costs represent anywhere from 30 to 50 percent of the total costs incurred by the three LOGCAP IV performance contractors. Under the LOGCAP contract, subcontractors provide a wide range of products and services from Dining facilities (DFAC) operations and waste management to construction and repair work.

Subcontract Costs Audit Effort

The FAR requires contracting officers to purchase supplies and services from responsible sources at fair and reasonable prices. The contracting officer is responsible for determination of price reasonableness for the prime contract, including subcontracting costs (FAR 15.404-3(a)). DCAA often provides the necessary audit support to the contracting officer during both the preaward and postaward contract stage in the evaluation of prime contract costs that include subcontract costs.

Preaward Audit Coverage

Based on audit risk, DCAA conducts audits of contractor estimating systems at all major contractors on a periodic basis. As part of that audit, we review the prime contractor's policies and procedures for ensuring the proposed subcontract costs are fair and reasonable. With respect to the three LOGCAP IV performance contractors, DCAA has reported all the estimating

systems as inadequate and cited their estimating practices as being deficient for ensuring fair and reasonable subcontract prices. For example, in November 2009, DCAA reported DynCorp's estimating system as being inadequate. The DCAA audit reported five material weaknesses in its estimating system and procedures that could result in inaccurate, unreasonable, and unallowable costs being proposed on Government contracts. One of the major weaknesses related to DynCorp's noncompliance with the FAR Part 15 requirements to perform adequate cost and/or pricing analysis to ensure fair and reasonable proposed subcontract prices.

In March 2010, DCAA reported estimating system deficiencies at DynCorp related to the inclusion of unsupported subcontract costs found during its audit of the LOGCAP IV proposal for Corps Logistics and Support Service, Theatre Transportation Mission and Postal Operations in Iraq (commonly referred to as the CTP proposal). During the audit of the CTP proposal, the auditors found the subcontract proposal from DynCorp's then "team member" subcontractor, Agility, to be inadequate. An examination of the U.S.-based Agility business unit disclosed that approximately 40 percent of the proposed direct costs were unsupported. That is, the subcontractor, Agility, was unable to support the reasonableness of the proposed direct labor costs proposed as part of the CTP proposal. Further, in its proposal to the prime contractor, Agility included lower-tier subcontractors to perform the bulk of the subcontract effort. In fact, Agility proposed to use two foreign-based Agility-affiliated subcontractors (sister business units). DCAA's Iraq Branch Office was requested to review the proposed lower-tier subcontract cost/prices included in Agility's proposal due to the non-arms-length nature of the subcontracting arrangement with related parties. During the review of one affiliate's proposal, the Iraq Branch found the lower-tier subcontractor had only prepared a rough order magnitude proposal without supporting detailed data. In the case of the other lower-tier subcontractor, the Iraq Branch was

initially denied access supposedly on the basis that its prices were commercial prices and exempt from any requirement for the submission of cost or pricing data. As a result, the auditors determined that almost all of the proposed Agility (and its affiliated subcontractor) costs were unsupported. However, just prior to the issuance of a final audit report Agility and its affiliates were suspended from receiving any new U.S. Government contracts, rendering any costs proposed based on Agility estimates inapplicable as a valid basis for estimating costs on the prime contract. As a result, the DCAA audit report classified over \$800 million of the proposed subcontract costs predominately related to Agility and its affiliates as unsupported. It is important to point out that the prime contractor had not performed adequate subcontract cost or price analyses. The DCAA reported the contractor proposal was not adequate for the basis of negotiating/awarding a fair and reasonable contract price.

Our audits of KBR proposals have disclosed similar significant unsupported subcontract costs. In May 2010, DCAA issued its report on the LOGCAP III Task Order (TO) 151 extension proposal. We identified over \$48 million of unsupported subcontract costs. KBR failed to obtain subcontract proposals and conduct the required price or cost analyses. The contractor's failure to obtain adequate support from its prospective subcontractors on this sole-source procurement increases the likelihood of subcontract prices being unreasonable in amount. Similarly, earlier this month, we completed an audit of Fluor's "rebaseline" proposal under LOGCAP IV TO 0002 that incorporated the impact of numerous change orders on the total task order price. The change orders included proposed subcontract costs of approximately \$35 million. DCAA reported over 40 percent of the proposed subcontract costs as unsupported because the prime contractor's proposal lacked sufficient supporting documentation (e.g., cost or price analysis, competitive quotations). The majority of the proposed subcontract costs that we

reported as unsupported were from foreign subcontractors of Fluor where, despite the sole source nature of the contracting action, Fluor did not obtain cost or pricing data from the related subcontractors.

