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Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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MEMORANDUM

May 22, 2008

To: Members of the Committee on Oversight and Government Reform

Fr: Committee on Oversight and Government Reform, Majority Staff

Re: Summary of New Defense Department IG Report

On Thursday, May 22, 2008, at 10:00 a.m. in room 2154 of the Rayburn House Office Building, the full Committee will hold a hearing on the failure of the Defense Department to properly account for nearly $15 billion in expenditures in Iraq. The focus of the hearing will be a new 68-page report that will be released by the Defense Department Inspector General (IG).

The new IG report, entitled "Improved Controls Needed for Payments Made in Iraq, Kuwait and Egypt," was provided to Committee staff yesterday on an embargoed basis. This memorandum summarizes its key findings. According to the report:

- **The Pentagon failed to properly account for an estimated $7.8 billion in U.S. funds paid to contractors in Iraq.** The Defense Department spent approximately $8.2 billion from 14 accounts to pay American and Iraqi contractors. The IG estimated that the expenditure of $7.8 billion (95%) failed to comply with federal statutes and regulations. In many cases, according to the IG, "[i]neffective internal controls could create an environment conducive to fraudulent activity or improper use of funds." The IG found that $1.4 billion in payments were missing critically important documentation "required to minimally support a commercial payment," such as "voucher certification, invoices, and receiving reports." To date, the IG has referred 28 cases to criminal investigators.

- **The Pentagon failed to properly document $135 million in U.S. payments to foreign governments under the Commander's Emergency Response Fund.** According to the IG, the Defense Department used $135 million in the Commander's Emergency Response Program (CERP) funds, which were supposed to fund local reconstruction and humanitarian projects, to make payments to foreign governments, such as South Korea and Poland. The IG reports that none of the files reviewed by the IG "contained sufficient supporting documentation to provide reasonable assurance that these funds were used for their intended purposes."

- **The Pentagon failed to properly account for the expenditure of over $1.8 billion in "seized and vested" Iraqi assets.** In 2007, the Special Inspector General for Iraq Reconstruction testified before the Committee that the U.S.-run Coalition Provisional Authority had failed to properly account for at least $8.8 billion in Iraqi funds in the Development Fund for Iraq. The new IG report concludes that the Defense Department failed to account for an additional $1.8 billion in assets under its control that were seized inside Iraq or frozen in U.S. accounts since the first Gulf War.

At the hearing, the Committee will also hear testimony about a report issued by the IG in November that found critical deficiencies in the Department's management of $5.2 billion in U.S. funds used to support the Iraq Security Forces. According to the IG, the Defense Department "did not have sufficient controls and procedures in place, did not maintain adequate oversight, and did not maintain accountable property records." The IG found that the Defense Department could not account for 12,712 of 13,508 weapons, including assault rifles, machine guns, and rocket-propelled grenade launchers, provided to Iraqi forces. The IG also found that the Department could not account for fuel tankers, tractor trailers, heavy tracked recovery vehicles, and thousands of generators.

The Committee has obtained additional information about one project identified by the IG in the November report. In this instance, the Defense Department paid $31.9 million for the construction of an Iraqi military facility that was never built. Defense Department officials reported to Committee staff that "this is embarrassing" because "not a spade of dirt was turned." In addition, the contractor has now incurred millions of additional dollars guarding paint, mortar, and concrete that was never.

I. Audit of $8.2 Billion in Payments to Contractors

The new report by the Defense Department Inspector General concludes that the Pentagon failed to account properly for the expenditure of a pool of approximately $8.2 billion in U.S. funds used to make commercial payments to American and Iraqi contractors in Iraq.

