



SPECIAL INSPECTOR GENERAL FOR IRAQ RECONSTRUCTION

July 30, 2012

LETTER FOR DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Gaps in Business System Reviews of Contractors with Generally Less Than \$100 Million Annually in Contracts in Iraq Increase U.S. Government Vulnerabilities to Fraud, Waste, and Abuse (SIGIR 12-019)

In this report, SIGIR focuses on the extent to which the U.S. government has performed business system reviews of Department of Defense (DoD) contractors operating in Iraq with total work amounting to less than \$100 million annually from 2004 to 2011. We focused on four key contractor business systems—accounting, billing, estimating, and purchasing. The report follows up on the Special Inspector General for Iraq Reconstruction’s (SIGIR) July 2011 audit that identified weaknesses in the government’s oversight of Anham, LLC.¹ We found in that audit that Anham had weak billing and purchasing systems and an estimating system that had not been reviewed, leaving the government vulnerable to overcharges.²

Reviews of contractors’ business systems and associated internal controls are considered the first line of defense in the fight to reduce the risk of fraud, waste, and abuse. The Commission on Wartime Contracting in Iraq and Afghanistan (CWC) and the Government Accountability Office (GAO) found widespread weaknesses in the government’s contracting oversight processes and emphasized the need for systemic improvements. In response, congressional legislation was recently introduced to improve the contracting process in high-risk overseas contingency operations.³

For this report, SIGIR judgmentally sampled 35 DoD contractors and found gaps in the business system review coverage for the sample contractors.⁴ Twenty-one of the 35 contractors had one or more of the 4 key business systems examined by either the Defense Contract Management Agency (DCMA) or the Defense Contract Audit Agency (DCAA).

Of the 21 contractors with system reviews, we found only 5 contractors had all 4 of their systems reviewed. Eleven contractors had system reviews that were more than 4 years old. This raises concerns as to whether the controls in these business systems were still adequate to reduce the risk of overcharges. Most contractors had their accounting and billing systems reviewed but less than a third had their estimating and purchasing systems reviewed.

¹ Anham is currently a large contractor with contingency work in both Iraq and Afghanistan.

² *Poor Government Oversight of Anham and Its Subcontracting Procedures Allowed Questionable Costs To Go Undetected*, SIGIR 11-022, 7/30/2011.

³ Comprehensive Contingency Contracting Reform Act of 2012, S3286, 6/3/2012.

⁴ Some of these contractors have, in addition to their Iraqi-based work, a considerable amount of other contract work with DoD.

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The lack of a purchasing system review or weaknesses in such a review is noteworthy because many of the problems SIGIR identified in its audit of the Anham contract last year pertained to the company's financial and management relationships with its subcontractors and the subcontractors' pricing of goods. Further, the revelation of such relationships through a business system review would raise red flags regarding possible inappropriate or excessive charges to the government. These problems should have been uncovered in purchasing system reviews.

For the remaining 14 contractors, SIGIR found that 12 had none of their business systems reviewed, but 10 were contractors with firm fixed-price contracts that are not routinely subject to such reviews. The other two are a foreign contractor and a joint venture; neither was found in DCAA and DCMA contractor databases.

DoD has taken actions over time to improve its oversight of contractors. Further, DCAA, given its resource limitations, has adopted a risk-based approach that focuses primarily on reviews of contractors with the largest valued contracts. Nonetheless, SIGIR believes smaller contractors operating in contingency environments need more oversight because of the increased risks associated with contracting in such settings. DCAA officials told SIGIR that they are working on a proposed approach as part of a broader DoD effort to improve the oversight of contractors' business systems and that this new approach will include coverage for smaller contractors.

Background

Since 2003, the U.S. government has awarded billions of dollars to contractors to support relief and reconstruction activities in Iraq. Appropriate government oversight of contractors supporting these efforts is critical in reducing the risk that U.S. taxpayer funds are wasted or susceptible to fraud or other abusive practices.

Government program management, contracting, contract administration, and audit personnel, as well as contractors, play important roles in monitoring and overseeing contracts. Agencies awarding contracts for work in Iraq, such as the U.S. Central Command, have contracting officers who, in accordance with the Federal Acquisition Regulation (FAR), are responsible for ensuring performance of all necessary actions for effective contracting and compliance. These contracting officers can request and consider the advice of specialists in other fields, as appropriate, to carry out their duties.

DCMA and DCAA provide key support to contracting offices in their oversight roles. Specifically, DCMA is charged with, among other things, contract administration when delegated that authority by the procuring contracting office, and DCAA provides audit and financial advisory services. Both agencies play a role in performing business system reviews. DCAA is responsible for reviewing accounting, billing, and estimating systems while purchasing system reviews are DCMA's responsibility.⁵

In its administrative contracting officer (ACO) role, DCMA has the authority to accept or reject DCAA's advice regarding the adequacy of a contractor's business systems. Table 1 lists the key

⁵ Previously, both agencies had responsibility for reviewing purchasing systems.

contractor business systems relevant to this audit and a brief description of the primary features of those systems.

Table 1—Key Contractor Business Systems

System	Description
Accounting system	Accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, and present accurate and timely financial data for reporting in compliance with laws, regulations, and management decisions.
Billing system	Billings on public vouchers, requests for progress payments, contract closing proposals, and related cost statements submitted by contractors.
Estimating system	Policies, procedures, and practices for budgeting and planning controls, and generating cost estimates, and other data included in proposals for expectation of receiving contract awards.
Purchasing system	Purchasing of material and services, subcontracting, and subcontract management from development of the requirement through completion of subcontract performance.

Source: DoD.

Aside from business system reviews, DCAA conducts audits to reduce the risk of contractor overcharges. For example, DCAA executes: (1) forward pricing audits, generally before contract award, in which it evaluates a contractor’s cost estimates for goods or services to be provided to the government; (2) special audits contracting officers request to assist them on specific contract elements; and (3) incurred cost audits on contracts to determine if costs claimed are reasonable, are applicable to the contract, and are in keeping with generally accepted accounting principles.

