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**EPA'S CONTRACT
MANAGEMENT**

**Audit Backlogs and Audit Follow-
up Problems Undermine EPA's
Contract Management**

Statement of
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Before the
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
House of Representatives



Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to discuss the auditing of contracts awarded by the Environmental Protection Agency (EPA). My testimony today presents the results of our review, made at the Subcommittee's request, of the timeliness of EPA's audit coverage and follow-up on audit findings. Our review included an overview of auditing in general and a detailed review of the recent audit histories of six of EPA's ten largest contractors.

In summary, audit backlogs and inadequate audit follow-up are serious problems at EPA because they increase the vulnerability of EPA's contracting dollars to waste, fraud, and abuse and make the job of cleaning up the environment that much harder. We found that EPA has a large backlog of requests for audits on its contracts, with audits of funds paid to contractors being delayed for years. From fiscal year 1983 through fiscal year 1990, the six contractors we reviewed received contract payments totaling over \$1 billion, but most of these costs have not been audited despite requests from EPA procurement officials. Delays in audits of contractor costs have resulted from decisions by the Defense Contract Audit Agency (DCAA)¹ and EPA's own Office of the Inspector General (IG) to use their limited resources for other types of audits.

Under the present system, the timeliness of many audits is not completely within EPA's direct control. DCAA, which audits most of EPA's contractors, has a large backlog of cost audits and has not kept up with EPA's requests. EPA's IG devotes most of its resources to reviews of agency programs and has extremely limited in-house expertise to audit contracts; therefore, it uses

¹As the audit arm for the Department of Defense, DCAA has as its mission to audit contracts for Defense and provide accounting and financial advisory services for the negotiation, administration, and settlement of contracts and subcontracts. DCAA also provides a range of contract audit services to other federal agencies, including EPA.

independent accounting firms to do most of its own contract audit work.

Audits are necessary for effective management and are a primary tool for deterring and detecting waste, fraud, and abuse. Thus, we believe this inattention to contract auditing must be corrected, especially since completed audits have uncovered significant problems with contractor costs. EPA contracting and IG officials, understanding the need for more timely EPA contract audits, have requested increased contract audit staffing, and have recently begun to consider ways to expedite auditing.

Even when audits are done, EPA cannot be sure that identified problems have been corrected because it has not developed a reliable audit follow-up system. The current system does not contain all audit reports and findings and contains inaccurate information on corrective actions. Follow-up can serve as an effective internal control mechanism for identifying weaknesses to senior management and tracking corrective action progress.

BACKGROUND

Before discussing our findings in more detail, I would like to briefly describe EPA's contracting program and the kinds of audits that are performed on federal contracts. EPA depends heavily on contractors to operate its programs. About 20 percent of EPA's \$5.1 billion fiscal year 1989 budget authorization was obligated for about 1,000 contracts. The Superfund program for cleaning up the nation's worst hazardous waste sites accounted for about 60 percent of those contractual obligations in fiscal year 1989. Nearly 90 percent of EPA's contracting dollars are spent on cost-reimbursable contracts, which, compared to fixed price contracts, provide fewer incentives for contractors to control costs and require more oversight by the government. As I testified in February 1989 before the Subcommittee on the Civil Service, House

Committee on Post Office and Civil Service, GAO has identified numerous weaknesses in EPA's contract management, in such areas as cost controls, the oversight of subcontractors, and the quality of contractors' performance.² In view of these weaknesses, audits can play a critical role in deterring waste, fraud, and abuse.

Audits can occur throughout a contract's life cycle and can serve a variety of purposes. Prior to a contract award, a preaward audit reviews the prospective contractor's cost estimates or prices. Preaward audits may also assess the contractor's systems for accounting, procurement, and property management. Although preaward audits are not required by the Federal Acquisition Regulation (FAR)³ these audits help ensure better award decisions by identifying early any weaknesses in financial systems or problems with proposed costs, according to an issue paper by a task force of EPA IG staff.

During the life of a contract or at its expiration, a number of audits, collectively called incurred cost audits, review direct or indirect costs charged to a contract. Indirect cost rate audits review whether a contractor has properly allocated overhead costs; interim audits verify whether the costs claimed are allowable; and final audits help establish proper final payment amounts and help allow the contract to be closed out. Audits of each year's indirect cost rate are required by the FAR. The timing of these audits is not specified in the FAR, but they must be done before final audits are completed. Interim audits are done at the discretion of procurement officials. Final audits are done for

²Sound Contract Management Needed at the Environmental Protection Agency (GAO/T-RCED-89-8, Feb. 23, 1989).

³Field pricing support is required for proposals valued at more than \$500,000, but preaward audits are not required if adequate data are available from other sources to determine the reasonableness of the proposed contract cost.

contracts over \$1 million, and final in-house desk audits are done for smaller contracts.