According to the IG, the Army made over 180,000 commercial payments, totaling approximately $8.2 billion, from seven Army contingency disbursing stations in Iraq, Kuwait, and Egypt between April 2001 and June 2006. These payments were made to both U.S. and Iraqi companies for a wide range of supplies and services, including vehicle rentals, trucks, trailers, bottled water, food services, support services, security services, and renovations.[1]

The Defense Department used 14 congressionally appropriated accounts as sources for these payments, including the Army's Operation and Maintenance Account, its Working Capital

[1] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

Fund, and its Military Construction Fund. The Defense Department also used accounts from the Navy, Marine Corps, and other defense agencies.[2]

The IG report concludes that "[t]he Army's weak internal controls over commercial payments in Iraq and Kuwait did not permit reasonable assurance that [it] properly authorized commercial payments and maintained the supporting documentation."[3] Because of these "internal control deficiencies," the IG was "unable to determine whether all of the payments reviewed were disbursed as intended."[4] The IG concludes that these "[i]neffective internal controls could create an environment conducive to fraudulent activity or improper use of funds."[5]

Specifically, the IG estimates that commercial payments totaling $7.8 billion "did not meet all statutory or regulatory requirements."[6] In other words, the IG concludes that approximately 95% of Army commercial payments made to support the war in Iraq failed to comply with federal laws and regulations.

The IG reports that an estimated $1.4 billion in commercial payments "lacked the minimum documentation for a valid payment, such as properly prepared receiving reports, invoices, and certified vouchers" and thus "do not provide the necessary assurance that funds were used as intended."[7]

In some cases, payments were made without any identified reason for the disbursement. For example, on May 24, 2005, an $11.1 million payment was made to a U.S. contractor even though there was no description of "the goods or services purchased" and even though the Defense Department was "missing both the receiving report and invoice."[8] In another instance, on August 13, 2004, a $5.7 million payment was made to a company known as Al-Kasid Specialized Vehicles Trading Company, also without any invoice or description of the goods or services provided.[9]

It appears that these problems have continued. The IG report states that the Defense Department "did not provide evidence that the supporting documentation for these commercial

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[2] Defense Department Inspector General, *Commercial Payments by Basic Symbol* (May 6, 2008).

[3] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Public Voucher for Purchases and Services,* Joint Area Support Group-Central Comptroller (No. 221089) (Aug. 9, 2004).

payments improved" from 2001 to 2006.[10] In addition, in August 2007, the Defense Finance and Accounting Service (DFAS) issued it own report on the accountability of U.S. payments made in Iraq from October 2005 through April 2007. This report concluded that 65% of these payments lacked legally required documentation, and 20% failed to comply with basic criteria that DFAS deemed critical and necessary to allow payments to be made.[11]

In response to the IG report, the Deputy Chief Financial Officer for the Defense Department stated that Pentagon officials "do not agree with the methodology used ... to estimate the projected dollar amount of payments lacking missing information or supporting documentation."[12] During a meeting with IG officials on May 13, 2008, the Principal Deputy Under Secretary of Defense in the Comptroller's office argued that "these were all valid payments" and all but two vouchers "had the appropriate supporting documents."[13]

The IG disagrees with these assessments, asserting that the Department "has not provided the information required to validate their assertion."[14] In addition, the IG highlighted the importance of ensuring accountability over these funds:

> [O]ur concern is more than an adequate audit trail. Rather, we are concerned that there are significant gaps in internal controls over commercial payments made in a military contingency operation. Those gaps in internal controls could create situations where we are more vulnerable to fraud, waste, and abuse.[15]

As a result of their work, IG officials report that they have referred 28 cases involving $35.1 million to criminal investigators.[16]

II. Audit of $135 Million in Payments from the Commander's Emergency Response Program

The report by the Defense Department Inspector General concludes that the Pentagon failed to exercise adequate accountability over $135 million in payments made to foreign governments from U.S. funds in the Commander's Emergency Response Program (CERP).

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[10] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[11] Defense Finance and Accounting Service, *Assessment of Iraq "Out-of-Country" Payments at DFAS Rome* (IN07SRC007IN) (Aug. 30, 2007).

