

Testimony

of

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before the

House Committee on Science, Space and Technology

on

“Review the Results of Two Audits of the National Ecological Observatory Network (NEON)”

December 3, 2014

Chairman Smith, Representative Johnson, and members of the Committee, thank you for the opportunity to appear before you today. I am pleased to provide you with an overview of DCAA's contract audit mission and responsibilities. I will also discuss the role DCAA plays in performing contract audits including grants and cooperative agreements at the National Science Foundation (NSF) and more specifically the recent work we have done at National Ecological Observatory Network (NEON).

Background

DCAA is a distinct agency of the Department of Defense (DoD) that reports to the Under Secretary of Defense (Comptroller). The DCAA mission is to perform the necessary audits of contractors for DoD components responsible for the negotiation, administration, and settlement of contracts and subcontracts. DCAA's mission supports DoD's efforts to obtain maximum value for the dollars spent in defense contracting, thereby protecting the taxpayer's interest and supporting the warfighter. Our charter was intentionally developed to permit DCAA to provide these same contract audit services to other Federal agencies.

To carry out its mission, DCAA has about 5,100 employees at 125 field audit offices around the world. More than 85 percent of DCAA's personnel are auditors. In FY 2014, DCAA performed about 6,000 audits covering \$183 billion in proposed or claimed contractor costs. These reviews recommended reductions in proposed or billed costs of \$10.7 billion (referred to as questioned costs), and \$6.0 billion in estimated costs for which the contractor did not provide sufficient information to explain the basis of the proposed amounts (referred to as unsupported costs). In any one year, DCAA audits between 5,000 and 7,000 different contractors.

DCAA Contract Audit Effort

To support the Secretary of Defense's initiatives to get the best value for the dollars spent in defense contracting, DCAA plays a critical role in the oversight and management of government contracts by ensuring that contractors comply with government contract regulations. Based on its audit findings, DCAA makes recommendations to contracting officers in the procurement and contract management organizations. Contracting officers, in turn, make final contract decisions based on their assessment of those recommendations. While each organization plays a different role, we all work closely together throughout the contracting process.

The type and extent of DCAA audit work varies based on the type of contracts awarded; however, the majority of DCAA effort can be categorized into two groups:

Forward Pricing Reviews – DCAA performs audits of contractors' bid proposals when cost data is provided and contracting officials determine the need for audit services. In accordance with the Federal Acquisition Regulation (FAR) for both fixed-price and cost-reimbursable contracts, DCAA performs these audits prior to contract award to assist the contracting officer in negotiating a fair and reasonable price. DCAA audit services are generally limited to those procurements under FAR Part 15 (Contracting by Negotiation). During FY 2014, DCAA conducted 1,089 audits of contractor proposals covering \$61.5 billion and reported cost questioned of about \$7.1 billion.

Incurred Cost Reviews – DCAA performs reviews of contractors' annual incurred cost submissions. DCAA performs these audits to ensure that the costs claimed by the contractor are reasonable, allocable, and allowable. These audits also establish final indirect rates for the contractor. During FY 2014, DCAA completed more than 11,000 contractor years and reported cost questioned of about \$2.7 billion.

DCAA National Science Foundation Effort

DCAA has performed contract audits for civilian agencies since its inception in 1965, a function that represents between 9 to 11 percent of our budget, or \$50 to \$64 million in funding. Both the type and scope of DCAA's efforts at civilian agencies are very similar to the audits we perform for the Department of Defense. Importantly, unlike the role of an Inspector General, DCAA's work for both DoD and civilian agencies focuses only on contractors and their financial assertions; DCAA does not review the actions of Government acquisition personnel, but rather acts as advisors to those personnel based on our audit findings.

The National Science Foundation, one of the civilian agencies DCAA assists, through either their IG or their Acquisition Division has asked us to perform multiple types of audit efforts to include forward pricing proposals and incurred costs. Over the last 5 years, total DCAA effort dedicated to NSF has averaged a little over 6,000 hours or almost 4 staff years' worth of effort each year.