One of the major root causes for the deficiencies can be attributed to the lack of cost data provided by subcontractors for use by the prime contractor or the Government in determining a fair and reasonable subcontract price. The current DFARS provides procedures for cases where the prime contractor does not submit the required information to the contracting officer (e.g., subcontract cost data). DFARS PGI 215.404-1(a)(i) provides a sequence of steps for the contracting officer to resolve issues when the offeror will not furnish information needed to determine price reasonableness and the deficiency impacts negotiations. These steps include: making it clear to the offeror what information is required and why it is needed to determine fair and reasonable prices; elevating the issue within the contracting activity if the offeror refuses to provide the data; the contracting activity management and contracting officer discussing the issue with appropriate levels of the offeror's management; and if the offeror continues to refuse to provide data, elevating the issue to the head of the contracting activity for a decision in accordance with FAR 15.403-3(a)(4). FAR 15.403-3(a)(4) and Section 808 of Public Law 105-261 require the Head of the Contracting Agency to determine that it is in the best interest of the Government to make the award of the contract when the offeror or subcontract has not provided the required data. In addition, the contracting officer shall document the contract file to describe the data requested, why there is no other alternative but to procure the item from this source, and a written plan for avoiding this situation in the future (e.g., develop a second source), as well as provide input into the past performance system noting the offeror's refusal to provide the requested information necessary to determine a fair and reasonable price.

Post Award Process

DCAA has performed contractors' purchasing system reviews (CPSRs) for the Defense Contract Management Agency (DCMA) Administrative Contracting Officer (ACO) at all of the three LOGCAP IV performance contractors and has found each system to be inadequate. Material weaknesses have been reported citing the contractor for inadequate procedures for ensuring subcontract prices are fair and reasonable resulting in unreasonable costs being paid by the prime contractor and being billed to the Government. At Fluor and DynCorp, DCMA, as the cognizant Federal agency for contract administration, has withdrawn approval of the contractors' systems. FAR 44.201-1 provides that where the contracting officer has not approved a contractor's purchasing system, the FAR requires the contractor obtain the contracting officer's permission, the "consent to subcontract," prior to awarding certain subcontract types and/or amounts. It also allows the Contracting Office to identify subcontracts requiring consent to subcontract from the contracting officer even when the contractor has an approved purchasing system. In the case of LOGCAP, the Procuring Contracting Officer decided it was in the Government's best interest to include a requirement for obtaining consent to subcontract even when the prime contractor's purchasing system was approved. The LOGCAP contract includes a requirement for Fluor, DynCorp, and KBR to get ACO consent prior to awarding any subcontract over \$550,000.

As part of the responsibilities for consenting to subcontracts, FAR 44.202-2 states the contracting officer/ACO must, at a minimum, review the request and supporting data and consider the following: was adequate price competition obtained or its absence properly justified; was an adequate cost or price analysis performed; is the subcontract type not appropriate for the

risks involved; does it comply with applicable cost accounting standards; etc. Careful and thorough consideration is necessary when the prime contractor's purchasing system or performance is inadequate; there are close working relationships of ownership affiliations between the prime and subcontract; subcontracts were proposed for award on a non-competitive basis or at prices that appear unreasonable; and when subcontracts are proposed on a cost-reimbursement, time-and-materials, or labor-hour basis. The "consent to subcontract" permission provided by the ACO is not considered a determination that the cost incurred under the subcontract is reasonable, allocable, and allowable; however, it is frequently interpreted by the contractor as such. Nevertheless, in most cases this is the first opportunity the Government has after contract award to examine the reasonableness of subcontract costs and the last opportunity to assess the reasonableness of subcontract costs before the costs are incurred. Therefore, it is an important tool available to the Government for providing adequate oversight on high-risk contracts.

