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Contracting Oversight, Committee on  
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## CONTRACT AUDITS

# Role in Helping Ensure Effective Oversight and Reducing Improper Payments

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**G A O**

Accountability \* Integrity \* Reliability

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

## Why GAO Did This Study

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

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

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

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

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

View [GAO-11-331T](#) or key components. For more information, contact Jeanette M. Franzel at (202) 512-9471 or [franzelj@gao.gov](mailto:franzelj@gao.gov).

February 1, 2011

## CONTRACT AUDITS

### Role in Helping Ensure Effective Oversight and Reducing Improper Payments

## What GAO Found

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

DOD accounts for the largest share of federal contract spending. DCAA was established in 1965 in response to studies which identified the need for consistency in contract audits at DOD. DCAA serves a critical role in DOD and other federal agency contractor oversight by providing auditing, accounting, and financial advisory services in connection with the negotiation, administration, and closeout of contracts and subcontracts. The majority of DCAA audits focus on cost-reimbursable and other nonfixed-price contracts, which pose the highest risk to the government.

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

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

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Madam Chairman and Members of the Subcommittee:

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

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

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

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<sup>1</sup> GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (November 1999).

<sup>2</sup> GAO, *Defense Management: Widespread DCAA Audit Problems Leave Billions of Taxpayer Dollars Vulnerable to Fraud, Waste, Abuse, and Mismanagement*, [GAO-10-163T](#) (Washington, D.C.: Oct. 15, 2009); *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009); *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-1009T](#) (Washington, D.C.: Sept. 23, 2009); *DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-993T](#) (Washington, D.C.: Sept. 10, 2008); *DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-857](#) (Washington, D.C.: July 22, 2008).

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(GAGAS). Those standards require that we plan and perform our audits to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## The Contracting Cycle and Internal Controls

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

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## Internal Control

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

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

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

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

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

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## Contract Types and Related Risks

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

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

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

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

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

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

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

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## DCAA's Origin and Contract Audit Role

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

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<sup>7</sup> 48 C.F.R. § 16.601(d).

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

In May 1962, Secretary of Defense Robert S. McNamara instituted “Project 60” to examine the feasibility of centrally managing the field activities concerned with contract administration and audit.<sup>9</sup> An outcome of this study was the decision to establish a single contract audit capability within DOD and DCAA was established on June 8, 1965.<sup>10</sup> At that time, DCAA’s mission was to perform all necessary contract audits for DOD and provide accounting and financial advisory services regarding contracts and subcontracts to all DOD components responsible for procurement and contract administration. DCAA was placed under management control of the Under Secretary of Defense (Comptroller), where it remains today. Other audit organizations, including the DOD and other federal agency Inspectors General (IG), the Special IGs for Iraq and Afghanistan, and the military service audit agencies also have a role in the oversight of federal contracts.

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

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<sup>8</sup> DCAA, *Contract Audit Manual* (CAM) DCAAM 7640.1.

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

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

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

DCAA contract audits are intended to be a key control to help ensure that prices paid by the government for needed goods and services are fair and reasonable and that contractors are charging the government in accordance with applicable laws, the *Federal Acquisition Regulation* (FAR), *Cost Accounting Standards* (CAS), and contract terms. DCAA's mission encompasses both audit and nonaudit services in support of DOD and other federal agencies' contracting and contract payment functions. FAR subpart 42.1, "Contract Audit Services," and DOD Directive 5105.36, *Defense Contract Audit Agency (DCAA)*, establish DCAA as the department's contract audit agency<sup>11</sup> and set forth DCAA's responsibilities.

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

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

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

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

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

Source: GAO analysis of DCAA information.

The majority of DCAA audits focus on cost-reimbursable and other nonfixed-price contracts, including progress payments on major weapon systems and time-and-materials contracts. These contract types pose the highest risk to the government because the government is generally not promised a completed deliverable or service at a set price. DCAA audits of contractor business systems and related internal controls support decisions on pricing, contract awards, and billing. For example, the FAR requires government contracting officers to determine the adequacy of a contractor’s accounting system before awarding a cost-reimbursement or other nonfixed-price contract.<sup>12</sup> Audits of estimating system controls support negotiation of fair and reasonable prices.<sup>13</sup> Also, billing system audits support decisions to authorize contractors to submit invoices

<sup>12</sup> FAR §§ 16.104(h) and 16.301-3(a)(1).