[12] Letter from James E. Short, Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller), to Office of the Inspector General (undated).

[13] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[14] *Id.*

[15] *Id.*

[16] *Id.*

CERP was created in May 2003 by the Coalition Provisional Authority to "enable local commanders in Iraq and Afghanistan to respond to urgent humanitarian relief and reconstruction requirements" by funding small, local projects.[17] The initial funds for CERP came from Iraqi sources, but in November 2003, the Defense Department began using U.S. funds.[18] Congress has appropriated $2.7 billion for CERP projects in Iraq through May 2008.[19]

The IG report finds that the Defense Department "did not maintain a complete audit trail over $134.8 million in CERP payments made to representatives of foreign governments."[20] The IG report also finds that the Defense Department "is unable to ensure that CERP funds provided to Coalition Partners have been used for their intended purposes."[21]

As part of its investigation, the IG examined 22 vouchers for CERP payments made to foreign governments present in Iraq as Coalition partners from 2003 to 2006. These payments included the following:

United Kingdom	$68.2 million
Poland	$45.3 million
South Korea	$21.3 million[22]

The IG report concludes that "[n]one of the 22 CERP payment vouchers we reviewed contained sufficient supporting documentation to provide reasonable assurance that these funds were used for their intended purpose."[23] The IG report discusses one example in which the Defense Department made an $8 million payment to South Korean forces with minimal documentation. The IG concludes that "we could not verify that the funds provided ... were used for CERP purposes."[24]

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17 Memorandum from Administrator of the Coalition Provisional Authority to the Commander of Coalition Forces (June 16, 2003).

18 Special Inspector General for Iraq Reconstruction, *Quarterly Report to the United States Congress* (Apr. 30, 2008).

19 Special Inspector General for Iraq Reconstruction, *Quarterly Report to the United States Congress* (Apr. 30, 2008); Special Inspector General for Iraq Reconstruction, *Commander's Emergency Response Program in Iraq Funds Many Large-Scale Projects* (SIGIR-08-006) (Jan. 25, 2008).

20 Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

21 *Id.*

22 Briefing to Staff, House Committee on Oversight and Government Reform, by Mary Ugone, Deputy Inspector General for Auditing, Department of Defense (May 20, 2008).

23 *Id.*

24 Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

It is unclear whether these payments to foreign governments are legally permissible under the laws and regulations governing CERP expenditures. On June 19, 2003, Lt. Gen. Ricardo Sanchez, the Commander of Combined Joint Task Force-7, issued a "Fragmentary Order" or "FRAGO" setting forth a list of "limitations on fund expenditures" that included the following restriction: "FUNDS WILL NOT BE USED FOR EITHER THE DIRECT OR INDIRECT BENEFIT OF CJTF-7 FORCES, TO INCLUDE COALITION FORCES."[25]

The prohibition was restated this month in the Defense Department's Financial Management Regulation. According to a May 2008 update of chapter 27 of the regulation, there are 19 permissible uses for CERP funds and 10 impermissible uses. According to section 270301 of the regulation, "[a]ppropriated funds made available for the CERP <u>shall not</u> be used for the following purposes: A. Direct or indirect benefit to U.S. coalition forces or supporting military personnel."[26]

In response to the IG report, the Deputy Chief Financial Officer for the Defense Department claimed that "all funds advanced to our coalition partners are reconciled when the coalition partner completes the assigned mission."[27] According to the IG, however, no foreign government had reconciled these funds and "Coalition Partners are being provided funds without reconciling."[28] The IG reports that as a result of its investigation, the United Kingdom has now committed to start the process of reviewing its files, but Poland and South Korea have not.[29]

III. <u>Audit of $1.8 Billion in Cash Payments from Seized and Vested Iraqi Assets</u>

The report by the Defense Department Inspector General concludes that the Pentagon failed to exercise proper accountability over $1.8 billion in cash payments made by U.S. forces using seized and vested Iraqi assets.