Prior Reports Have Revealed Weaknesses in Government’s Oversight of Contractors in Contingency Areas

SIGIR, the CWC, and GAO have reported weaknesses in the government’s contracting oversight process and the need to reduce fraud, waste, and abuse.

SIGIR’s July 30, 2011, report on Anham found significant weaknesses in the government’s oversight of Anham’s business systems and other contract administration functions concerning a \$119.1 million contract.⁶ These weaknesses left the government at risk of paying excessive costs. We found that of the three key Anham business systems that DCAA was responsible for reviewing, it had audited the accounting system, had not reviewed the estimating system, and had reviewed the billing system very late into the contract, finding significant weaknesses with that system.

We further reported that DCMA reviewed and recommended approval of Anham’s purchasing system but did so without asking important questions about close and/or affiliated relationships

⁶ SIGIR-11-022, 7/30/2011.

that Anham may have had with its subcontractors. SIGIR believes that identifying these types of relationships is critical to determining the level of risk of overbillings to the government. SIGIR also reported that DCMA's review team recommended approval of Anham's purchasing system even though Anham did not justify sole source purchases in 32 of 34 cases, and in all 34 cases there was no required documentation showing Anham determined that the U.S. government was getting a fair and reasonable price. We performed a limited incurred cost review of the contract, questioning 39%, or \$4.4 million, of the costs. As a result of the multiple problems identified with the Anham contract, we subsequently questioned all reported costs.

The CWC's September 21, 2009, report concluded that defense agencies must improve their oversight of contractors' business systems to reduce fraud, waste, and abuse.⁷ The CWC identified five systemic problems regarding the oversight of contractors' business systems:

- DCMA's and DCAA's divergent and often contradictory behaviors send mixed messages to contractors.
- Separate government reporting lines of authority complicate issue resolution.
- Audit reports are not informative enough to help contracting officers make effective decisions.
- DCMA is not aggressive in motivating contractors to improve business systems.
- DCMA and DCAA are under-resourced to respond effectively to wartime needs.

In its report, the CWC emphasized that weak control systems—such as estimating, billing, purchasing, labor, and compensation—increase the risk that unallowable and unreasonable costs will be charged, especially in contingencies like Iraq and Afghanistan. Moreover, according to CWC, financial risks are greatly heightened in a contingency environment where business operations include new and unfamiliar business markets, foreign practices which often sanction graft, and poor communication that complicates oversight.

GAO's November 3, 2011, performance audit report found deficiencies in the oversight of contractors' business systems and challenges facing both DCMA and DCAA in performing this oversight.⁸ GAO noted that delays in obtaining audits from DCAA adversely impacted DCMA's ability to effectively carry out its ACO responsibilities and that DCMA contracting officers determined that many business systems were adequate despite the fact that the systems had not been reviewed by DCAA in a number of years—in many cases well beyond the guidelines established by DCAA.⁹

GAO concluded that, when business systems are not reviewed in a timely manner, the government faces an increased risk of paying for unallowable and unreasonable costs, because a

⁷ *Special Report on Contractor Business Systems: Defense Agencies Must Improve Their Oversight of Contractor Business Systems to Reduce Waste, Fraud and Abuse*, CWC Special Report 1, 9/21/2009.

⁸ *Defense Contract Management Agency: Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions*, GAO-12-83, 11/03/2011.

⁹ DCAA and DCMA guidelines specify that major contractors' accounting systems should be reviewed at least every 4 years, and other systems—purchasing, billing, and estimating—should be reviewed at least every 2-4 years. FAR 44.302(b) provides that once an initial determination has been made at least every three years, the ACO shall determine whether a purchasing review system is necessary.

contractor's cost structure or accounting procedures may change over time. The GAO review cited a variety of challenges that accounted for oversight weaknesses, such as staffing shortages. GAO subsequently recommended that the Secretary of Defense work with DCMA and DCAA to identify and execute options, such as hiring external auditors to assist in conducting audits of contractor business systems as an interim step until DCAA could increase its work force enough to fulfill this responsibility. DoD agreed to consider alternative approaches to audit contractor business systems but did not identify planned actions or timeframes.

DoD Has Taken Some Actions To Improve Oversight

DoD recognizes the importance of contractors' business systems and internal controls as the first line of defense against fraud, waste, and abuse, and has recently initiated actions intended to strengthen the oversight process. Specifically, DoD amended the Defense Federal Acquisition Regulation Supplement (DFARS) in February 2012 to:

1. set forth the elements of and process for determining the acceptability of contractors' business systems
2. require that when significant deficiencies are found and continue to exist in contractors' business systems, contracting officers are to withhold a percentage of payment until the deficiencies are corrected
3. require that there be no remaining deficiencies before the contractors' systems are approved and the contractors are authorized further work

Recognizing that DCAA was under-resourced to fully address its missions, DoD issued a policy change effective September 17, 2010, that directs DCAA to no longer review contractors' forward pricing proposals for cost-type contract proposals below \$100 million or fixed-priced contract proposals below \$10 million, thus enabling DCAA to apply more of its resources to higher risk work.¹⁰ Moreover, as part of an initiative to reduce overlap of DCMA and DCAA responsibilities, DCMA now has sole responsibility for performing purchasing system reviews, a function that DCAA sometimes performed in the past.

DCAA officials told us that they are focusing their oversight efforts on the largest contractors operating in overseas contingencies and are currently performing pilot audits at several of those locations to determine compliance with the new business system criteria cited in DFARS. In addition, in response to GAO's recommendation that it consider alternative approaches for auditing business systems, DCAA officials told us that they are working on a proposed approach as part of a broader DoD effort that they believe will better protect the government's interest given limited resources and will also help address risks associated with smaller (non-major)

¹⁰ *Office of the Under Secretary of Defense (Acquisition, Technology, and Logistics) Memorandum: Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending; "Align Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) Processes to Ensure Work is Complementary,"* 1/04/2011.

contractors, in addition to major contractors.¹¹ Finally, both DCMA and DCAA told us that they are continuing to increase their staffing levels to help address the increasing workload demands on their missions.

