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Report to the Ranking Minority Member, Committee on Commerce, House of Representatives

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DEFENSE PROCUREMENT

E-Systems' Reporting of Alleged Wrongdoing to Army's Fraud Division

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Washington, D.C. 20548

Office of Special Investigations

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May 16, 1996

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

After E-Systems, Inc., a defense contractor, pleaded guilty in July 1990 to violations of federal law related to contracts with the Department of the Army, the Army entered into a 3-year administrative settlement agreement (Memcor Agreement) with the company. Among other things, the agreement required E-Systems to report all hotline[1] allegations to the Army's Procurement Fraud Division. When the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, received allegations from a former chief investigator for E-Systems' Greenville (Texas) Division concerning the division's hotline/ethics program, you, as the Subcommittee's then Chairman, asked us to answer the following questions.

- Did federal law, regulations, or the Memcor Agreement require E-Systems to disclose suspected violations of procurement law?
- How many and what types of hotline complaints were lodged against E-Systems' Greenville Division?
- Did E-Systems' employees, contrary to federal law, alter or reinvestigate hotline complaints and investigation results to avoid disclosing information to the federal government; and what were the details behind three cases that had been brought to the Subcommittee's attention?
- Why did the Army not debar E-Systems from doing business with the government, given the serious accusations contained in a May 1994 Army "show cause" letter?
- What loss did the government experience as a result of E-Systems' actions in the three previously mentioned hotline cases?

Results in Brief

Although federal laws and regulations did not require E-Systems to report suspected violations of procurement law to the government, the August 1990 Memcor Agreement, and a later second administrative agreement, required the company to do so, as did its Standards of Business Conduct and Ethics.

[1]Under the Defense Industry Initiative on Business Ethics and Conduct, E-Systems established a hotline in June 1987

During the period covered by the Memcor Agreement (Aug. 1990-Aug. 1993), E-Systems' Greenville Division reported that 202 cases regarding hotline complaints had been opened or closed. All were reported to the Army's Procurement Fraud Division. Of the 202 cases, 83 (about 41 percent) related to alleged wrongdoing in federal contracts; the rest, management and employee-relations issues. From the start of a second administrative agreement in July 1994 through November 1994, the latest date covered by our investigation, E-Systems opened and reported three hotline cases; one dealt with procurement law violations.

In its quarterly reports to the Army, required by the Memcor Agreement, E-Systems did not report the findings of wrongdoing for one of the three hotline cases that were the focus of the allegations to the Subcommittee. The E-Systems reports included inaccurate information or omitted relevant facts about the other two cases. Information about these wrongdoings—including making false claims and falsifying documents—was contained in the hotline investigator's reports. The Defense Logistics Agency (DLA), in its 1994 review of E-Systems' compliance with the Memcor Agreement, generally concurred with the hotline investigator's reports. We found no evidence that E-Systems had altered internal investigation reports or reinvestigated hotline complaints to avoid disclosing information to the federal government.

Following that 1994 review, DLA reported that E-Systems had violated the Memcor Agreement. However, E-Systems' violations did not merit debarment,[2] according to the Chief, Army's Procurement Fraud Division, because the Army did not have sufficient evidence to prove that E-Systems had intentionally withheld information from the government. Nevertheless, in July 1994, the Army entered into a second administrative settlement agreement that required E-Systems' reports to the Army to provide more detailed information about each allegation and its resolution than did the first agreement.

A potential loss to the government occurred in at least one of the three hotline cases that we examined. The Defense Contract Audit Agency (DCAA) estimated that E-Systems' actions may have cost the government about $228,000, resulting from mischarged labor hours.

[2]"Debarment" is excluding a contractor from government contracting for a reasonable, specified period of time, generally not to exceed 3 years FAR 9 406-4(a) "Suspension" is temporarily disqualifying a contractor from government contracting for up to 18 months unless legal proceedings are initiated during that period. FAR 9 407-4 A contractor found guilty of violating procurement law or an administrative settlement agreement faces possible suspension or debarment action

Background

As a result of numerous reports of questionable procurement practices by defense contractors, in 1986 the President's Blue Ribbon Commission on Defense Management (Packard Commission) recommended contractor self-regulation to strengthen accountability in lieu of increased federal legislation and oversight. To implement the recommendation, a number of Department of Defense contractors adopted the Defense Industry Initiative on Business Ethics and Conduct (DII).