"Seized" assets generally consist of funds confiscated from Iraqi vaults and other locations inside Iraq following the invasion of Iraq, while "vested" assets include funds and other

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[25] Lt. Gen. Ricardo Sanchez, Commander, Combined Joint Task Force-7, *Fragmentary Order 89: Commander's Emergency Response Program (CERP)* (June 19, 2003) (emphasis in original). *See also The Commander's Emergency Response Program,* Joint Force Quarterly (issue 37, 2d Quarter, 2005) (online at www.dtic.mil/doctrine/jel/jfq_pubs/0937.pdf) (article by Lt. Col. Mark S. Martins, Deputy Legal Counsel to the Chairman of the Joint Chiefs of Staff, restating restriction on "direct or indirect benefit of CJTF-7 forces, to include coalition forces").

[26] Department of Defense Financial Management Regulation 7000.14R, v.12, ch. 27, sec. 270301 (updated May 2008) (online at www.defenselink.mil/comptroller/fmr/12/12_27.pdf) (emphasis in original).

[27] Letter from James E. Short, Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller), to Office of the Inspector General (undated).

[28] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[29] *Id.*

property of the Saddam Hussein regime that were frozen by banks and financial institutions outside Iraq.[30] After the war in Iraq began in March 2003, the United Nations Security Council issued Resolution 1483, which created a new Development Fund for Iraq and directed the Coalition Provisional Authority to spend these funds "in a transparent manner to meet the humanitarian needs of the Iraqi people."[31]

The Bush Administration formally recognized its obligations under international law to properly account for these funds. On March 20, 2003, President Bush issued an executive order proclaiming that Iraqi assets "shall be used only to assist the Iraqi people and support the reconstruction of Iraq, consistent with the laws and usages of war."[32] On August 19, 2003, the CPA Administrator, Ambassador L. Paul Bremer, issued CPA Memorandum No. 4, which specifically ordered that seized and vested assets be managed transparently, in accordance with international law:

> As steward for the Iraqi people, the CPA will manage and spend Iraqi funds, which belong to the Iraqi people, for their benefit. ... [T]hey shall be managed in a transparent manner that fully comports with the CPA's obligations under international law, including Resolution 1483.[33]

According to its report, the IG audited cash payments worth $1.8 billion made by U.S. forces using seized and vested Iraqi asset. The IG concludes that the Pentagon "did not ensure that $1.8 billion of seized and vested assets payments made to Iraqi representatives were adequately accounted for and auditable, as prescribed by Executive Order 13290."[34] The IG also concludes that the Pentagon "did not maintain sufficient documentation supporting the justification and use of seized and vested asset payments" and that the Pentagon is "unable to provide reasonable assurance that the seized and vested asset funds ... were used to assist the Iraqi people."[35]

After examining 53 different vouchers for payments made in 2003 and 2004, the IG reports that "this documentation was inadequate because it did not validate who actually received

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[30] *Id. See also* Executive Order No. 12817, 57 Fed. Reg. 48433 (Oct. 23, 1992); Executive Order No. 12724, 55 Fed. Reg. 33089 (Aug. 13, 1990); Executive Order No. 12722, 55 Fed. Reg. 31803 (Aug. 3, 1990); United Nations Security Council, *Resolution 778* (Oct. 2, 1992).

[31] United Nations Security Council, *Resolution 1483* (May 22, 2003).

[32] Executive Order No. 13290, 68 Fed. Reg. 14,307 (Mar. 20, 2003).

[33] Coalition Provisional Authority, *Memorandum No. 4: Contract and Grant Procedures Applicable to Vested and Seized Iraqi Property and the Development Fund for Iraq* (Aug. 19, 2003) (including "proceeds from Iraqi state-owned property that has been vested or seized with applicable law and made available to the CPA to assist the Iraqi people and assist in the reconstruction of Iraq").