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

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directly to DOD payment offices for payment without government review.<sup>14</sup> Internal control audits also impact the planning and reliability of other DCAA audits, such as audits of contractors' pricing proposals and annual incurred cost claims, because DCAA uses the results of its internal control audits to assess risk and plan the nature, extent, and timing of tests for these audits.

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## Risks of Ineffective Contract Controls and Auditing

Agencies across the government are increasingly reliant on contractors to execute their missions. In fiscal year 2010, federal agencies reported obligating approximately \$535 billion on goods and services—more than double the amount obligated at the start of the last decade in real terms. Our analysis of Federal Procurement Data System–Next Generation (FPDS-NG) contract obligations<sup>15</sup> determined that although federal contract spending increases have slowed and decreased slightly in recent years, over the past 5 years federal contract spending has increased by \$100 billion.<sup>16</sup> As illustrated in figure 2, the sheer size of federal contract spending poses significant risk if effective processes, controls, and oversight are not in place. DOD accounts for approximately 70 percent of the federal government's FPDS-NG reported annual contract spending—\$367 billion in fiscal year 2010—and other federal agencies accounted for \$168 billion in contract spending. With hundreds of billions in taxpayer dollars spent on government contracts, strong contract oversight is essential.

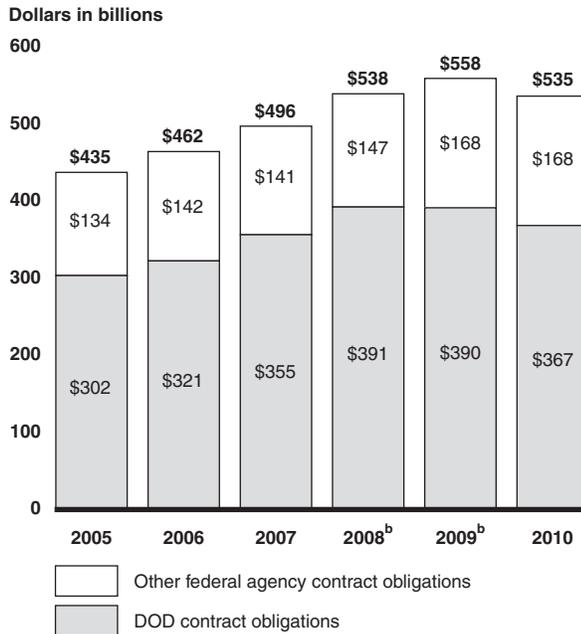
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<sup>14</sup> FAR § 42.101 and DFARS § 242.803.

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

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

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



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

<sup>a</sup>Contract obligations are adjusted for inflation using the fiscal year 2010 Gross Domestic Price Index.

<sup>b</sup>DOD's reported obligations in fiscal year 2008 and 2009 reflected an approximately \$13.9 billion adjustment to correct an error made in fiscal year 2008.

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

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

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

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## Contracting Control Weaknesses Identified in GAO Work

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

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

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<sup>17</sup> See list of related products at the end of this testimony.

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

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

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

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

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

As a result of the contracting weaknesses we found in the MMA program, GAO was asked to evaluate CMS's internal controls over its contracting activities.<sup>20</sup> Based on our audit, we found pervasive deficiencies in CMS's internal controls over contracting and payments to contractors. The internal control deficiencies occurred throughout the contracting process phases. These deficiencies were due in part to a lack of agency-specific policies and procedures to ensure that FAR requirements and other control objectives were met. CMS also did not take appropriate steps to ensure that existing policies were properly implemented nor maintained adequate documentation in its contract files. As a result of our work, we estimated that at least 84.3 percent of FAR-based contract actions made by CMS in fiscal year 2008 contained at least one instance in which a key control<sup>21</sup> was not adequately implemented. We also estimated that at least 37.2 percent of FAR-based contract actions made in fiscal year 2008 had three or more instances in which a key control was not adequately implemented. The high percentage of deficiencies indicated a serious failure of control procedures over FAR-based acquisitions, thereby creating a heightened risk of making improper payments or waste. Our October 2009 report made nine additional recommendations to the CMS Administrator to develop and implement policies and procedures to ensure that FAR requirements and other control objectives are met. We have obtained documentation on CMS's actions and are in the process of validating this information. CMS officials told us they expect to complete actions on all but one of our recommendations by March 31, 2011.

