

**Statement of Mr. William H. Reed
Director, Defense Contract Audit Agency
House Committee on Government Reform
9 June 2004**

Mr. Chairman, members of the committee, my statement for this hearing will center on the Defense Contract Audit Agency's (DCAA) oversight of contracts related to military operations and reconstruction in Iraq.

DoD Contract Performance Oversight Responsibility

DCAA has been an integral part of the oversight and management controls instituted by DoD to ensure integrity and regulatory compliance in Iraq-related contracting. DCAA's services include professional advice to acquisition officials on accounting and financial matters to assist them in the negotiation, award, administration, and settlement of contracts. Decision-making authority on DCAA recommendations resides with contracting officers within the procurement organizations who work closely with DCAA throughout the contracting process.

DCAA Staffing and Actions

Since April 2003, DCAA has worked with all U.S. procurement organizations supporting Iraq Reconstruction to establish the resources and planning information needed to carry out required audits of contract costs as they are incurred and billed. These organizations include the CPA, the Army Materiel Command, Army Corps of Engineers, USAID, and State Department. This coordination has enabled DCAA to build a universe of all Iraq-related auditable contracts, which is a significant step towards ensuring that needed audit procedures are timely and comprehensive.

DCAA currently is responsible for providing Iraq-related contract audit services to both DoD and other Government organizations at 56 contractors holding more than 80 prime contracts with contract ceiling amounts of \$34.6 billion and funding to date under those contracts of about \$12.4 billion.

To carry out the extensive and time-sensitive audit requirements, DCAA has implemented new planning and coordination procedures to effectively integrate audit work between the new Iraq Branch Office, opened in May 2003, and more than 50 DCAA CONUS Audit Offices with cognizance of companies performing contracts in Iraq. The Iraq Branch Office itself now has 22 auditors, and will increase to 28 auditors by the end of June.

During the first 8 months of FY 2004, DCAA has issued 285 audit reports related to Iraq reconstruction contracts. These reports address forward pricing proposals, adequacy of contractor internal controls and business systems, as well as compliance with acquisition regulations and contract terms. Especially important has been DCAA's in-country testing of contractor timekeeping, subcontract management, and cash disbursement procedures which represent immediate risk in the provisional approval of interim contract payments. In the balance of my statement, I will present some of the more significant examples of what we have

found in these audits, beginning with the largest contractor, Halliburton, Kellogg Brown & Root (KBR).

Contract Issues related to Halliburton - KBR

KBR has been awarded Iraq Reconstruction contracts with ceilings totaling more than \$18 billion under two major programs: Logistics Civil Augmentation Program (LOGCAP III) for \$10 billion; and Restore Iraqi Oil (RIO) for \$8.2 billion. DCAA has been providing continuous contract audit oversight on both programs.

Estimating Practices. DCAA has identified significant deficiencies in KBR's estimating practices related to the award of subcontract costs. Earlier this year, after consultation with the Contracting Officer, DCAA returned two major task order proposals (worth more than \$3 billion) to KBR because they were inadequate for the purpose of negotiating a fair and reasonable price. On January 13, 2004, DCAA notified the appropriate Government contracting officials that KBR's subcontracting estimating process and procedures were considered inadequate. Currently DCAA is in the process of performing a comprehensive review of the entire estimating system to address this matter as well as other possible deficiencies.

KBR's deficiencies in estimating subcontracts are contributory factors in potential dining facility overpricing and delays in definitization of task order prices under the LOGCAP contract, both of which I would like to comment on next. They were also a contributory factor in potential gasoline overpricing under the Restore Iraqi Oil contract as explained in Dr. Dov S. Zakheim's testimony before this committee on 11 March 2004.

Dining Facility (DFAC) Subcontract Costs. DCAA has identified issues related to the reasonableness of negotiated subcontract costs for DFACs. KBR has been unable to support the reasonableness of subcontract prices or the appropriate billing methodology intended in its subcontracts. The DFAC subcontractor costs exceed \$800 million and are continuing to increase. KBR awarded contracts to several subcontractors to provide dining facility services at more than 60 locations throughout Iraq and Kuwait. The DFAC subcontractors generally charge for meals at a negotiated fixed meal cost (per person) using various headcount schemes including estimated camp population, estimated numbers from the subcontract statement of work and billeting records to set the number of billed meals. These billed headcount numbers exceed the actual meals served by at least 19 percent according to KBR's own studies and could be as high as 36 percent based on on-going DCAA analysis. KBR has been unable to support the intended billing methodology or how it may relate to the fixed cost per meal negotiated with its various subcontractors.

Initially, DCAA and KBR agreed on a withholding of \$176.5 million until additional supporting data could be provided by KBR (\$140.7 million that KBR voluntarily withheld from future billings and \$35.8 million that DCAA suspended on current billings). KBR performed an internal analysis and estimated that billed meals exceeded actual meals served based on headcount (boots through the door) by approximately 19 percent. However, KBR asserts that the excess meals are allowable, primarily because the various task orders under the LOGCAP contract do not specify a specific billing methodology. While KBR has since re-negotiated the terms of most of the DFAC subcontracts to establish a "boots through the door billing

methodology”, they have begun to resubmit their voluntary withhold under the original subcontracts.

DCAA found substantial deficiencies in the data provided by KBR and believes cost should continue to be suspended related to the original subcontracts until additional support and analysis can be completed. Therefore DCAA has currently increased its suspended DFAC costs to \$186 million.