Under DII, signatories commit to a written code of business ethics and conduct, create a free and open atmosphere that encourages employees to report violations to the company without fear of retribution, and monitor compliance with federal procurement law. They also commit to voluntarily report procurement violations and corrective actions to the appropriate federal agency. In a July 1986 letter, the Deputy Secretary of Defense encouraged all defense contractors to report potential criminal matters to the Deputy Inspector General, Department of Defense, and report potential noncriminal matters to DCAA or the appropriate contracting officer. Since DII is a voluntary disclosure program, federal agencies cannot initiate enforcement action for noncompliance with DII's principles.

On July 3, 1986, E-Systems signed DII—one of the first companies to do so. To comply with DII, each E-Systems division, including the Greenville Division, established an Ethics Hotline for employees to report suspected violations of federal procurement law, an Ethics Program Director to direct internal investigations of hotline cases, and a senior-level management Ethics Committee.

After E-Systems pleaded guilty in July 1990 to three counts of false claims and conspiracy committed by its Memcor Division in Bushnell, Florida, (1) E-Systems provided the Army a compliance plan to ensure that failures to comply with federal procurement law would not recur; and (2) the Army, in August 1990, entered into a 3-year administrative settlement agreement with E-Systems (Memcor Agreement). The agreement, which included the compliance plan, required E-Systems to report all hotline allegations and their resolution to the Army's Procurement Fraud Division.

E-Systems Did Not Abide by Its Own Requirement to Report Suspected Violations and Did Not Fully Detail Violations Under the Memcor Agreement

E-Systems' Own Reporting Requirements Not Followed

Federal law and regulations did not require E-Systems to report suspected violations of procurement law to the government. However, as a DII signatory, E-Systems has committed—but is not required—to implement six principles of business ethics and conduct, including those that relate to the disclosure of procurement law violations to the federal government. Although E-Systems' own Standards of Business Conduct and Ethics required the company to report suspected violations to the appropriate government agencies, E-Systems did not begin to formally report suspected violations to the government until required to do so in August 1990 by the Memcor Agreement.

E-Systems officials told us that "where issues of potential significance were identified, notification to the government did occur" outside the timeframes of the Memcor and second administrative agreements. However, the experiences of the government agencies that should have received such reports differed. E-Systems' lack of disclosure was evidenced by a DCAA audit report and the experiences of DCAA representatives, the Defense Plant Representative Office,[3] and the Department of Defense Office of Inspector General (OIG).

[3]E-Systems specifically identified a former Commander of the Defense Plant Representative Office who, according to E-Systems, had been briefed on November 1, 1988, on a hotline case Although the Defense Plant Representative Office has no record of the issue, the former Commander told us he recalls the issue but not its details According to the former Commander, he trusted E-Systems to protect the government's interests in such cases He said that because he had been at E-Systems only a month on November 1, his former Deputy and Chief of the Contracts Division would have been included in any formal meeting with E-Systems and would be the best source for follow-up action on the issue However, that individual told us that he had not been made aware of the allegation, as such an issue would normally have been referred for further inquiry to the Defense Investigative Service (now the Defense Criminal Investigative Service) or to the Department's legal department.

Alleged Violations Not Fully Detailed in E-Systems' Reports Under Memcor Agreement

Although the Memcor Agreement required E-Systems to provide the Army quarterly reports of all hotline cases and their resolution, the agreement did not specify the level of detail that E-Systems should use in the reports. The Army agreed that E-Systems would provide it with copies of quarterly reports made to the company's Audit Committee. According to E-Systems' compliance policies, these reports to the Audit Committee would ensure "a high level of review and oversight." The reports did not, however, contain the level of detail that the Army had expected.

For example, an April 1994 DLA compliance review concluded that E-Systems' quarterly reports "did not always depict the allegations accurately" and did not "necessarily depict the findings of the investigator." The Army concurred with DLA's findings and in July 1994 entered into a 2-year administrative agreement with E-Systems. This second agreement required E-Systems to modify its quarterly reports so that the Army would receive a copy of the hotline allegations, the status of the investigation, and the investigation's findings and conclusions.