[34] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[35] *Id.*

the funds or how the funds were to be used."[36] In one case, the IG reports that there was inadequate accountability over a $320 million payment for Iraqi salaries. According to the IG, the minimal documentation provided by the Defense Department to support this payment "did not account for how the funds were used for salaries or the benefit of the Iraqi people."[37]

In response to the IG report, the Deputy Chief Financial Officer for the Defense Department stated: "We do not agree the audit trail documentation should include supporting budget details and spending plans that can be reconciled to payment vouchers. This is not a disbursing officer responsible [sic]."[38]

The IG does not agree with this assertion. According to the IG, the executive order signed by President Bush in 2003 "prescribed that all seized and vested Iraqi assets would be properly accounted for, audited, and used to assist the Iraqi people."[39] The IG report states:

> The payments were to be based on spending plans and budgets, which would document the support for the justification and use of seized and vested assets. Without such support, there is no audit trail that would be needed to meet the prescribed requirement.[40]

The IG asked the Deputy CFO to "reconsider his position and provide additional comments to the report," a recommendation the Deputy CFO rejected.[41]

IV. Audit of $5.2 Billion in Payments from the Iraqi Security Forces Fund

In addition to testifying about the report issued today, the Deputy Inspector General will also testify about a report issued in November 2007 that found major deficiencies with the Defense Department's oversight of $5.2 billion in U.S. payments to support the Iraqi security forces.

Providing assistance to help train and equip the Iraqi security forces has been one of the President's core strategies in Iraq. On June 28, 2005, President Bush delivered a nationally televised address from Fort Bragg, North Carolina, in which he asserted:

> [O]ur military is helping to train Iraqi security forces so that they can defend their people and fight the enemy on their own. Our strategy can be summed up this way: As the Iraqis stand up, we will stand down.[42]

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[36] *Id.*

[37] *Id.*

[38] Letter from James E. Short, Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller), to Office of the Inspector General (undated).

[39] Defense Department Inspector General, *Internal Controls Over Payments Made in Iraq, Kuwait and Egypt* (D2008-098) (May 22, 2008).

[40] *Id.*

[41] *Id.*

To implement the President's goal, Congress provided $5.2 billion in 2005 to the Multi-National Security Transition Command-Iraq (MNSTC-I) to provide assistance to the Iraq Security Forces (ISF), including weapons, equipment, and the construction of training and operating facilities.[43]

In a report issued on November 30, 2007, the IG concluded that there were serious deficiencies with accountability over these funds and that the Department of Defense could not ensure that they were used for their intended purposes. The IG's report stated:

> MNSTC-I did not have sufficient controls and procedures in place, did not maintain adequate oversight, and did not maintain accountable property records. As a result, MNSTC-I was unable to provide reasonable assurance that funds appropriated for ISF achieved the intended results, that resources were used in a manner consistent with the mission, and that resources were protected from waste and mismanagement.[44]

In its report, the IG provided many illustrations of these deficiencies, including the failure of MNSTC-I to properly account for:

- 12,712 of 13,508 weapons, including pistols, assault rifles, rocket-propelled grenade launders, and machine guns;

- 18 of 31 heavy tracked recovery vehicles valued at $10.2 million;

- 2,126 of 2,943 generators valued at $7 million; and

- Fuel tankers, five tractor trailers, and six low boy trailers valued at $1.5 million.[45]

As a result of these inadequacies, the IG concluded that the Defense Department did not know "what equipment is due in, due out, issued, and on hand" and could not "determine which constructions projects have been completed and transferred to the ISF."[46]

One example of a flawed construction project cited by the IG was a $34 million contract to build a military base for the New Iraqi Army in Al Anbar Province. According to the IG

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[42] Office of the Press Secretary, The White House, *President Addresses Nation, Discusses Iraq, War on Terror* (June 28, 2005) (online at www.whitehouse.gov/news/releases/2005/06/20050628-7.html).