Gaps Exist in Business System Reviews for Smaller Scale Contingency Contractors

Our review of the 35 sampled contractors showed that either DCAA or DCMA reviewed 1 or more of 4 key business systems—accounting, billing, estimating, and purchasing—for 21 contractors. For these 21 contractors, SIGIR found only 5 contractors had all 4 systems reviewed, and 11 of the latest reviews for 17 contractors were more than 4 years old. This raises concerns as to whether the controls were still adequate to reduce the risk of overcharging. Most of the 21 contractors had their accounting and billing systems reviewed, but less than a third had their estimating and purchasing systems reviewed. Many of the issues we found with our prior review of the Anham contract pertained to Anham’s relationship with its subcontractors and the subcontractors’ pricing of goods, areas that should be included in purchasing system reviews.

For the remaining 14 contractors, SIGIR found that 12 had none of their business systems reviewed, but 10 were contractors with firm fixed-price contracts. The remaining two contractors were a foreign contractor and a joint venture; neither were found in DCAA and DCMA contractor databases.

The gaps in review coverage and the presence of reviews that are several years old raise the risk of fraud, waste, and abuse.

Overall Business Systems Review Coverage Has Gaps

Our analysis of DCAA and DCMA documentation indicates that gaps exist in the business systems review coverage for the 35 contractors in our sample. Specifically, we found that 21 contractors had 1 or more of their business systems reviewed, 12 had no reviews, and 2 contractors could not be found in either DCAA or DCMA databases. For the 12 contractors that we have characterized as having no business system reviews, 10 did not appear in either DCMA or DCAA’s databases. However, using other sources, we were able to determine that these 10 contractors had firm fixed-price contracts for their work in Iraq.

DCAA officials told us that there are no requirements to conduct business system reviews or incurred cost audits for fixed-price contracts.¹² In general, fixed-price contracts are viewed as less risky to the government than cost-type contracts because fixed-priced contract cost overruns are borne by the contractor, whereas cost overruns on cost-type contracts may be borne by the government. Two of the 12 contractors did have cost-type contracts, but DCAA told us they

¹¹ DCAA officials told us that they consider most contractors with less than \$100 million related to cost-reimbursement contracts on an annual basis to be of lesser risk and refer to them as non-major contractors while major contractors are those that exceed the \$100 million threshold. DCAA performs accounting system audits at non-major contractors based on identification of high risk and when requested by the contracting officer.

¹² Competitively awarded firm fixed-price, competitively awarded fixed-price with economic price adjustment, and commercial item contracts are exempt from a purchasing system review.

were considered non-major contractors on which they would perform other audits, such as incurred cost audits. DCAA includes in the audit reports the material weaknesses and significant deficiencies related to the contractors' business systems that are identified while conducting those audits.

Table 2 provides a more detailed breakout of the latest reviews conducted for the 21 contractors which received 1 or more business system reviews.¹³ As shown in the table, the majority of reviews were for accounting and billing systems, and only five contractors had reviews for all four of the key systems. Moreover, the review gaps that exist are primarily for the estimating and purchasing systems for non-major (smaller-scale) contractors. The table also shows that DCMA's business systems review coverage is more limited than that of DCAA's, primarily because DCMA performs purchasing system reviews primarily in response to requests from ACOs.

¹³ Appendix B shows total DoD funds obligated for these contractors for work in Iraq over the years 2004-2011.

Table 2—Sample Contractors with One or More Business System Reviews

Contractor	Major/Non-Major	Accounting	Billing	Estimating	Purchasing (DCAA or DCMA)^a
1	Major	X	X	X	Y
2	Non-Major	X			
3	Non-Major	X	X		Y
4	Non-Major			X	Y
5	Major	X	X		Y
6	Major	X	X	X	X
7	Major	X	X		
8	Non-Major	X	X ^b		
9	Non-Major	X			
10	Non-Major	X	X ^b		
11	Non-Major	X	X ^b		
12	Non-Major	X	X ^b		
13	Non-Major	X	X ^b		
14	Major	X	X	X	Y
15	Major	X	X		
16	Non-Major	X	X		
17	Non-Major	X	X ^b		
18	Non-Major	X	X ^b		
19	Major	X	X	X	XY ^c
20	Non-Major	X	X		XY ^c
21	Non-Major	X	X	X	Y

Notes: Due to the sensitive nature of the information the names of the contractors have been removed.

^a DCAA-conducted reviews are noted by an X and DCMA-conducted are noted by a Y.

^b These reviews were incorporated into the accounting system reviews.

^c These contractors had purchasing system reviews conducted by both DCAA and DCMA.

Source: Analysis of DoD provided data.

Our analysis of the sampled contractors’ most recent DCAA-provided business system reviews shows that DCAA frequently noted deficiencies. If these deficiencies are not remedied and revisited with follow-up reviews, we believe they would open the U.S. government to fraud, waste, and abuse. Of the 20 accounting system reviews performed, 12 were determined to be “adequate” and 8 were “inadequate,” and several in each category contained significant deficiencies. Of the 18 billing system reviews performed, 9 systems were determined to be “adequate,” and 9 were “inadequate” and/or contained significant deficiencies. Most deficiencies, such as double billings and cost mischarges, could lead to the government overpaying for goods and services rendered.

Of the six estimating system reviews performed, three were determined to be “adequate” and three “inadequate,” with several significant deficiencies cited for the inadequate systems. Of the three purchasing system reviews performed by DCAA, one system reviewed was determined to

be “adequate” and two “inadequate,” with several significant deficiencies noted for the inadequate systems.