Number and Types of Hotline Complaints

As a result of signing DII, E-Systems established an Ethics Hotline in each of its divisions so that its employees could report suspected violations. In June 1987, the Greenville Division received its first hotline call. From that time until November 1994 (the latest date covered by our investigation), E-Systems' hotline log showed that it had opened cases for 260 complaints. The division delineated the allegations into six categories: (1) improper time charging; (2) improper work, parts, and procedures; (3) conflict of interest/vendor issues; (4) safety, security, and drugs; (5) personnel; and (6) other. Of the 260 cases, 106 related to allegations of procurement violations and 154 to management and employee-relations issues. (See table 1.)

Table 1: E-Systems/Greenville Division's Hotline Calls Received

Hotline time frame	Alleged procurement violations	Management/ employee relations issues	Total hotline calls
June 1987 - August 1990[a]	17	22	39
August 1990 - August 1993 (Memcor Agreement)	83	119	202
August 1993 - July 1994[b]	5	11	16
July 1994 - November 1994[c]	1	2	3
Total	**106**	**154**	**260**

[a]Period from hotline inception until beginning of Memcor Agreement

[b]Period between Memcor Agreement and second administrative agreement

[c]Period from beginning of second administrative agreement through the latest data received

The 202 hotline cases opened during the period covered by the Memcor Agreement were reported to the Army's Procurement Fraud Division. According to a DCAA audit report as well as representatives of DCAA, the Defense Plant Representative Office, and the Defense OIG, E-Systems, counter to its standards of ethics and DII, did not report to the federal government any of the 39 cases opened prior to the Memcor Agreement. E-Systems also did not report to the federal government any of the 16 cases it opened during the period between when the Memcor Agreement had expired and the second administrative agreement took effect.

E-Systems did report the three cases it received from the beginning of the second administrative agreement through November 1994.

Complaints Not Altered but Reports Did Not Fully Disclose Investigative Findings in Three Cases

None of the information that we examined indicated that E-Systems had altered the hotline reports, or reinvestigated the cases, prepared by the hotline investigator for cases 66, 114S, and 226—the subjects of concern to the Subcommittee—to avoid disclosing information to the government. However, E-Systems' quarterly reports to the Army did not completely or accurately disclose the hotline investigators' findings in the three cases. The findings in one case were not disclosed at all, while in the two remaining cases, the reported findings did not reflect those developed by the hotline investigator. E-Systems' reports showed that no wrongdoing

had occurred even though the investigator reported that he substantiated that it had. DLA later concurred with most of his findings.

According to the former chief investigator for E-Systems' Greenville Division, he had substantiated almost all of the allegations in the three cases. They included allegations of document falsification, false statements, and violations of company policies. Nevertheless, the quarterly reports that E-Systems sent to the Army did not include such information.

Regarding the completeness of the quarterly reports, E-Systems' outside counsel said the company's practice was to include all of the allegations of a hotline case in the quarterly report that closed the case. However, only case 114S appeared in a quarterly report (Mar. 1992) to the Army when it was closed. According to an E-Systems representative, the company inadvertently omitted case 66 (closed in Jan. 1992); and case 226 was not reported because it was closed in December 1993, after the Memcor Agreement had expired and before the second administrative agreement had been implemented. E-Systems did provide the Army a copy of the quarterly report that contained closing information about case 226, after the Army requested that it do so as a result of the DLA compliance review of E-Systems. However, that quarterly report did not contain all of the allegations received. Instead, the quarterly report stated, in part, "During the investigation the caller made five other allegations. Of the five only one required corrective action. . . ." The report provided details about only the one allegation for which E-Systems required correction.

In a June 28, 1994, letter to the Army's Procurement Fraud Division, E-Systems' outside counsel stated that case 226 had been reported to DCAA and the Defense Plant Representative Office during a meeting. We confirmed that E-Systems had discussed case 226 with government representatives—1 month after E-Systems had been notified of an impending DLA compliance review of the Memcor Agreement.