After a contract expires, it must then be formally closed out, which involves determining that contract work has been completed, receiving pertinent bills and other paperwork from the contractor, and having a final audit done if needed. The FAR requires closeout of fixed price contracts within 6 months, and of cost-reimbursable contracts within 36 months, of the time when the agency receives evidence that work has been completed and receives pertinent paperwork from the contractor.

In auditing its contracts, EPA relies largely on assistance from other agencies, especially DCAA. Although not explicitly set forth by federal regulations or Office of Management and Budget (OMB) guidance, customarily the federal agency having the most business with a contractor usually performs audits for all federal agencies that hold contracts with that contractor. DCAA currently audits three of the six case study contractors (Ecology and Environment, Inc.; ICF, Inc.; and Roy F. Weston, Inc.); EPA's IG audits two others (CH2M Hill, Inc.; and Riedel Environmental Services, Inc.); and the Department of Energy's (DOE) IG audits one (Ebasco Services, Inc.). These six contractors currently hold 44 EPA contracts with a maximum potential value of \$3.7 billion. The staff of EPA's Procurement and Contracts Management Division (PCMD) requests preaward and incurred cost audits directly from the appropriate EPA divisional IG office, DCAA branch office, or DOE regional IG office. Under interagency agreements the IG reimburses other federal agencies for audits of EPA's contractors.

AUDITS ARE UNTIMELY

I would like to turn now to our first issue--contract auditing at EPA. We found that, with the exception of preaward audits, which are generally being done, contract audits are

backlogged. Incurred cost audits and final audits have often been delayed for at least 4 years. Such audit backlogs contribute to untimely contract closeouts. Without effective audits, EPA's contracting dollars are at increased risk because audits are a primary tool for deterring and detecting waste, fraud, and abuse.

Incurred Cost and
Final Audits Are Backlogged

We found that incurred cost audits for the six case study contractors are backlogged. These contractors collectively received over \$1 billion in EPA contract payments in fiscal years 1983 through 1990, most of which remains unaudited. Incurred cost audits have been completed only through fiscal year 1986 for CH₂M Hill, Riedel, and Roy F. Weston and only through fiscal year 1985 for Ebasco, Ecology and Environment, and ICF. DCAA officials said they have work in progress and expect to complete audits through fiscal year 1989 for ICF and Weston and through fiscal year 1988 for Ecology and Environment by the end of fiscal year 1991.

We also found that incurred cost audits for EPA's contractors overall are backlogged. As of November 30, 1990, PCMD data showed 273 outstanding requests for incurred cost audits, about 40 percent of them over 2 years old. The majority of PCMD's audit requests are to DCAA, which audits these contractors. EPA's outstanding requests are part of a substantial backlog at DCAA of incurred cost audit requests on defense and nondefense contracts that had grown from about \$33 billion worth of contracts in fiscal year 1981 to nearly \$170 billion in fiscal year 1989, according to DCAA. In fiscal year 1990 DCAA reduced this backlog somewhat from the previous fiscal year: the dollar value of contracts for which there were outstanding audit requests decreased by \$9 billion, and the number of backlogged audits decreased by about 640 from their fiscal year 1989 peaks.

Backlogs of annual incurred cost audits contribute to delays of final contract audits. As of August 1990, PCMD had a backlog of 85 final audit requests, all of them to DCAA.⁴

Contract Closeouts Are Untimely

Partially because of the audit backlogs, EPA does not always meet time frames imposed by the FAR for closing out contracts (6 months for fixed price and 36 months for cost-reimbursable contracts). Contracts cannot be closed out before annual indirect cost rates are verified and final audits completed. The six contractors we reviewed hold 47 contracts that have expired but have not yet been closed out. EPA has not even initiated closeout or requested audits on about half of the 47 contracts.

An internal study by PCMD of selected cost-reimbursable contracts closed in fiscal years 1987 and 1988 found similar problems with the timeliness of PCMD's contract closeouts. As of October 1990, EPA had almost 2,400 expired contracts worth nearly \$4.1 billion that have not yet been closed out. EPA has not even begun closing out over 1,000 of these 2,400 contracts although some were completed as many as 19 years ago. EPA's problem with untimely contract closeouts is not unique. According to documents from DOE, as of June 30, 1990, about 47 percent of the agency's contract closeouts in fiscal year 1990 exceeded federal time frames.