We are continuing to evaluate additional supporting information provided by KBR and will be issuing final recommendations to the Contracting Officer on the first of several of the DFACs in the near future. Depending on our conclusions, DCAA may either reinstate the suspended cost or convert the suspension to a disallowance. If a disallowance is recommended, this will provide the basis for the Contracting Officer to evaluate and decide the merits of the dispute.

Violation of the Anti-Kickback Act. KBR has voluntarily disclosed a possible violation of the Anti-Kickback Act by two of its employees. KBR has already reimbursed the Government for the estimated impact of \$6.3 million, but has failed to provide data necessary for DCAA to verify the accuracy of that amount. We have brought this to the attention of the DoDIG, which is in the process of reviewing the matter as part of its normal Voluntary Disclosure Program process.

Application of Federal Acquisition Regulations (FAR) on Contract Definitization. Due to urgent requirements, most of the LOGCAP contract task orders were issued as undefinitized contract actions. The FAR limits contract reimbursement to a maximum of 85 percent until a contract price is definitized to adequately protect the Government’s interest in effective cost management. DCAA found that KBR had never applied reimbursement limitations to undefinitized LOGCAP task orders and brought the matter to the Army contracting officer’s attention. She agreed to apply the clause on a prospective basis to LOGCAP task orders depending on KBR agreeing to a firm schedule for submitting the required proposals. Currently a mutually agreeable schedule has been established, and KBR proposals are being submitted for audit. As of this date, the LOGCAP contract has 36 task orders with an estimated value of \$8.2 billion that require proposal audits and final price determination. Of that amount, DCAA has received and is in the process of auditing 28 proposals with an estimated value of \$7.6 billion.

Billing System Review. DCAA recently completed a comprehensive billing system review at KBR. The audit report was issued May 13, 2004, with an overall opinion that the billing system is inadequate in part. As a result, KBR is not authorized for direct billing and is required to continue to provide all billing to DCAA for provisional approval prior to submission for payment. Key issues disclosed during our audit include:

- Not effectively monitoring subcontract billings (e.g. DFAC costs)
- Inadequate written policies and procedures for the billing system
- Failure to adjust billings for changes in indirect rates

DCAA will continue to monitor all aspects of the billing system.

Other Contract Issues

Titan Corporation. Titan was awarded a contract valued at \$402 million to provide linguist and translator services to the U.S. Government – mostly in Iraq. Titan presently has over 4,400 linguists working in Iraq. Recent DCAA audits disclosed deficiencies in Titan's labor distribution system, which records costs for Titan employees. DCAA also found that Titan lacked procedures for adequate tracking of hours worked by foreign national consultants. Based on these findings, the DCMA Contracting Officer implemented a 10 percent withhold on all of Titan's labor and consultant costs until all identified deficiencies are corrected and bills to the Government are based on adequate internal controls. The resulting withhold amount could be as much as \$4.9 million on future billings depending on the timeliness of the needed improvements. In addition, DCAA recently discovered that Titan was not adjusting their provisional billing rates to actual rates at the end of each fiscal year. Titan agreed to make the necessary billing adjustments of \$937,000. Lastly, Titan recently informed us that they will adjust previously billed costs for the Titan employee and the subcontractor employee named in connection with potential abuses at Abu Ghraib Prison. These reductions are scheduled to be made by June 18, 2004 and include Titan and subcontractor costs totaling over \$178,000.

CACI. DCAA is expanding its audit coverage at CACI based on recent disclosure of additional contracts awarded to the Company. Since August of 2003, the Army has awarded 11 task orders under a GSA Supply Contract for Information Technology services for interrogation and intelligence gathering effort in Iraq. At least three of those tasks related to interrogation of Iraqi prisoners. Billed costs as of March 2004 under these task orders is \$12.7 million, with a total funded contract value in excess of \$60 million. DCAA is reviewing the potential misuse by CACI of the GSA schedule contract on this Department of Interior contract that is funded by the Army, since "interrogator" type effort is not a function provided by CACI in their GSA schedule. We understand the GSA and DOI Inspectors General have initiated reviews of this matter as well.

Washington Group International (WGI). In support of the Restore Iraqi Electricity Program, WGI received a contract totaling \$309 million. As a result of a WGI proposal to definitize this contract, on February 13, 2004, DCAA reported to the Corps of Engineers' Contracting Officer that WGI had substantial subcontract estimating problems. On February 26, 2004, DCAA also reported to the Contracting Officer that WGI's estimating system deficiencies were significant and required immediate contractor attention. Since that period, DCAA and the Corps have worked closely with WGI to correct estimating system deficiencies and obtain improved subcontract cost support. While WGI has made excellent progress in providing additional documentation for the majority of the unsupported cost, DCAA has suspended over \$11.5 million of billed costs because WGI has been unable to support the reasonableness of certain security related subcontract costs. In addition, DCAA has suspended \$4.9 million on a separate contract related to costs billed for undefinitized task orders. As discussed earlier, the FAR limits contract reimbursement until a contract price is definitized to adequately protect the Government's interest. DCAA is working closely with the Corps of Engineers and WGI to address these issues.

Closing

In closing, I want to underscore that I am committed to working with other DoD organizations to insure an integrated, well-managed contracting process in Iraq. The Department will not tolerate the billing of costs that are not properly documented and supported. If internal control systems are deficient, we will continue to use protections, such as contract withholdings and cost suspension to safeguard the Department's interests. Rest assured that I will provide whatever resources are needed for DCAA to continue to provide contract audit oversight in Iraq.

In sum, I believe that DCAA has been vigilant about contract oversight and protecting the taxpayers' interests. I am committed to making sure this continues. I look forward to addressing whatever questions or comments you have on this oversight. Thank you.