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## Ineffective Contract Auditing

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

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

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

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

As a result of our work, DCAA rescinded over 80 audit reports because its underlying audit evidence was outdated, insufficient, or inconsistent with reported conclusions and opinions. Those rescinded audits had been issued to support decisions on contract pricing and awards and impacted the planning and reliability of hundreds of other DCAA audits, representing billions of dollars in DOD expenditures. About one-third of the rescinded reports relate to unsupported opinions on contractor internal controls and were used as the basis for risk assessments and planning on subsequent internal control and cost-related audits. Other rescinded reports relate to *Cost Accounting Standards* (CAS) compliance and contract pricing decisions. Because the conclusions and opinions in the rescinded reports were used to assess risk in planning subsequent audits, they impact the reliability of hundreds of other audits and contracting decisions covering billions of dollars in DOD expenditures.

A management environment and agency culture that focused on facilitating the award of contracts and an ineffective audit quality assurance structure are at the root of DCAA's agencywide audit failures we identified. DCAA's focus on a production-oriented mission led DCAA management to establish policies, procedures, and training that emphasized performing a large quantity of audits to support contracting decisions and gave inadequate attention to performing quality audits. An ineffective quality assurance structure, whereby DCAA gave passing scores to deficient audits, compounded this problem.

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<sup>22</sup> GAO, DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009).

<sup>23</sup> Of the 69 DCAA assignments we reviewed, 37 were audits of contractor systems and related internal controls and 32 were cost-related audits and assignments.

<sup>24</sup> [GAO-08-857](#).

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**Lack of independence.** In seven audits, independence was compromised because auditors provided material nonaudit services to a contractor they later audited; experienced access to records problems that were not fully resolved; and significantly delayed report issuance, which allowed the contractors to resolve cited deficiencies so that they were not cited in the audit reports.

**Unsupported opinions.** Thirty-three of 37 internal control audits did not include sufficient testing of internal controls to support auditor conclusions and opinions, which are relied on for 2 to 4 years, and sometimes longer. The lack of sufficient support for those audit opinions rendered them unreliable for decision making on contract awards, direct-billing privileges, the reliability of cost estimates, and reported direct cost and indirect cost rates. For example, we found that:

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

Similarly, the 32 cost-related assignments we reviewed did not contain sufficient testing to provide reasonable assurance that overpayments and billing errors that might have occurred were identified. As a result, there is

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little assurance that any such errors, if they occurred, were corrected and that related improper contract payments, if any, were refunded or credited to the government. Contractors are responsible for ensuring that their billings reflect fair and reasonable prices and contain only allowable costs, and taxpayers expect DCAA to review these billings to provide reasonable assurance that the government is not paying more than it should for goods and services. We identified the following problems with these assignments.

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

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

<sup>26</sup> CAM 6-1007.

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

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

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

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<sup>27</sup> CAM 6-102.

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

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

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Madam Chairman and Members of the Subcommittee, this concludes my statement. We would be pleased to answer any questions that you may have at this time.

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## Contacts and Acknowledgments

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# Appendix I: DCAA Audit and Nonaudit Services

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

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

<sup>2</sup> FAR § 32.503-4.

**Table 1: Examples of DCAA Audit and Nonaudit Services.**

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

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

Source: GAO analysis.

<sup>a</sup>Indicates DCAA audit and nonaudit services covered in this audit.

<sup>b</sup>Indicates types of audits covered in our prior investigation ([GAO-08-857](#)). We reviewed progress payment and contract closeout audits that related to audits in our earlier investigation or this audit where the auditors considered the evidence in those audits.

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

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

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## Short-term Legislative Actions

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

**Leadership.** The IG Act provides for the President to appoint the IG, with Senate confirmation, at many federal agencies.<sup>3</sup> Under the act, Congress must be notified in advance of removing the IG, and only Congress can eliminate the office of an IG. Currently, the head of DCAA is appointed and can be removed by the Secretary of Defense. Further, DCAA was created and can be reorganized or reassigned by departmental order without notice. IG Act protections Congress could grant to DCAA would therefore include (1) Senate confirmation of a presidentially appointed DCAA Director<sup>4</sup> and (2) removal of the DCAA Director conditioned on congressional notification.<sup>5</sup> Specifically, the act provides that an IG may be removed from office by the President and any removal is to be reported to both Houses of Congress 30 days prior to the removal. In addition to these IG Act protections, Congress could build additional provisions into legislation, to include the following:

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<sup>1</sup> [GAO-09-468](#).

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

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

<sup>4</sup> 5 U.S.C. App. § 3(a).

<sup>5</sup> 5 U.S.C. App. § 3(b).

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

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

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

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<sup>6</sup> 5 U.S.C. App. § 8F(4)(A).