The FAR time frames for closing out contracts begin only after the agency receives evidence that the contract has been completed and obtains pertinent paperwork from the contractor. Because these actions frequently are not performed promptly, closeout delays do

⁴PCMD's data include audit requests from EPA headquarters, but not from EPA's Cincinnati or Research Triangle Park contracts management divisions, which also request final audits and close contracts.

not necessarily violate the FAR. But delays of years before closing out expired contracts run counter to good management. According to EPA's IG, when contracts are not closed on time, funds are not deobligated, thus increasing the federal government's need to borrow and reducing the interest on funds due the government from any contract overpayments.

Audit and Closeout Delays
Occur for Various Reasons

The audit and closeout delays occur in part because agencies auditing EPA contracts place low priority on incurred cost audits. EPA's IG, DCAA, and DOE's IG all give the highest contract audit priority to preaward audits because they help ensure better award decisions by verifying contractor cost projections, according to agency officials. Additionally, problems with EPA IG's coordination and managing of audits have contributed to some delays.

The agencies have cited resource limitations as affecting the timeliness of contract audits done. Of the staff years expended on audits by EPA's IG and its contracted auditing firms, about 3 percent were charged to contract audits in fiscal year 1989. According to EPA's IG, adequate resources have not been available to perform all essential audits. DCAA has had backlogs of incurred cost audits for years, in part as a result of increasing work loads during the military buildup of the 1980s, according to DCAA officials. Although DCAA's audit staff has grown, increasing work loads and a hiring freeze produced an increasingly unmet demand for incurred cost audits. DCAA has begun to reduce its audit backlog, but expects elimination of the backlog to take several years.

Priorities for conducting audits and the limited resources delayed audits for the contractors we reviewed. For example, between March 1988 and September 1989, PCMD requested five audits

of CH₂M Hill and Riedel that the EPA IG's Western Audit Division did not begin because the division gave priority to internal and construction grant audits and because additional funds were not available to meet the requests. During this period, four major Superfund cleanup contracts with a maximum potential value of \$664 million were awarded to CH₂M Hill with internal reviews of proposed costs by PCMD instead of the usual preaward audits by independent auditors. According to a PCMD official, these audits were not requested because the IG had told PCMD that funding was not available.

Delays in funding audits by other agencies, communication problems with other federal audit groups, and changing the private accounting firms performing audits also contributed to delays in auditing. For example, PCMD's requests for incurred cost audits of Ebasco were not done for several years by DOE, the agency which performs audits of Ebasco, in part because setting up an interagency agreement to reimburse DOE for audit services, previously provided free to EPA, took the EPA and DOE IGs more than a year. In another case, misunderstandings between the EPA IG and DCAA about which agency would audit ICF in the future led DCAA to suspend for 2 months 12 audits of the contractor that were in progress. An 8-month delay in audit work on Riedel and CH₂M Hill resulted when EPA IG switched independent accounting firms in 1989, which compounded existing delays on these contractors.

While the incurred cost audit backlog has delayed closing out contracts, closeout delays also have been caused in part because EPA does not have procedures that identify who is responsible for specific steps in contract closeout or establish time frames for performing them.

EPA IG and PCMD officials have recognized the problems with backlogged audits. To address them, EPA's IG is contemplating doing the auditing of several major contractors instead of relying

on other agencies to perform the audits. Although this proposal may help, audit delays could result if EPA does not expend more resources for contract audits and does not coordinate closely with other federal agencies that use these contractors.

More Timely Audits Are Needed
for Several Reasons

According to the Director of PCMD, unfulfilled audit requests make it difficult for EPA to effectively manage its contracts. He added that unfulfilled requests can result in added costs, weaker negotiating positions, and the failure of EPA to live up to its contractual responsibilities. When annual incurred cost audits are delayed, contractors may lose or misplace records, making the audits more difficult to perform. For the Superfund program, such missing records can hinder the documentation of costs and can affect the government's attempts to recover cleanup costs from parties responsible for cleaning up hazardous waste sites.

The problems identified by audit reports and PCMD's internal reviews of the six case study contractors also demonstrate why more timely audits are needed. For EPA contracts held by each of the contractors, we reviewed all 68 audit reports provided by EPA and DCAA, and 29 financial monitoring reviews (FMR).⁵ These reports identified some recurring problems.

For example, commonly cited problems in FMR reports included: unallowable, unauthorized, or unsupported charges; deficient billing and accounting systems; failure to submit required documentation; potential cost overruns; inadequate administrative

⁵FMRs, which are internal reviews performed by PCMD staff of large ongoing Superfund contracts, cover billing and accounting systems, direct contract costs, costs billed by subcontractors, indirect costs, and other aspects of these contracts. Although FMRs are not independent audits, they can identify contract problems that are current, which may prove especially important in the absence of audits.

procedures; and deficient timekeeping. More specifically, audits of one contractor over several years revealed ongoing timekeeping problems:

- A 1990 audit by DCAA questioned approximately \$180,000 in labor costs from fiscal years 1986 to 1989 because the contractor charged EPA for about 11,000 hours of employee time off in excess of earned time off and holidays. This time off was in addition to time provided for in the contractor's policy, and, according to the audit report, the contractor could not adequately explain why the government should pay for these costs.