During our review of prime contractor billings and incurred cost audits, DCAA has identified situations where the prime contractor has not awarded its fixed-price subcontracts based on fair and reasonable prices leading to unreasonable or unallowable costs being paid by the Government. For example, DCAA has identified several cases where the prime contractor asserted the subcontract price was based on adequate competition; however, our audit disclosed that adequate competition did not exist. Although the prime contractor is required to pay its fixed price subcontract amount, FAR 52.216-7 and the FAR 31.2 principles state the Government only makes payments of amounts determined to be allowable and reasonable. Therefore, where DCAA has determined that the subcontract price is not fair and reasonable, DCAA has attempted to calculate a reasonable amount for reimbursement of the contractor's

billings attributed to subcontractor costs. However, in those cases where the subcontract is sole-source, it is often difficult to obtain cost data to ascertain the reasonable costs without access to the subcontractor's books and records. DCAA access to subcontractor books and records is generally limited and dependent on the flow down by prime contractor to the subcontractor of the appropriate FAR clauses, and in instances of fixed price subcontracts, virtually nonexistent. For example, during DCAA's reviews of Fluor vouchers submitted for payment under a LOGCAP IV Task Order, the prime contractor was unable to show the prices paid to its subcontractor for DFAC and other services were fair and reasonable in amount. Since DCAA does not have access to the subcontractor's books and records, we were unable to determine through other processes the reasonableness of the prices being paid to the subcontractor and subsequently passed on to the Government for reimbursement. As a result, the DCAA auditors have suspended much of the subcontractor's costs from payment on vouchers (invoices) submitted for payment by Fluor. In addition, the contractor has been withholding a portion of the subcontractor billings, so that in total approximately \$24.5 million is being withheld from payment until the issue is settled. The FAR audit access clause does not provide for Government access to the subcontractor's costs records when the subcontract is firm-fixed-price.

At DynCorp, DCAA has suspended \$13 million of subcontract costs and disapproved \$1.4 million of subcontract costs. DCAA disapproved approximately \$1 million of subcontract costs billed on the Air Force's War Reserve Material contract. During its review of 10 subcontracts issued by DynCorp under the War Reserve Material prime contract, it found that DynCorp could not provide adequate support to show that the subcontract prices were fair and reasonable. Specifically, the auditors found the prime contractor (i) did not obtain adequate cost or pricing data from the prospective subcontractors, (ii) could not document there was adequate

competition from which to determine price reasonableness, and (iii) did not perform an adequate cost or price analysis. As a result, the DCAA auditors disapproved approximately \$1 million of unreasonable subcontract costs associated with the six subcontracts.

DCAA has suspended over \$12 million of costs billed by DynCorp for costs from its segment, Global Linguists Solutions (GLS), of which \$6 million relate to one subcontract awarded to a foreign company. Our review of DynCorp's GLS billings disclosed unsupported billings from Al-Shora International General Trading and Contracting Company (Al-Shora). The Al-Shora subcontract is cost-type and the subcontractor is required by subcontract terms to provide actual cost data to support its invoices. Al-Shora has denied DCAA access to this cost data, therefore, we have suspended the DynCorp billed costs.

One final illustration in this area is the continuing challenges related to contractors new to OCO effort. For example, Mission Essential Personnel (MEP) provides linguist services to the Army in Afghanistan. MEP's contract effort has grown significantly in a relatively short period of time, increasing almost 20 times from 2006 to 2010. MEP is now classified as a major contractor for DCAA audit purposes with auditable contracts valued at more than \$300 million a year, and growing. Our experience has demonstrated that contractors are often challenged to maintain well functioning business systems when faced with this level of contract growth, especially in a contingency contracting environment. A significant part of MEP's effort is subcontracted. DCAA plans to significantly increase our audit effort at this location with a primary focus on MEP's accounting and billing systems, which would include a review of the contractor's subcontract management practices.

On Going In-Theater Economy and Efficiency Audits

We anticipate that we will expend in excess of 12,000 hours on approximately 14 separate audit assignments that have been initiated in Iraq and Afghanistan during FY 2010 to perform operations audits, as we commonly refer to them. This is a significant commitment when compared to 2008 and 2009 when we expended roughly 900 and 3,500 hours respectively. The objective of operations audits is to assess whether the contractor's practices are inefficient and/or ineffective ultimately resulting in unreasonable costs.

Three of the 14 audit assignments that we currently have in process, specifically relate to the management and monitoring of subcontractors by the three major prime contractors operating under the LOGCAP contract in Afghanistan and Iraq. These audits are:

- KBR, the review of prime contractor's policies and practices in managing its subcontract cost and related labor staffing with an emphasis on Fire Services (i.e., Fire Warden and Fire Protection), Cleaning Services, Laundry Services and Bus Services.
- Fluor Federal Services, an evaluation of the prime contractor's policies and practices in assuring that subcontract procurement and management tasks are carried out in a timely, efficient, and economical manner. This audit will include the review of several subcontract procurements.
- DynCorp International, a review of the practices and procedures in managing several subcontracts. This audit will focus on whether the prime contractor is basing its subcontract awards on adequate competition.