One of the contractors that NSF requested help with is the National Ecological Observatory Network (NEON). NEON is a non-profit organization and as a non-profit must follow the cost principles outlined in OMB Circular A-122 for determining costs of grants, contracts and other agreements. While not as comprehensive OMB Circular A-122 is similar in principle and function to the Federal Acquisition Regulations (FAR). DCAA has performed two significant audits at NEON.

Forward Pricing Examinations – At the request of the NSF Inspector General in August of 2011 DCAA attempted to perform a proposal evaluation of NEON's cooperative agreement for major research equipment and construction of the National Ecological Observatory Network. Despite significant coordination with NEON, DCAA was not able to perform an audit because of

numerous inadequacies in the proposal. Specifically, DCAA noted the following inadequacies in NEON's proposal:

- The proposed cost elements did not reconcile to its supporting data.
- The proposal did not include a time phasing of costs for the proposed contract period of performance.
- The proposal did not include a consolidated bill of materials and equipment for the proposed direct material and direct equipment costs under the anticipated contract.
- The proposed direct labor did not include a consolidated listing of labor costs by job categories for the contract base period which includes total direct labor costs.
- The proposal did not show how the proposed indirect costs were computed. OMB Circular A-122 requires the breakout of indirect cost components into two broad categories, *Facilities and Administration*.

These deficiencies made it impossible for the Agency to complete an audit of the proposal.

About a year after its first attempt to audit the National Ecological Observatory Network, DCAA again audited NEON's proposal. While there was still major inadequacies associated with the proposal, DCAA was able to issue an audit report in September of 2012. Highlights from the audit included:

- Of the \$433,798,768 proposed by NEON DCAA questioned \$102,139,400 and unsupported \$52,298,348. Of the \$102 million questioned, about \$72 million related to contingency costs which as noted later, were not questioned in the system audit based on additional research. Questioned costs are costs the auditor considers not acceptable for negotiating a reasonable contract price or not acceptable for

reimbursement under existing contracts. Unsupported costs denote instances where the contractor has not provided specific evidence or documentation to support assertions related to the cost of future work.

- NEON did not provide adequate documentation or support to demonstrate the allowability, allocability or reasonableness for a significant amount of the proposed direct labor, material, equipment, and other direct costs.
- The inadequacies noted in our audit report were significant enough for us to recommend that the proposal should not be considered acceptable as a basis for negotiating a fair and reasonable cooperative agreement price.

It is also important to note that our proposal review of NEON was different from the normal forward pricing reviews we perform for DoD and other Civilian agencies. First, we were asked to review the proposal more than 7 months after the cooperative agreement had been awarded and a price established. The normal process is for contracting officers to request the audit of a proposal before the award is made. This process allows for the contracting officer to make full use of the auditor's recommendations to negotiate a fair and reasonable price.

Second, we normally work with the contracting officer responsible for awarding the contract action. As described above, the results of our proposal audits are used by acquisition officials to negotiate fair and reasonable prices. In this case we were asked to perform the effort for the NSF Inspector General. However, the ability to implement any of our recommendations or make any changes to the cooperative agreement rests with the contracting officer.

Accounting System Examination – At the request of the NSF Inspector General DCAA performed a review of NEON's accounting system, issuing our report in October of 2014. Our

audit disclosed a material noncompliance with NEON's timekeeping system; specifically, NEON's actual timekeeping practices do not comply with its written policies and procedures.

Our audit also disclosed two other material noncompliances that were corrected during the course of our field work. First, NEON failed to comply with the OMB Circular A-122 requirement that organizations receiving more than \$10 million in Federal funding of direct costs in a fiscal year must break out indirect costs into two broad categories: *Facilities and Administration* before developing indirect rates. Prior to our audit, NEON had reported these indirect costs together. Second, our audit determined that NEON excluded unallowable costs from the G&A base. The OMB Circular A-122 requires unallowable cost be included in the G&A allocation base so they absorb their share of an organization's indirect expenses. Our fieldwork verified that NEON corrected both of these conditions after we identified them.