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

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budget requests separately. DCAA currently does not have this protection. IGs that are appointed by the President with Senate confirmation receive a separate appropriation, preventing agencies from reprogramming IG funds to other programs and activities. However, there is currently little visibility over DCAA's budget because it is funded under the Operations and Maintenance, Defense-wide appropriation, which includes numerous DOD agencies, such as the Defense Contract Management Agency (DCMA), the Defense Logistics Agency, the Defense Finance and Accounting Service, and some buying command activities. Therefore, DCAA's share of annual appropriations is subject to reprogramming, sometimes without congressional notification. According to the DCAA Director and documentation provided by the Director and Office of Comptroller/CFO, in the past, DOD has reprogrammed funding between DCAA and other DOD activities on numerous occasions. Because these reprogrammings were below the \$15 million threshold for congressional notification, Congress did not have notice of these funding decreases at the time they occurred. For fiscal year 2009, DOD reprogramming increased DCAA's funding by \$3.5 million. Legislation similar to the IG Act could grant DCAA a separate budget<sup>8</sup> to provide visibility and protections from reprogramming of funds to other agency priorities.

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

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<sup>8</sup> 5 U.S.C. App. § 6(f)(1).

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

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

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

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

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

<sup>11</sup> 5 U.S.C. App. § 5(a).

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

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## Longer-term actions

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

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

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

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

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

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

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

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# Related GAO Reports and Testimonies

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## High-Risk Series

*DOD's High-Risk Areas: Actions Needed to Reduce Vulnerabilities and Improve Business Outcome*, [GAO-09-460T](#), Washington, D.C.: March 12, 2009.

*High-Risk Series: An Update*, [GAO-09-271](#), Washington, D.C.: January 2009.

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## DCAA Audits

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

*DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#), Washington, D.C.: Sept. 23, 2009.

*DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-1009T](#), Washington, D.C.: Sept. 23, 2009.

*DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-993T](#), Washington, D.C.: Sept. 10, 2008.

*DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-857](#), Washington, D.C.: July 22, 2008.

*Iraq Contract Costs: DOD Consideration of Defense Contract Audit Agency's Findings*, [GAO-06-1132](#), Washington, D.C.: Sept. 25, 2006.

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## Contract Management

*Centers for Medicare and Medicaid Services: Pervasive Internal Control Weaknesses Hindered Effective Contract Management*, [GAO-10-637T](#), Washington, D.C.: Apr. 28, 2010.

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

*Contract Management: Minimal Compliance with New Safeguards for Time-and-Materials Contracts for Commercial Services and Safeguards Have Not Been Applied to GSA Schedules Program*, [GAO-09-579](#), Washington, D.C.: June 24, 2009.

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*Defense Acquisitions: Charting a Course for Lasting Reform*, [GAO-09-663T](#), Washington, D.C.: April 30, 2009.

*Global War on Terrorism: DOD Needs to More Accurately Capture and Report the Costs of Operation Iraqi Freedom and Operation Enduring Freedom*, [GAO-09-302](#), Washington, D.C.: Mar. 17, 2009.

*Defense Acquisitions: Perspectives on Potential Changes to Department of Defense Acquisition Management Framework*, [GAO-09-295R](#), Washington, D.C.: February 27, 2009.

*Defense Management: Actions Needed to Overcome Long-standing Challenges with Weapon Systems Acquisition and Service Contract Management*, [GAO-09-362T](#), Washington, D.C.: Feb. 11, 2009.

*Defense Management: Actions Needed to Overcome Long-standing Challenges with Weapon Systems Acquisition and Service Contract Management*, [GAO-09-362T](#), Washington, D.C.: February 11, 2009.

*Space Acquisitions: Uncertainties in the Evolved Expendable Launch Vehicle Program Pose Management and Oversight Challenges*, [GAO-08-1039](#), Washington, D.C.: September 26, 2008.

*Financial Management: FBI Has Designed and Implemented Stronger Internal Controls over Sentinel Contractor Invoice Review and Equipment Purchases, but Additional Actions Are Needed*, [GAO-08-716R](#), Washington, D.C.: July 15, 2008.

*Defense Contracting: Post-Government Employment of Former DOD Officials Needs Greater Transparency*, [GAO-08-485](#), Washington, D.C.: May 21, 2008.

*Defense Contracting: Army Case Study Delineates Concerns with Use of Contractors as Contract Specialists*, [GAO-08-360](#), Washington, D.C.: March 26, 2008.

*Defense Contracting: Additional Personal Conflict of Interest Safeguards Needed for Certain DOD Contractor Employees*, [GAO-08-169](#), Washington, D.C.: March 7, 2008.

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

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