Our analysis of the most recent purchasing system reviews that DCMA performed shows that all recommended for ACO approval were determined to be adequate; however, DCMA frequently noted deficiencies, which, if not remedied and revisited with follow-up reviews, would leave the U.S. government vulnerable to fraud, waste, and abuse.

The fact that business system reviews of non-major contractors surfaced deficiencies demonstrates the importance of such reviews and suggests that additional oversight of these contractors would likely better protect U.S. government and American taxpayer interests.

While our analyses show that DCAA and DCMA had gaps in their coverage of contractors’ business systems, it should be noted that some of the gaps are permitted by DFARS. This applies primarily to estimating and purchasing system reviews. According to DFARS, estimating and purchasing system reviews are required only when the following criteria are met:

- For estimating systems, a large contractor is subject to review requirements if, in the preceding fiscal year, the contractor received DoD prime contracts or subcontracts totaling \$50 million or more for which cost or pricing data were required, or lesser amounts totaling \$10 million or more (but less than \$50 million) for which cost or pricing data were required and the contracting officer, with concurrence or at the request of the ACO, determines it to be in the best interests of the government.
- For purchasing systems, the ACO is to determine the need for a business system review and where sales to the government (excluding competitively awarded firm fixed-price and competitively fixed-price with economic adjustment contracts and sales of certain commercial items) are expected to exceed \$25 million during the next 12 months. The \$25 million threshold can be raised or lowered if considered in the best interests of the government.

DCMA officials told us that ACOs use risk assessment forms to determine whether there is a need to review purchasing systems. DCMA provided us 12 assessment forms for 11 of our sample contractors, including 4 major contractors. While we found most were fully completed and the ACOs had made a determination—either yes or no—on the need for a review, other forms were only partially completed with no determination made. In two cases where the ACO had requested a review, we had no documented evidence that a review was performed. This gives cause for concern as some systems may have needed reviews but no such reviews were conducted.

While the FAR does not require reviews of estimating and purchasing systems under certain circumstances, this does not diminish the importance of these system reviews in the contracting process. In this regard, the Director of the DCAA, in testimony before the CWC in July 2009, said these two review areas are important in the proposal phase of a contract award because they

help determine an adequate cost estimate or price.¹⁴ The Director further testified that this determination of cost or price extends beyond prime contractors to subcontractors in that the two system reviews help ensure the subcontractors' price proposals are fair and reasonable.

Incurred Cost Audit Coverage Has Gaps and Is Back-logged

DCAA also performs incurred costs audits on cost-type contracts to determine if costs claimed for reimbursement are reasonable, are applicable to the contract, and are in keeping with generally accepted accounting principles. These audits provide information contracting officers need to recover overcharges for the government.

At our request for documentation of incurred cost audits for the 16 non-major contractors in our sample¹⁵, DCAA provided us with a total of 11 audits for only 6 contractors, as shown in Table 3. Our analysis of the documentation showed that for 6 of the 11 audits, 3 or more years had passed between when the costs were incurred and when the audits were performed. Moreover, the fact that 10 of the non-major contractors in our sample had no incurred cost audits is cause for concern.

Table 3—Sample Non-Major Contractors with Incurred Cost Audits Performed by DCAA

Contractor^a	Incurred Cost Audits Performed
3	X
10	X ^b
11	X ^b
12	X
21	X ^b
24	X

Notes:

^a The Contractor number corresponds to the Contractor number in Table 2.

^b This contractor had multiple audits.

Source: Analysis of DoD provided data.

DoD is increasing DCAA staff over the next several years to address its incurred cost audit workload and the consequent delays in performing them. At the end of FY 2011, DCAA reported having about 15,000 incurred cost audit requests, with a total value of about \$254 billion awaiting audit.¹⁶ DCAA also reported that it was either awaiting receipt of or had not made an adequacy determination for about 9,000 incurred cost contractor submissions with a total value of about \$320 billion.

¹⁴ Testimony of Patrick J. Fitzgerald, Director of the Defense Contracting Audit Agency (DCAA), before the CWC in Iraq and Afghanistan, DCAA, 7/26/2010.

¹⁵ The 16 non-major contractors include those that had business system reviews as shown in Table 2 and 2 additional non-major contractors that had no reviews.

¹⁶ Report to Congress on FY 2011 Activities at the Defense Contract Audit Agency, U.S. Department of Defense, 3/30/2012.

We believe that, to the extent that incurred cost audits are occurring late in the contracting process, the risk of not detecting unreasonable or unallowable costs increases—especially in contingency areas where records can be difficult to find. In this regard, it is important that the upfront review of contractors’ business systems in the contracting process be performed and updated as necessary to help ensure that these systems are adequate to help mitigate the risk of overcharges to the government.

Some Business System Reviews Are Outdated

Our analysis of the most recent business system reviews for contractors show that some were more than four years old. This raises concerns as to whether the controls in these business systems were still adequate to reduce the risk of overcharges. DCMA and DCAA officials told us that they do not have specific timeliness standards or guidelines in place for non-major (i.e., smaller scale) contractors but do have them for major (i.e., larger) contractors. Those guidelines specify that accounting systems for major contractors should be reviewed at least every 4 years and other systems—billing, estimating, and purchasing—should be reviewed at least every 2-4 years.¹⁷

We found that DCAA had not reviewed three major contractors’ systems within its timeliness guidelines and, when it performed the reviews, it found one accounting system adequate and one billing system adequate; for two contractors, it found one estimating system adequate and the other contractor’s estimating system inadequate. We also found that DCMA had not reviewed one major contractor’s purchasing system within established guidelines. That review contained 21 informal comments or recommendations, and the system was recommended for approval.¹⁸ Although not subject to specific review timeliness guidelines, we found that 7 of the 14 non-major contractors had a total of 12 of their most recent business system reviews that were more than 4 years old. DCMA and DCAA officials attributed their agencies’ inability to review major contractors’ business systems within timeliness standards or review non-major contractors’ systems to limited personnel resources devoted to higher priority work.