Further, E-Systems' summary reports on two (66 and 114S) of the three cases—prepared for the Air Force Office of Special Investigations (AFOSI), the Defense Criminal Investigative Service, and an Assistant U.S. Attorney during an investigation of E-Systems—also did not indicate any wrongdoing. Yet, a 1994 DLA report generally concurred with the hotline investigator's findings of wrongdoing and noted that E-Systems should have fully disclosed these findings to the federal government. With regard to all three cases, the DLA compliance review of the Memcor Agreement indicated that E-Systems should have involved the government in the

hotline investigations and should have disclosed suspected wrongdoing to the government. (App. I, II, and III discuss the three cases.)

No Debarment but More Detailed Reporting Required

In April 1994, following DLA's compliance review of the Memcor Agreement, DLA reported that E-Systems had violated that agreement by (1) restricting the agency's access to hotline files and other supporting documents and (2) not submitting accurate reports of fraud and ethical violations. The report continued that E-Systems' actions during the review appeared "to run counter to the spirit and letter of the Memcor Agreement, DII principles and contractor integrity." As a result of these findings, on May 26, 1994, the Army's Procurement Fraud Division required E-Systems to show cause, or justify, why it should not be suspended or debarred for violating the Memcor Agreement.

On the basis of E-Systems' response and a meeting with company officials, according to the Chief, Remedies Branch, Army Procurement Fraud Division, the Army determined that it did not have sufficient evidence to prove that E-Systems had intentionally withheld information from the government. Nevertheless, to ensure that E-Systems provided the Army sufficient information to assess the company's hotline/ethics program, the Army negotiated a 2-year administrative agreement with E-Systems in July 1994.

Under the 1994 agreement, E-Systems was required to provide greater details in its quarterly reports to the Army. According to the Chief, as of November 1995 E-Systems had provided the information required under the second agreement. Our review of the first quarterly report submitted under the second agreement confirmed that E-Systems had provided the agreed-upon information—nature of hotline allegations, status of investigations, and their resolution.

Potential Loss to the Government

The government experienced a potential loss as a result of E-Systems' actions pertaining to hotline case 226. According to DCAA and AFOSI, E-Systems employees mischarged their time on case 226 to overhead instead of to bid-and-proposal costs.[4] E-Systems performed an internal audit of the charging and, according to an E-Systems official, credited approximately $33,000 to the government. However, according to DCAA and AFOSI, E-Systems' mischarging also affected labor rates charged to

[4]Costs allocable to only one government contract are direct costs of that contract and are to be charged directly to the contract FAR 31 202(a) Direct costs of a specific contract requirement or an element of a specific contract's performance cannot properly be allocated as indirect costs

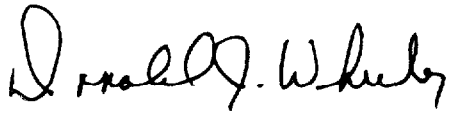
subsequent government contracts and may have resulted in "harm" to the federal government of about $228,000. As a result, AFOSI and DLA referred the issue to the Defense Plant Representative Office at E-Systems' Greenville Division for audit. As of April 1996, according to a DLA official, the resolution of this issue was still in process.

Further, in case 66 we determined, on the basis of information provided to us by DCAA, that E-Systems had scrapped purchased parts[5] having a replacement value of about $92,000. The government later repurchased, through contracts with E-Systems, many of the same type of parts at a cost of over $57,000. We were unable to determine what loss to the government, if any, this constituted because necessary documentation was unavailable.

We conducted our investigation between June 1994 and December 1995. Our scope and methodology are discussed in appendix IV.

As arranged with your office, unless you announce its contents earlier, we plan no further distribution of this report until 7 days after the date of this letter. At that time, we will send copies of the report to interested congressional committees; the Inspector General, Department of Defense; the Chief, Procurement Fraud Division, U.S. Army; President, Raytheon (which recently acquired E-Systems); President, E-Systems; and the Chief Executive Officer, Greenville Division, E-Systems. We will also make copies available to others upon request. If you have questions regarding this report, please contact me or Assistant Director William L. Davis III at (202) 512-6722.