Comments on Addressing Contracting Vulnerabilities Relating to Subcontract Costs:

1. Prime contractors must be held accountable for establishing fair and reasonable subcontract prices. As I stated in my testimony, a prime contractor's purchasing system is the key business system that should be the primary control to ensure subcontracts are placed at fair and reasonable prices. I believe the Director, Defense Procurement, Mr. Assad's current actions in revising the Defense Federal Acquisition Regulations on business systems will go a long way in ensuring prime contractors strengthen their purchasing systems. The proposed rule will require contract withholds if deficiencies are reported by DCMA or DCAA. I believe contractors will be more aggressive in correcting purchasing system deficiencies.

2. Prime contractors have the responsibility to manage their subcontracts (FAR 42.202(e)(2)) and also have a fiduciary responsibility to monitor subcontractor performance and control costs to ensure the U.S. taxpayer resources are used wisely and appropriately. Since the beginning of the contingencies in Iraq and Afghanistan, we have found that prime contractors have not consistently monitored subcontractor performance and subcontractor billings submitted to the prime contractor for inclusion in the prime contractor's billings to the Government. Although the FAR requires the management of subcontracts by the prime contractor and higher tier subcontractors, DCAA intends to recommend a review to the Director, Defense Procurement and Acquisition Policy, of the feasibility of specific contract clauses that would implement the basic FAR provision on management of subcontracts. For example, prime contractors should have systems or processes in place to review subcontractor billing processes to ensure subcontract billings are in accordance with subcontract terms and conditions.

3. As I discussed previously, DCAA has taken exception to several subcontract pricing actions where the prime contractor asserted a fair and reasonable subcontract price based on "adequate competition" or "adequate pricing analysis" when in fact that our audit found no

support for the contractor assertions. We believe the Government's interests would have been better protected by the prime contractor requiring the subcontractor to submit certified cost or pricing data. Based on our audit results we question whether there was adequate/true competition considering the limitations that the contractors have in a contingency environment. In Iraq and Afghanistan, U.S. and coalition military organizations most likely have consumed almost all of the capacity of most or all subcontractors capable of performing in-theater. Therefore, at best, competition within the area of a contingency is limited because the Government-required goods and services generally exceeded vendor capacities (that is, the Government is the sole or major purchaser of goods and services from all vendors) and all vendors are provided a portion of the requirements in order to satisfy the Government's needs. In such circumstance, we do not believe competition and/or market forces provide better prices to the Government and believe cost data should be provided to determine fair and reasonable subcontract prices.

4. As I discussed previously, DCAA has taken exceptions to several subcontract pricing actions where the prime contractor asserted a fair and reasonable subcontract price based on "adequate competition" where in fact only one bid was received by the prime contractor. DCAA is concerned about the risks created by current regulations permitting awards to subcontractors using competitive pricing procedures when only one bid is actually received. Again, in these cases, we believe it would be beneficial for the prime contractor and contracting officer to have access to subcontractor cost data to determine fair and reasonable contract prices. The Adequate Pricing Subcommittee under Mr. Assad's Panel on Contracting Integrity is taking a look into this area. They are ascertaining the need to revise this "loophole" in the regulation that we believe

leads to subcontract prices being awarded at unreasonable prices. I will continue to work this issue as the Chair of this Subcommittee.

Closing

In closing, I would like to say that I am very proud of DCAA's highly skilled, hard-working and dedicated auditors supporting DCAA's important mission. In particular, I would like to personally acknowledge the dedication of those auditors on the ground with our soldiers in Iraq, Afghanistan, and Kuwait, who are supporting the overseas contingency contracting oversight in austere environments and conditions. I would also like to acknowledge those at our CONUS field audit office locations who are also supporting this important work that continues to provide real value to the Department. The Under Secretary of Defense (AT&L), Dr. Ashton Carter, recently wrote that we need to deliver "better value to the taxpayer and improving the way the Department does business." DCAA's efforts as discussed above are consistent with Dr. Carter's mandate by continuing to identify significant unreasonable costs and recommending that they be returned to the taxpayer. I appreciate the opportunity to testify before you today and I will be glad to respond to your questions.