Although we are aware of DCAA and DCMA personnel shortages, the absence of current reviews, whether subject to the timeliness guidelines or not, puts the government at risk for paying for unallowable and unreasonable costs as contractors’ business systems deemed adequate may change over time. The issue of outdated business system reviews was also highlighted in a recent GAO report.¹⁹ In its review of three types of business systems—accounting, estimating, and material management and accounting—GAO found that a substantial number of systems had not been reviewed within the DCAA timeframes; that is, 12 of the 17 defense contractors in their audit had at least one system without a current and timely review. GAO further reported that contracting officers were generally relying on the reviews even though they exceeded the timeframe guidelines.

¹⁷ Competitively awarded firm fixed-price, competitively awarded fixed-price with economic price adjustment, and commercial item contracts are exempt from a purchasing system review.

¹⁸ DCMA Report, CSC CPSR 2007 (1SXC4), 8/3/2007.

¹⁹ GAO-12-83, 11/03/2011.

Some Purchasing System Reviews Raise Questions as to Review Coverage

Because our Anham report raised concerns regarding its purchasing system²⁰, we examined the 11 most recent purchasing system reviews we received—8 from DCMA and 3 from DCAA—for 9 separate contractors and found issues with 2 reviews that are similar to those uncovered in the Anham audit. Our Anham report noted that DCMA recommended approving Anham’s purchasing system despite significant gaps in the documentation of price competition and questions about close and/or affiliated relationships that Anham may have had with some of its subcontractors. Our analysis of the eight contractors’ (four major and four non-major) purchasing system reviews performed by DCMA showed that all included some reviews of subcontractor pricing, and two of them identified issues with the subcontractors’ pricing systems. However, the two systems with issues were deemed “adequate,” and no follow-up work had been done at the time of our audit.

DCAA reviewed purchasing systems for two major contractors and one non-major contractor and found one system of a major contractor and one system of a non-major contractor to be inadequate while one major contractor’s system was found to be adequate. DCAA determined a major contractor’s purchasing system was inadequate because of six significant deficiencies considered to be material weaknesses that adversely affected the contractor’s ability to procure material and services in a manner consistent with applicable government contract laws and regulations. As a result, DCAA recommended that the system be disapproved and that the contracting officer suspend a percentage of progress payments or cost reimbursements in accordance with DFARS 242.7502. The contractor took corrective actions and DCAA stated it planned to perform a follow-up assessment. For the other inadequate purchasing system review for the non-major contractor, DCAA found four significant deficiencies considered to be material weaknesses that could result in overcharges. We did not have any evidence at the time of our review that corrective actions had been taken.

Considering these issues and that only nine of our sample contractors had their purchasing systems reviewed by the government, we believe there exists an ongoing risk of potential overbilling of the kind uncovered in our Anham audit.

Conclusions

Business system reviews are key controls for protecting U.S. government interests against fraud, waste, and abuse. To the extent these reviews are not conducted or exceed established timeliness guidelines, U.S. government vulnerabilities increase.

SIGIR acknowledges that the task of performing business system reviews on the large number of contractors performing billions of dollars of work in contingency areas is a huge challenge, especially given DCMA’s and DCAA’s resource constraints. SIGIR further recognizes that DoD’s focus on larger contractors with contracts exceeding \$100 million annually is an

²⁰ SIGIR-11-022, 7/30/2011.

appropriate focus of its limited resources. However, SIGIR found that some of the smaller contractors also have sizeable contracts with DoD.

Some of the contractors included in our sample had total contracts valued at over \$100 million for work in Iraq over the 2004-2011 time period. We believe that increased attention is warranted for smaller contractors that work in high-risk contingency areas, such as Iraq and Afghanistan. This is based on the findings of this review; SIGIR's findings on the Anham audit, which questioned the appropriateness of contractor and subcontractor relationships and all contract costs; and the sizeable DoD business base of contractors classified as small or non-major. We further believe that opportunities may exist to improve this oversight and thus reduce the risk for further fraud, waste, and abuse.

DCAA has informed SIGIR that DoD is working on a proposed approach intended to strengthen the oversight of contractors' business systems and that this proposal addresses smaller-scale contingency contractors as well as larger contractors. These officials told us that the proposal includes recommended revisions to the DFARS to require contractors to report and document their compliance with business system criteria set forth in DFARS on May 18, 2012. We believe that such an effort is a step in the right direction towards reducing contracting risks to the government in contingency areas in the future.

Many of the problems SIGIR identified in its audit of the Anham contract last year pertained to the company's financial and management relationships with its subcontractors and the subcontractors' pricing of goods. These problems should have been uncovered in purchasing system reviews. SIGIR noted there are gaps in purchasing system reviews. Since DCMA performs these reviews primarily at the request of ACOs, we do not know if these gaps in coverage are attributable to the absence of ACO requests. We believe that without these reviews, the risk is increased for fraud, waste, and abuse.

Recommendations

1. SIGIR recommends that the Director, DCMA, and the Director, DCAA jointly develop action-plans to increase their oversight of business systems for smaller scale contractors performing work in high-risk contingency areas, such as Iraq and Afghanistan. Recognizing that resources are limited in the near term, these actions could include more limited reviews of specific aspects of business systems for smaller contractors that are deemed to be high risk. For example these actions could entail reviews of small contractors' business relationships with subcontractors when these appear to be questionable or reviews of contractor/subcontractor pricing when these appear to be inflated, as identified in SIGIR's prior Anham audit.
2. SIGIR also recommends that DCMA explore with ACOs ways to put more attention on smaller contingency contractors' purchasing systems.

Management Comments and Audit Response

In written responses to a draft of this report, DCAA and DCMA concurred with SIGIR's first recommendation and DCMA concurred with the second recommendation which was directed only to DCMA. Both agencies' responses are printed in their entirety in Appendices C and D.