Sincerely yours,



Donald J. Wheeler
Acting Director

[5]According to DCAA representatives, purchased parts are parts that E-Systems has purchased from other contractors and then resold to the government.

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Abbreviations

AFOSI	Air Force Office of Special Investigations
DCAA	Defense Contract Audit Agency
DII	Defense Industry Initiative on Business Ethics and Conduct
DLA	Defense Logistics Agency
GAO	General Accounting Office
OIG	Office of Inspector General
OSI	Office of Special Investigations

Hotline Case 66 at E-Systems' Greenville Division

Allegations

On February 7, 1991, a hotline caller alleged that E-Systems had built more printed circuit boards and panels than required by "planning tickets."[6] Further, the caller alleged that a supervisor had stored excess computer parts in his office and substituted them on subsequent planning tickets instead of building new parts as required by the planning tickets.

Hotline Investigator's Findings

The hotline investigation substantiated the allegations. Hotline investigators found excess printed circuit boards and other parts in the supervisor's possession after he told them that he had none. The supervisor later admitted to (1) substituting excess parts, instead of building new ones, to fulfill subsequent planning tickets and (2) falsifying the planning tickets to indicate that he had made new parts.

The investigators' subsequent company-wide examination located more than 130,000 excess parts. The excess represented parts generally found in all E-Systems production areas and included such items as electrical components and sheet-metal parts. The investigation report indicated that, counter to company policies and procedures, the use of excess parts from one contract on another contract was a historical practice at E-Systems.

The case was closed January 29, 1992.

E-Systems' Reports of Investigative Findings

E-Systems' Quarterly Report to the Army

E-Systems reported the hotline allegations to the Army's Procurement Fraud Division in a March 29, 1991, quarterly report. E-Systems did not report the results of the hotline investigation, dated December 2, 1991, in any quarterly report. An E-Systems representative told us the company had "inadvertently omitted" the information.

E-Systems, Inc., Greenville Division Ethics Committee Review Summary

In a January 1992 report to the Corporate Ethics Program Director, Greenville's Ethics Program Director concluded that E-Systems' policy regarding excess parts was "not clear or just not followed" and the supervisor had made no deliberate attempt to hide or manipulate contract

[6]According to a DCAA Technical Specialist, at E-Systems all manufactured parts required planning tickets, i e , written plans and specifications that accompany the items during their journey from raw material to finished products

costs. The report further concluded that the supervisor had believed the process he used was beneficial and followed historical practices.

Greenville Division's Summary Report

One stated purpose of the October 1993 Greenville Division report was to summarize the circumstances associated with the hotline case. However, the report did not address two related critical issues—the supervisor's initial attempt to mislead investigators about his possession of excess parts and his falsification of documents concerning the parts.

Defense Logistics Agency's 1994 Compliance Review

In 1994, DLA completed, at the Army's request, a review of E-Systems' compliance with the Memcor Agreement at the Greenville Division. DLA found that, with the exception of the investigator's report, the Greenville Division reports had minimized the importance of the investigative findings—mischarging, damage to the government, and the supervisor's role—by explaining (1) company processes; (2) the causes of the excess (engineering changes, human error within the production process, and machinery set-up materials); and (3) the disposition of the parts.

DLA concluded that due to the extensive nature of the improper practices, E-Systems should have (1) requested DCAA and the Defense Plant Representative Office to participate in E-Systems' review of the allegations and (2) made full disclosure of the investigation findings to the government. In addition, DLA reported that the supervisor identified should have been disciplined.

Hotline Case 114S at E-Systems' Greenville Division

Allegations

On January 2, 1991, a hotline caller alleged that E-Systems' quality control and Material Review Board personnel had rejected—and the customer, the U.S. Air Force, had agreed to scrap—two printed circuit boards. After the boards had been designated as scrap, personnel in E-Systems' Engineering Department obtained the boards and used them in the Air Force's final product. E-Systems falsified paper and computer records to remove the Material Review Board disposition on the boards from "scrapped" to "use as is."