In addition to our audit report on the accounting system, DCAA provided the NSF supplemental information regarding both NEON's accounting for contingencies and NEON's use of the management fee it earns.

Although our accounting system report did not identify NEON's treatment of contingency costs as a deficiency, DCAA invested a significant amount of time examining NEON's accounting and estimating of contingency costs as specifically requested by the NSF Inspector General. DCAA found that NEON utilizes a process for identifying potential risks to performance (budget, schedule and scope) when estimating contingency costs for budgeting purposes on NSF cooperative agreements in accordance with NSF guidance. Amounts budgeted for contingency are not allocated to the awardee initially, but are held in reserve by NSF management until the awardee justifies the need for additional funding due to contingencies. After the NSF allocates the additional funds to NEON and NEON incurs an expense it pays for

with amounts from the contingency budget, the cost is recorded on NEON's books as an actual expense to a project (e.g. labor or material). This practice complies with OMB Circular A-110 which is not specific on contingency expenditures or the tracking of those expenditures.

However, we did recommend that NSF consider strengthening its Grant Policy and guidance to awardees to improve internal controls over contingencies on construction projects with regard to estimating, monitoring, and accounting for contingency expenditures. Specifically, have NSF require an awardee to (i) separately track, (in more detail than what the contractors are currently doing) the use of the proposed contingency costs in the budget control log as a condition of the award, and (ii) provide fully supported bases of estimate for contingencies. This should provide NSF with better oversight of how the contingency is used.

We also provided the NSF Inspector General with supplemental information related to NEON's use of the management fee it earns under the cooperative agreement. Based on our observations during the accounting system review, NEON and NSF negotiated a "management fee" in the cooperative agreements that NEON uses to pay non-reimbursable costs incurred by NEON. The NSF Proposal Award Policies and Procedures Guide and the NSF Grant Policy Manual address fee in general terms, making it clear that fee is permissible if approved by the grants/agreements officer, which it was. We can find no regulation that prohibits the payment of a management fee under a cooperative agreement to a non-profit entity. The management fee established for this cooperative agreement is 0.5 percent, which is at the low end of NEON's stated policy of assessing fees of 0.5 – 1 percent on NSF projects.

However, we were unable to find any NSF Grant Policy determining when a fee should be awarded or how a negotiated fee should be used by a non-profit entity. We also found expenses being incurred that would ordinarily be unallowable under OMB Circular A-122 if they

had been paid for separately as costs (for example, \$56,000 for lobby costs and \$19,000 for a holiday party).

DCAA recommended that NSF consider strengthening their Grant Policy to specify requirements for determining and monitoring the award of fee. NSF should benchmark with other federal agencies to determine how they use management fee and how other agencies allow the use of that fee.

Financial Oversight at DoD Non-Profit Companies – The Department of Defense has established comprehensive procedures for providing oversight to non-profit companies under their cognizance. For example, DoD has established a management plan (see Department of Defense Federally Funded Research and Development Center Management Plan, dated April 25, 2011) that provides extensive guidance and procedures for the management, oversight, and use of FFRDCs. An important aspect of the management plan requires close monitoring of the types of costs that are being incurred as a fee to assure they are appropriate and directly or indirectly benefit the federal agency. The monitoring process includes both a budgeting process where the specific costs are identified in advance, and an annual review of the expenditures to assure that the prior representations and justifications were reliable. This type of close monitoring is not readily apparent in the NEON cooperative agreement.

DCAA is an important component of that oversight and we work closely with the Department's acquisition community providing auditing and financial services.

Finally, based on our experience with other nonprofit companies and contractors in general, we believe there are additional opportunities for NSF to strengthen their oversight of contracts and contain costs. First, for all significant or high risk awards, NSF should obtain an audit of contractors' forward pricing proposal prior to negotiating the price. These audits

provide important cost information to the contracting officer and can prove instrumental in arriving at a fair and reasonable price for the contract action provided they are incorporated into the acquisition or grant process and all parties have a common understanding of what audit work is required. Forward pricing audits can be especially helpful in a sole source environment (similar to the subject NEON award) where there is limited or no competition.