DCAA concurred with SIGIR's first recommendation that the Director, DCMA and the Director, DCAA jointly develop action plans to increase their oversight of business systems for smaller-scale contractors performing work in high-risk contingency areas, such as Iraq and Afghanistan. DCAA cited two broader DoD ongoing efforts that are intended to strengthen oversight of contingency contractors.

First, DCAA stated that both DCAA and DCMA are participating in a DoD effort to revise the DFARS to include contractor reporting and documentation requirements regarding the contractors' compliance with the DFARS business system criteria. According to DCAA, the expectation is that (1) contractors will have readily available information that demonstrate their compliance with DFARS and monitoring procedures to ensure compliance and (2) greater contractor accountability will assist in the oversight of high-risk contingency contractors.

Second, DCAA stated that DoD's Functional Capabilities Integration Board for Overseas Contingency Operations is performing a critical capability gap analysis which includes one gap related to providing the joint force with sufficient capacity to effectively administer, oversee, and close contracts to ensure contractor performance is properly tracked and accessible and desired outcomes are achieved. One key action to close this gap is to strengthen remedies against contractors' inadequate business systems. DCMA and DCAA have been assigned a support role in developing a plan so that by the end of fiscal year 2014, the joint force will be equipped with a sufficient amount of trained personnel, formal guidelines, and systems to administer all aspects of the contracts used in operational support. SIGIR believes that these two efforts, if properly implemented, should provide for improved oversight of high-risk contingency area contractors.

DCMA also concurred with SIGIR's first recommendation and stated that it will explore regulatory change that will facilitate the conduct of purchasing system reviews of contractors performing under firm-fixed price contracts. Moreover, DCMA concurred with SIGIR's second recommendation that DCMA explore with ACOs ways to put more attention on smaller contingency contractors' purchasing systems and stated that it will engage customers awarding contingency contracts to include contract provisions that will provide insight into pricing. SIGIR believes these actions should provide for improved oversight of contractors' purchasing systems.

We appreciate the courtesies extended to the SIGIR staff. For additional information on the report, please contact James Shafer, Assistant Inspector General for Audits (Washington, DC), 703-604-0894/ fred.j.shafer.civ@mail.mil or Tinh Nguyen, Principal Deputy Assistant Inspector General for Audits (Washington, D.C.), (703) 604-0545/ tinh.t.nguyen4.civ@mail.mil.

A handwritten signature in black ink, appearing to read "Stuart W. Bowen, Jr.", with a period at the end.

Stuart W. Bowen, Jr.
Inspector General

cc: Secretary of Defense
Commander, U.S. Central Command

Appendix A—Scope and Methodology

In October 2011, the Special Inspector General for Iraq Reconstruction (SIGIR) initiated Project 1113 to examine the extent to which the Department of Defense (DoD) has conducted reviews of business systems for contractors supporting contingency operations in Iraq. This audit is a follow up to a July 2011 SIGIR report in which SIGIR identified significant weaknesses in the government’s oversight of a specific contractor’s (Anham) business systems that left the U.S. government potentially vulnerable to overcharges.²¹ Our focus in this audit was on business system reviews for contractors who had contracts in Iraq, generally valued less than \$100 million annually over the 2004 through 2011 time period.

To achieve our objective of determining the extent of business system reviews, we judgmentally sampled 35 contractors that met the previously specified criteria. We drew our sample from a publicly available web site containing government contract data and focused on contractors with work in Iraq over the time period specified above. Our sample contractors’ workload as of June 25, 2012 totaled about \$5.2 billion. We requested Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) officials provide us with all selected business system reviews—accounting, billing, estimating, and purchasing—for the sample contractors over the 2004 through 2011 time period for our review.²² We subsequently analyzed the provided documentation to determine the extent and timeliness of reviews that had been performed on the sample contractors’ business systems. For those instances in which neither DCMA nor DCAA could find the sample contractors in their databases, we accessed a public web site to extract contract data for these contracts to determine the types—either fixed-price or cost-plus—under which the contractors were performing work in Iraq and arrived at a determination as to whether these contractors’ business systems were subject to government review. We also analyzed the purchasing systems reviews to determine whether key aspects of those reviews, such as analysis of contractor relationships with subcontractors and pricing, were addressed, because these were areas of concern in our prior review of Anham.

We also reviewed the Federal Acquisition Regulation (FAR), as well as recent revisions to the Defense Financial Acquisition Regulation Supplement (DFARS), which were to improve the effectiveness of DoD oversight of contractors’ business systems, and its intended impact on the current business system review process. Those revisions were issued as an interim Defense Financial Acquisition Regulation Supplement on May 18, 2011, and finalized on February 24, 2012. We also interviewed knowledgeable DCMA and DCAA officials regarding the impact of

²¹ *Poor Government Oversight of Anham and Its Subcontracting Procedures Allowed Questionable Costs To Go Undetected*, SIGIR-11-022, 7/30/2011.

²² To assist DCAA and DCMA in identifying our potential sample contractors, we provided them with many Data Universal Numbering System or DUNS Numbers and/or Commercial and Government Entity (CAGE) Codes for the contractors. DUNS is Dunn and Bradstreet’s copyrighted, proprietary means of identifying business entities on a location-specific basis. This unique nine-digit number has been assigned to over 100 million businesses worldwide since 1994 and was incorporated into the FAR in April 1998 as the Federal Government’s contractor identification code for all procurement-related activities. A CAGE Code is a five-character code that identifies companies doing or wishing to do business with the Federal Government.

the DFARS revisions to date on their contractor oversight responsibilities and any plans to modify their approach to systems reviews in the future.

We also reviewed our prior work, along with Commission on Wartime Contracting in Iraq and Afghanistan and U.S. Government Accountability Office (GAO) reports that have pointed out weaknesses in the government's contracting oversight process and the need for improvements to reduce fraud, waste, and abuse.