Hotline Investigator's Findings

The hotline investigation substantiated all the allegations. The investigation found that E-Systems' quality control had rejected the two circuit boards. The boards were then processed through a Material Review Board representative, who declared the boards as "scrap" with the Air Force's approval and generated new planning tickets to build new boards. The engineering staff believed the scrapped boards would be functional if fixed and requested that the boards be turned over to them for use as test models. Prior to returning the boards to the engineering staff, the Material Review Board representative broke off one corner of each board to show that they could not be used in a final product.

About 2 months after the engineering personnel received the scrapped boards, they canceled the newly generated planning tickets for replacement boards. They then had the broken corners of the boards repaired. Subsequently, a Material Review Board representative, who normally performed quality control in sheet-metal areas and not electronics, was requested to change the original computer records for the boards from "scrap" to "use as is." He did so. In addition, E-Systems charged all costs associated with reusing the boards as an indirect cost to overhead instead of directly to the contract. The company subsequently used the boards in the final product without the Air Force's knowledge that they had originally been scrapped and had not been appropriately tested.

The investigator's report stated,

> "Interviews of the personnel . . . reflects [sic] a total departure and callous disregard for Company approved and prescribed procedures, overt attempts to hide the fact the boards were rejected and scrapped, and efforts from the onset to deceive a Quality Control and MRB [Material Review Board] representative . . Investigation shows a clear and deliberate attempt to by-pass the initial Inspector, Quality Assurance, MRB and Customer representatives." (Emphasis added)

The investigator further noted, "New inspectors, MRB and Customer representatives were sought out, not given all the details, and instructed to reverse the process." He continued that E-Systems' claim of an "urgent need" for the boards did not exist because the company had had ample time to manufacture the parts after the initial scrapping.

The case was closed on January 30, 1992.

E-Systems' Reports of Investigative Findings

E-Systems' Quarterly Reports to the Army

E-Systems reported the hotline allegations to the Army in its March 29, 1991, quarterly report. The caller making the allegations was concerned that two printed circuit boards that had been rejected and then sent to Engineering for test work would ultimately be shipped to the Air Force, which had been informed that the boards were to be used only for test purposes.

E-Systems reported the results of the hotline investigation to the Army in its March 25, 1992, quarterly report. The report noted that the investigation revealed that two printed circuit boards had been scrapped but subsequently changed to "use as is" to meet an urgent Desert Storm requirement and that this was done with the concurrence of Engineering, Quality Control, and the Air Force.

E-Systems, Inc., Greenville Division Ethics Committee Review Summary

In a January 30, 1992, review summary, the Ethics Program Director did not concur with the hotline investigator's findings, stating ". . . neither that information nor the interview transcripts conclusively proves [sic] such conclusions. . . ." The Ethics Program Director also cited the customer's approval of the repaired boards' use in the end product. However, the director recommended that new procedures, guidance, and changes to the computerized record system be issued to prevent subsequent changes of previously entered data.

Greenville Division's Summary Report With Concurrence of E-Systems' Outside Counsel

In May 1993, in response to an AFOSI inquiry, E-Systems' Greenville Division issued—and provided to AFOSI, the Defense Criminal Investigative Service, and an Assistant U.S. Attorney—a report that stated that nothing in the conduct of division personnel "in any way suggests any element of deception." E-Systems' outside counsel concurred with the report and justified the employees' actions by saying their intent was to deliver a functioning system. Neither the division report nor the counsel's concurrence specifically addressed the employees' actions as contained in the hotline investigator's report.

Air Force Office of Special Investigations Summary

A February 24, 1994, AFOSI report supported many of the hotline investigator's findings and included the following information:

- the estimated value of the printed circuit boards, after electrical components were added, was about $7,000 each;
- E-Systems, in violation of company policy, used a Material Review Board member in the Sheet Metal Shop to override the circuit boards' rejection by a Quality Control Inspector assigned to the circuit board area;
- the scrapped boards—repaired and manufactured outside of normal procedures—were used and delivered to the Air Force;
- the repaired boards were never processed through E-Systems' Quality Control section and were not manufactured in accordance with military specifications;
- some costs associated with the production of the boards were charged to overhead rather than to the contract;
- E-Systems did not perform any functional tests on the boards other than operationally in the end item;
- the Air Force was given no monetary consideration when the final products (search receivers) were delivered even though costs were charged to overhead and then again when the search receivers were delivered as an end item;
- E-Systems created work orders showing the manufacture of the boards, after delivering boards to the Air Force; and
- both boards failed in the field, one within months of delivery.