[43] Emergency Supplemental Appropriations for Defense, the Global War on Terror, and Tsunami Relief, FY 2005 (Pub. L. 109-13) (May 11, 2005).

[44] U.S. Department of Defense Inspector General, *Management of the Iraq Security Forces Fund in Southwest Asia — Phase III* (Nov. 30, 2007).

[45] *Id.*

[46] *Id.*

report, the Defense Department paid a contractor, Ellis World Alliance Corporation, $31.9 million out of $34.2 million obligated for the project, but the facility was never built.[47]

Since the IG's report was released, Committee staff conducted further investigation of this contract, which was awarded in May 2006 by the Air Force Center for Environmental Excellence for the construction of 35 facilities, including a 700-person camp to house laborers.[48] In a briefing for the Committee, the Air Force reported that when the contract was awarded, the Air Force had not secured legal rights to the land necessary to proceed with construction, which proved to be a critical oversight.[49]

According to the Air Force, it was not until February 3, 2007, approximately nine months after it awarded the contract, that the Air Force finally directed the contractor to cease work.[50] It was at this point that the Air Force, in conjunction with MNSTC-I, determined that it would be unable to resolve the land rights. The Air Force official in charge of this procurement told Committee staff that no buildings were ever constructed and "not a spade of dirt was turned."[51] He stated: "This is embarrassing, and we're just not going to do it again."[52]

By this time, the contractor had billed for labor and supplies totaling $31.9 million, more than 93% of the $34.2 million in total obligated funds. Officials representing the contractor reported that the Air Force repeatedly instructed them to continue working and that "a simple e-mail from the contracting officer would have resulted in a halt."[53] Company officials told Committee staff that they provided information on their activities through daily reports to the Air Force, including details about mobilizing their workers, constructing an airstrip, and deploying security convoys to escort the necessary supplies to the site. Company officials also reported that Air Force contracting officials flew to the site and inspected it on several occasions and were fully aware of their progress.

Air Force officials are now questioning the contractor's charges for providing security to its convoys and the site. Air Force officials stated that the contractor's security charges of $10 million exceed the originally contemplated amount of $4.7 million. The contractor contends that its security costs were justified by the deteriorating security conditions on the ground in Al Anbar Province. The Air Force informed Committee staff that it has instituted a ban on any

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[47] *Id.*

[48] Briefing by Jeff Bleke, Chairman and CEO, Ellis Worldwide Alliance Corporation, to Staff, House Committee on Oversight and Government Reform (May 9, 2007).

[49] Briefing by Paul Parker, Director, Air Force Center for Engineering and the Environment, to Staff, House Committee on Oversight and Government Reform (May 8, 2008).

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] Briefing by Jeff Bleke, Chairman and CEO, Ellis Worldwide Alliance Corporation, to Staff, House Committee on Oversight and Government Reform (May 9, 2007).

future Air Force awards to this contractor, and the contractor stated that the Air Force has terminated a number of its other contracts in Iraq as they were nearing completion.

Air Force officials informed Committee staff that they believe not all of this $31.9 million was wasted. While they acknowledged that they are unlikely to recover $16.4 million in labor costs, they reported that $9 million of equipment, including residential trailers, have been used on other projects. They also argued that they might find alternate uses for the remaining $6 million worth of supplies that were purchased and not used, such as paint, mortar, and concrete.

The contractor informed the Committee that it is unlikely that the remaining supplies will be used productively because the cost to store, protect, and transport these materials to a new location with security convoys could be more than the supplies are worth. For this reason, according to the contractor, the Air Force has not decided what to do and the contractor "has been sitting for 14 months guarding the supplies without any action by the Air Force."[54] The contractor's costs for guarding these materials for over a year are reportedly "in the millions," and it plans to seek reimbursement for those costs from the Air Force.[55]

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[54] *Id.*

[55] *Id.*