We did not assess the overall quality of the business system reviews or other DCMA or DCAA oversight efforts. It should be noted that the quality of DCAA's work was questioned by GAO in a September 2009 report.²³ GAO found audit quality problems at DCAA offices nationwide, including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision. Since that time, DCAA has reported taking actions to improve quality. In a March 2012 report to the Congress, for example, DCAA cited a number of strategies implemented to improve audit quality, conduct more rigorous evaluations of contractor data, increase communication with stakeholders, and support DCAA audit recommendations at negotiations.²⁴

SIGIR performed this audit under the authority of Public Law 108-106, as amended, which incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We conducted our work during November 2011 through July 2012 in Arlington, Virginia.

Use of Computer-processed Data

We used computer-processed data in this report from a public spending website and database at www.usaspending.gov. Because the data were not critical to the findings, conclusions, and recommendations in this report, we determined that the data were sufficiently reliable for the purposes of this report.

Internal Controls

In conducting this audit, we examined the extent to which the government was reviewing contractors' business systems for support work in Iraq. DoD considers these reviews to be the first line of defense in the contracting process for reducing the risk of fraud, waste, and abuse.

²³ *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reformed*, GAO-09-468, 11/23/2009.

²⁴ *Report to Congress on FY 2011 Activities at the Defense Contract Audit Agency*, U.S. Department of Defense, 3/30/2012.

Prior Coverage

We reviewed the following reports issued by SIGIR, the Government Accountability Office, and the Commission on Wartime Contracting in Iraq and Afghanistan. We also reviewed testimony given by the Director, DCAA, before the Commission.

Special Inspector General for Iraq Reconstruction

Poor Government Oversight of Anham and Its Subcontracting Procedures Allowed Questionable Costs To Go Undetected, SIGIR-11-022, 6/30/2011.

U.S. Government Accountability Office

Defense Contract Management Agency: Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions, GAO-12-83, 11/3/2011.

DCAA Audits: Widespread Problems with Audit Quality Require Significant Reformed, GAO-09-468, 11/23/2009.

Commission on Wartime Contracting in Iraq and Afghanistan

Special Report on Contractor Business Systems: Defense Agencies Must Improve Their Oversight of Contractor Business Systems to Reduce Waste, Fraud, and Abuse, the Commission on Wartime Contracting in Iraq and Afghanistan, 10/21/2009.

Defense Contract Audit Agency

Testimony of Patrick J. Fitzgerald, Director of the Defense Contracting Audit Agency (DCAA), before the CWC in Iraq and Afghanistan, DCAA, 7/26/2010.

Appendix B—Contract Values for SIGIR’s Sample Contractors with Business System Reviews

Table 4—Contract Values for Contractors with Business System Reviews

Contractor	Major/Non-Major	Contract Value	Work in Afghanistan
1	Major	\$26,340,208	Yes
2	Non-Major	\$150,488,155	No
3	Non-Major	\$32,846,016	No
4	Non-Major	\$48,561,589	Yes
5	Major	\$171,293,685	Yes
6	Major	\$817,550,454	Yes
7	Major	\$274,676,237	Yes
8	Non-Major	\$135,765,403	Yes
9	Non-Major	\$16,174,543	Yes
10	Non-Major	\$52,410,539	No
11	Non-Major	\$90,551,959	No
12	Non-Major	\$6,679,582	Yes
13	Non-Major	\$5,750,176	Yes
14	Major	\$126,356,213	Yes
15	Major	\$13,821,400	Yes
16	Non-Major	\$91,986,203	No
17	Non-Major	\$432,875,682	No
18	Non-Major	\$37,508,309	Yes
19	Major	\$641,964,701	Yes
20	Non-Major	\$359,621,306	Yes
21	Non-Major	\$317,920,416	Yes

Note:

The contract values above are the reported cumulative DoD obligated funds for all contracts for the contractors in our sample who had business systems reviews over the years 2004-2011 for work in Iraq (some Afghanistan funding may be included). As such, the data show the relative magnitude of the contract values for these particular contractors. The last column shows whether these contractors have contract work in Afghanistan.

Source: Analysis of www.usaspending.gov data, as of 6/25/2012.

Appendix C—DCAA Management Comments



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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OFFICE OF THE DIRECTOR

July 25, 2012

MEMORANDUM FOR SPECIAL INSPECTOR GENERAL FOR IRAQ RECONSTRUCTION
(SIGIR)

ATTENTION: Mr. James Shafer

SUBJECT: Response to Special Inspector General For Iraq Reconstruction (SIGIR) Draft Report, *Gaps in Business System Review of Contractors with Generally Less Than \$100 Million Annually in Contracts in Iraq Increase U.S. Government Vulnerabilities to Fraud, Waste, and Abuse* (SIGIR 12-019)

Thank you for the opportunity to respond to the subject draft report, *Gaps in Business System Review of Contractors with Generally Less Than \$100 Million Annually in Contracts in Iraq Increase U.S. Government Vulnerabilities to Fraud, Waste, and Abuse*. The following is DCAA's response to the recommendation.

Recommendation: SIGIR recommends that the Director, DCMA, and the Director, DCAA jointly develop action plans to increase their oversight of business systems for smaller scale contractors performing work in high-risk contingency areas, such as Iraq and Afghanistan. Recognizing that resources are limited in the near term, these actions could include more limited reviews of specific aspects of business systems for smaller contractors that are deemed to be high risk. For example, these actions could entail reviews of small contractors' business relationships with subcontractors when these appear to be questionable or reviews of contractor/subcontractor pricing when these appear to be inflated, as identified in SIGIR's prior Anham audit.