Defense Logistics Agency's 1994 Compliance Review

DLA in its 1994 compliance review report to the Army noted that the hotline investigation had substantiated the allegations of the improper use of scrapped circuit boards and the changing of records. DLA concluded that the hotline investigator's interviews of company employees had clearly shown deception by Engineering Department personnel so as not to hold

up delivery. The supervisor who had repaired the boards admitted to the hotline investigator that the boards should have been scrapped. Furthermore, the Material Review Board representative stated that the boards should have been destroyed and that he had allowed them to be used only for test purposes.

In addition, DLA noted that the interview transcripts contained in the Ethics Program Director's file showed that a supervisor in the Engineering Department had made false representations to a government representative when he said "... the only reason those boards were scrapped was because that corner was notched out." DLA further concluded that the outside counsel's May 1993 position—that nothing done by E-Systems or government personnel "suggests any element of deception"—was in direct conflict with the interview transcripts.

DLA also reported that E-Systems should have (1) requested DCAA and the Defense Plant Representative Office to participate in E-Systems' review of the hotline investigation and, (2) due to the apparent intentional misconduct involved, fully disclosed the investigation findings to the government. In addition, the report noted that individuals and supervisors identified by the hotline investigation should have been significantly disciplined.

Hotline Case 226 at E-Systems' Greenville Division

Allegations

On April 19, 1993, a hotline caller made three allegations. During the subsequent hotline investigation, the caller made five additional allegations. The following summarizes the allegations raised:

(1-3) The first three allegations in this hotline case involved personnel matters, not violations of procurement law, and are not addressed in this report.

(4) Upon termination of an Air Force contract for aircraft equipment, E-Systems' Vice President, Finance, caused funds owed to the government for work completed by the company to be lowered from $1,348,000 to $1,068,000 without justification.

(5) The Vice President, Finance, violated E-Systems' ethics policy by not allowing a voluntary refund to the government for training that E-Systems had not conducted under a government contract.

(6) The Vice President, Finance, directed employees to mischarge their time to overhead instead of to bid-and-proposal costs.[7]

(7) A subcontractor submitted inaccurate time charges to E-Systems, which were subsequently submitted to the government.

(8) The Vice President, Finance, directed that hazardous duty pay be added to a government contract after negotiations had been completed and while the contract was awaiting signature. The direction was refused, and another vice president signed the contract without the addition while the vice president who had given the direction was on vacation.

Hotline Investigator's Findings

Allegation 4 was not substantiated.

Allegation 5 was not substantiated. However, the Division Counsel sent the Vice President, Finance, a memorandum along with a copy of E-Systems' voluntary refund policy for the vice president's consideration.[8]

[7]Knowingly charging the overhead account for an employee's time used to prepare bid-and-proposal information on a specific government contract is a false claim, a violation of 18 U S C. § 287

[8]E-Systems' ethics policy concerning voluntary refunds states, " When it is determined that overpricing has occurred, then it is the Company's policy to refund the amount of the overpricing even when there is no contractual or legal obligation to do so "

Allegation 6 was substantiated. The hotline investigator determined that company procedures required employees to charge their time to bid-and-proposal costs (and not overhead) when they were doing technical writing for a contract proposal. The Division Controller—under the impression that the Vice President, Finance, had told employees to charge to overhead—advised several employees that because they were writing the technical proposal, they should instead charge their time to bid and proposal. According to the investigator's report, these employees stated that the proposal manager, at the direction of the Vice President, Finance, had told them to charge overhead because the bid-and-proposal budget had been overrun.

According to the Division Controller, permission had to be obtained from corporate headquarters if the bid-and-proposal budget was to be exceeded. The excess still would be charged to overhead, but it became an unallowable cost and would be taken from the division's profit.[9] Division Counsel, after being made aware of the matter by the Division Controller, wrote the Vice President, Finance, suggesting that he examine the bid-and-proposal issue. The counsel told the hotline investigator that the vice president had told the counsel, in effect, "to mind his own business."