Second, for all flexible priced awards (i.e., cost-type contracts) NSF should require contractors to submit annual incurred cost submissions and obtain an audit of significant submissions. It is our understanding that NEON has no contractual requirement to submit annual incurred cost submissions to NSF beyond the annual Indirect Rate Cost submission. A more comprehensive incurred cost submission would also cover direct costs. Incurred cost reviews are an important part of ensuring that costs are properly supported, indirect rates are accurate, and the Government is not paying for unallowable costs.

Closing

Let me assure you that we are committed to providing NSF and all civilian agencies with high-quality audits that protect the interests of the American taxpayer. As we go forward, we intend to work with NSF Acquisition and the NSF Inspector General through the normal contracting process to provide comprehensive contract audit services for NEON and other NSF contractors.

I appreciate the opportunity to testify before you today and I will be glad to respond to your questions.



Ms. Anita F. Bales
Director
Defense contract Audit Agency

Ms. Anita Bales was appointed as the Director, Defense Contract Audit Agency on August 31, 2014, and is responsible for all matters related to the management of the Agency and its resources. In that position she is responsible for managing the worldwide operation of the DCAA and its resources.

DCAA performs contract audits for DoD and provides accounting and financial advisory services regarding contracts and subcontracts to all DoD Components in support of national defense. These services are provided in connection with negotiation, administration, and settlement of contracts and subcontracts. Ms. Bales, through an executive team, exercises executive direction for a staff of over 5,000 personnel, 85 percent of which are professional auditors, with a \$600 million annual operating budget. As the Director, Ms. Bales directs the planning, development, execution, and evaluation of comprehensive programs to implement public law and Secretary of Defense Directives in carrying out the contract audit mission assignment to the Agency.

Ms. Bales entered the Senior Executive Service in November 2006

CAREER CHRONOLOGY:

- April 2011-August 2014: Deputy Director, Defense Contract Audit Agency, Ft. Belvoir, VA
- Nov 2006-April 2011: Deputy Auditor General, Forces and Financial Audits, Army Audit Agency, Alexandria VA
- Oct 2001 – Nov 2006: Program Director, Financial Management Audits, Army Audit Agency, Alexandria, VA
- Sep 1998 – Sep 2001: Audit Manager, Force Management Audits, Army Audit Agency, Ft. Belvoir, VA
- Jun 1996 – Aug 1998: Student, Syracuse University

- Mar 1992 – Jun 1996: Audit Supervisor, Central Region, Army Audit Agency, St. Louis, MO
- Jan 1988 – Mar 1992: Auditor: European Region, Army Audit Agency, Frankfurt, Germany
- Aug 1983 – Dec 1987: Auditor: Midwest Region, Army Audit Agency, Rock Island, IL

COLLEGE:

- MBA, Syracuse University
- BS, Business Administration/Accounting, Drake University

SIGNIFICANT TRAINING:

- Federal Executive Institute, Leadership in a Democratic Society
- Syracuse University, Army Comptrollership Program

CERTIFICATIONS:

- Certified Public Accountant
- Certified Information Systems Auditor
- Certified Government Financial Manager

AWARDS AND HONORS:

- Neil Ginetti Award for Outstanding Performance in Financial Management, Professional Development, Career Management and Mentoring
- President's Council on Integrity and Efficiency Award for Auditing
- Leonard F. Keenan Award (Syracuse University)
- Resource Management Award from the Assistant Secretary of the Army (Financial Management and Comptroller)
- Commander's Award for Civilian Service
- Achievement Medal for Civilian Service

PROFESSIONAL MEMBERSHIPS AND ASSOCIATIONS:

- Association of Government Accountants
- American Society of Military Comptrollers
- Association of the U.S. Army
- Professional Advisory Board for Drake University's School of Accounting