- During a "floor check" to verify that employees were actually working on the projects assigned, which DCAA conducted as part of a special interim 1989 audit, the contractor was unable to locate over half of the employees selected for checking.

AUDIT FOLLOW-UP IS INADEQUATE

The second contract auditing area we reviewed was audit follow-up. Agencies are required by OMB to establish a system to track whether problems identified in audit reports are corrected. EPA's system is not effective. EPA's IG reported in September 1989 that the agency did not have an effective audit follow-up system. The report noted that the system was not producing accurate information on what, if anything, was being done to correct the problems uncovered by audits. According to the report, in one EPA region, officials responsible for reporting on corrective actions considered the process nothing more than a "paper shuffling" exercise and did not check the accuracy of the information that program officials gave them. As recommended by the IG, EPA listed audit follow-up as a material weakness in its Federal Managers'

Financial Integrity Act of 1982 (FMFIA) report to the President and the Congress for fiscal year 1989.

In 1990 EPA initiated a new audit follow-up system, but an August 1990 IG report concluded that it was still unreliable. For example, several corrective actions shown as completed in the audit follow-up data base were not completed. Because of these ongoing deficiencies, EPA is considering reporting audit follow-up as a material weakness again in its fiscal year 1990 FMFIA report.

In addition to containing inaccuracies about action on audit findings, the follow-up system, we noted, is incomplete--it did not include some audit reports on EPA's contractors or any GAO reports. The contractor audit reports were omitted because they were not included in the IG's data base of completed audit reports.

The data base maintained by EPA's IG logs completed audit reports and is used to compile the IG's semiannual reports to the Congress. The IG's data base is the primary source of information on completed audits for EPA's audit follow-up system. The IG's data base also records whether agency officials develop corrective action plans within 180 days of receipt of the audit report. Once the IG receives the plans, the agency follow-up official, using the audit follow-up data base, is supposed to track them to ensure they are actually implemented. Omissions from the IG's data base cause the audit follow-up system to be incomplete.

In reviewing data pertaining to the six case study contractors, we found the IG's data base did not contain three reports by DOE on Ebasco and three reports by DCAA on ICF. Because of these omissions, questioned costs totaling about \$7.6 million from the DOE reports and several problems requiring resolution identified in the DCAA reports were not tracked in the EPA follow-up system nor reported semiannually to Congress by the IG, as required by the Inspector General Act of 1978, as amended.

Collectively, these omissions result in incomplete reporting on audit follow-up to the agency head and, in turn, to the Congress.

SUMMARY

To recap, Mr. Chairman, in an era of large federal deficits, good contract management and auditing help ensure that EPA wisely spends its limited funding for environmental programs. This is especially important because the nation faces hundreds of billions of dollars of unmet environmental needs.

EPA has recognized problems with audit backlogs and follow-up and is acting to correct them. However, obtaining timely audit coverage of contracts is not completely within EPA's direct control under the present system of having the agency spending the preponderance of the federal dollars with a contractor perform the audits of that contractor. The full resolution of these problems requires the involvement of other federal agencies, as users and suppliers of audit services, and OMB, which establishes various audit policies. In the interim, however, EPA can take more aggressive actions to expedite audits of those contractors that it audits. Because it will undoubtedly take years to eliminate, we believe the Congress should be apprised periodically of the status of the audit backlog of EPA contracts. The IG's semiannual reports to the Congress provide a means for doing this. EPA can also take steps to improve the timeliness of contract closeouts and the reliability of its audit follow-up system, including the IG's data base for tracking completed audit reports.

RECOMMENDATIONS

We are recommending that, to address more fully problems of contract auditing, EPA's Inspector General

- report the problem of obtaining timely audits of EPA contracts and any progress toward correcting it in the Inspector General's required semiannual reports to the Congress;
- develop a plan for auditing contracts that EPA audits, including identifying and requesting the resources required to reduce the audit backlog within a reasonable period and keep abreast of future requirements; and
- correct and accurately maintain the Office's data base that tracks completed audit reports.

We are also recommending that the Administrator, EPA,

- work with the other federal agencies, including OMB, to develop ways to expedite audit coverage of contractors for which EPA relies on other agencies to audit and
- develop written procedures for closing out expired contracts, including better defining closeout responsibilities and establishing time frames for meeting them.

Mr. Chairman, this concludes my prepared statement. I will be glad to respond to any questions that you or Subcommittee Members may have.