DCAA Response: Concur. DCAA continues to work with DCMA to assist in providing increased oversight over contractor business systems. Currently, DFARS case (2012-D042) has been established to help in this effort. Both DCAA and DCMA are part of the ad hoc group that is tasked with drafting the proposed rule that will revise the business system clauses. The DFARS case has been established to include contractor reporting and documentation requirements regarding the contractor's compliance with the DFARS business system criteria. The expectation is that contractors will have readily available information that demonstrates its compliance with the DFARS criteria and its monitoring procedures that ensure business systems are in compliance with the DFARS criteria. Having greater contractor accountability will assist in the degree of oversight needed for these high risks contingency contractors. In conjunction, DCAA will continue to report deficiencies as identified in our real time testing audits (e.g., timekeeping), incurred cost and proposals audits for the smaller contractors.

SUBJECT: Response to Special Inspector General For Iraq Reconstruction (SIGIR) Draft Report, *Gaps in Business System Review of Contractors with Generally Less Than \$100 Million Annually in Contracts in Iraq Increase U.S. Government Vulnerabilities to Fraud, Waste, and Abuse* (SIGIR 12-019)

In addition, the Department's Functional Capabilities Integration Board (FCIB) for Overseas Contingency Operations (OCO) is in the process of performing a critical capability gap analysis. FCIB-OCO has identified 10 critical capability gaps. GAP 8 is related to providing the joint force with a sufficient capacity to effectively administer, oversee, and close contracts to ensure contractor performance is properly tracked and accessible and desired outcomes are achieved. One of the key actions to close this gap is to strengthen remedies against inadequate contractor business systems. DPAP, with the support of DCMA and DCAA, has been assigned to develop a plan so that by the end of FY 2014, the joint force will be equipped with a sufficient amount of trained personnel, formal guidelines, and systems to administer all aspects of the contracts used in operational support.

DCAA and DCMA have coordinated their replies and are in agreement. DCMA will be providing their reply under separate cover and will provide an additional response to the action plan related to contractor/subcontractor relationships as suggested in recommendation one.

Questions regarding this memorandum should be directed to Mr. John Shire, Deputy Assistant Director, Policy and Plans Directorate, at (703) 767-3280.


Patrick J. Fitzgerald
Director

Appendix D—DCMA Management Comments



DEFENSE CONTRACT MANAGEMENT AGENCY
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FORT LEE, VA 23801-1809

JUL 26 2012

MEMORANDUM FOR MR. JAMES SHAFER, ASSISTANT INSPECTOR GENERAL FOR
AUDITS, SPECIAL INSPECTOR GENERAL FOR IRAQ
RECONSTRUCTION (SIGIR)

SUBJECT: Response to Special Inspector General For Iraq Reconstruction (SIGIR) Draft
Report, *Gaps in Business System Review of Contractors with Generally Less Than
\$100 Million Annually in Contracts in Iraq Increase U.S. Government
Vulnerabilities to Fraud, Waste, and Abuse* (SIGIR 12-019)

Thank you for the opportunity to respond to the subject draft report, *Gaps in Business System Review of Contractors with Generally Less Than \$100 Million Annually in Contracts in Iraq Increase U.S. Government Vulnerabilities to Fraud, Waste, and Abuse*. The following is DCMA's response to the recommendation.

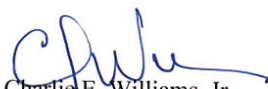
Recommendation: SIGIR recommends that the Director, DCMA, and the Director, DCAA jointly develop action plans to increase their oversight of business systems for smaller scale contractors performing work in high-risk contingency areas, such as Iraq and Afghanistan. Recognizing that resources are limited in the near term, these actions could include more limited reviews of specific aspects of business systems for smaller contractors that are deemed to be high risk. For example, these actions could entail reviews of small contractors' business relationships with subcontractors when these appear to be questionable or reviews of contractor/subcontractor pricing when these appear to be inflated, as identified in SIGIR's prior Anham audit.

DCMA Response: Concur. DCMA will explore regulatory change that will facilitate the conduct of purchasing system reviews of contractors performing under firm-fixed price contracts.

Recommendation: SIGIR recommends that DCMA explore with ACOs ways to put more attention on smaller contingency contractors' purchasing systems.

DCMA Response: Concur. DCMA will engage customers awarding contingency contracts to include contract provisions that will provide for insight into subcontract pricing.

Questions regarding this memorandum should be directed to Ms. Joyce Blais, Director, Business Operations Center at (617)-753-3398.


Charlie E. Williams, Jr.
Director

Appendix E—Acronyms

Acronym	Description
ACO	Administrative Contracting Officer
CWC	Commission on Wartime Contracting in Iraq and Afghanistan
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DoD	Department of Defense
FAR	Federal Acquisition Supplement
GAO	Government Accountability Office
SIGIR	Special Inspector General for Iraq Reconstruction

Appendix F—Audit Team Members

This report was prepared and the audit conducted under the direction of James Shafer, Assistant Inspector General for Audits, Office of the Special Inspector General for Iraq Reconstruction.

The staff members who conducted the audit and contributed to the report include:

Josh Moses

Robert Pelletier

James Reifsnyder

Jamie Smith

Appendix G—SIGIR Mission and Contact Information

SIGIR’s Mission

Regarding the U.S. reconstruction plans, programs, and operations in Iraq, the Special Inspector General for Iraq Reconstruction provides independent and objective:

- oversight and review through comprehensive audits, inspections, and investigations
- advice and recommendations on policies to promote economy, efficiency, and effectiveness
- deterrence of malfeasance through the prevention and detection of fraud, waste, and abuse
- information and analysis to the Secretary of State, the Secretary of Defense, the Congress, and the American people through Quarterly Reports

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To Report Fraud, Waste, and Abuse in Iraq Relief and Reconstruction Programs

Help prevent fraud, waste, and abuse by reporting suspicious or illegal activities to the SIGIR Hotline:

- Web: www.sigir.mil/submit_fraud.html
- Phone: 703-602-4063
- Toll Free: 866-301-2003

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