Allegation 7 was substantiated. A Corporate Internal Audit review of the subcontractor's inaccurate time charges found that the problem had been corrected.

Allegation 8 was substantiated in that the directed insertion of hazardous duty pay was refused and another vice president signed the contract. However, the Vice President, Finance, told the hotline investigator that the insertion was not improper because the matter was not a contract; it was a proposal. He advised that if the customer objected to the new rates the customer could negotiate them out.

The case was closed on December 5, 1993.

[9]According to the Chief, Operations Audits, DCAA, E-Systems' overhead costs are shared by all government customers instead of being billed to just the one for which the work is done. He said that although the bid-and-proposal account is a type of overhead account, employees may charge up only to a specified limit before the company begins incurring the costs. He said when the division exceeds the limit, charges then become "unallowable." In case 226, the Greenville Division's bid-and-proposal budget was exceeded.

E-Systems' Reports of Investigative Findings

E-Systems Corporate Counsel's Summary Report

E-Systems' Corporate Counsel determined that some of the various allegations involved in case 226 involved financial and legal issues that should be investigated by someone from outside the Greenville Division. As a result, it initiated a parallel investigation of the financial and legal issues to determine if wrongdoing had occurred and what corrective action should be implemented. The Corporate Counsel invited the hotline investigator to attend all interviews relevant to the allegations he was investigating. On August 13, 1993, the Corporate Counsel issued a report covering hotline allegations 4, 5, 6, and 7. According to the Corporate Counsel representative who conducted the investigation, these were the only allegations he examined.

The Corporate Counsel's report differed from the hotline investigator's report. For example, the Corporate Counsel's report never mentioned that the investigator reported that at least two employees had directed the mischarging, one being the vice president whom the Division Controller and the Division Counsel had told that the charging was incorrect. Instead, the counsel said, "[S]ome employees may have charged into overhead accounts rather than [the] bid and proposal (B&P) account." He said that the employees working on the program charged to bid and proposal when writing a substantial portion of the proposal although the majority of the proposal was written after hours and in small discreet increments.

E-Systems, Inc., Greenville Division Ethics Committee Review Summary

A December 15, 1993, Ethics Committee Review Summary found that the hotline investigation ". . . did not reveal wrongful intent as implied by the caller's statements to the investigator. The implication of wrongful intent was apparently motivated by the caller's high degree of animosity toward the Division Vice President." Regarding the specific allegations, the report stated the following:

Allegation 4—The investigation did not substantiate the allegation that the vice president had caused a federal repayment to be lowered without justification. The report therefore recommended no action.

Allegation 5—The investigation did not substantiate the allegation that the vice president had violated ethics policy on voluntary refunds. Since the government had accepted the work product, no action was recommended.

Allegation 6—The report did not state that the allegation was substantiated. However, as corrective actions, (1) the Division Controller was to issue detailed guidance to employees for labor charging; (2) the labor charges to identify the financial entries that should be corrected were audited; (3) DCAA was advised about the "inadvertent" charging errors and proposed corrections of $33,350; (4) the Vice President, Finance, position was separated from responsibilities for the Federal Information Systems proposals and program; (5) the vice president addressed in the case became the Federal Information Systems Vice President and a newly selected vice president assumed the finance position; (6) the former Vice President, Finance, was required to review division policies and explain them to his subordinates; and (7) the Greenville Division was directed to conduct a comprehensive director-level training program on bid-and-proposal labor charging.

Allegation 7—The report did not state that the allegation had been substantiated. Instead, the report noted that the hotline investigation had revealed a problem in the calculation of subcontractor's hours but that the problem had been detected and corrected before the hotline investigation had begun. The report had no recommendations.

Allegation 8—The report stated that the hotline investigation had revealed that a proposal, not a contract, existed at the time the hazardous pay issue arose. Furthermore, if the hazardous duty rates had been put into the proposal, the customer would have had an opportunity to negotiate them out of the contract. The report had no recommendations.

E-Systems' Quarterly Report to the Army

E-Systems did not report the five additional allegations in the quarterly reports covering the period when the allegations were received. The report—representing November 1, 1993, to March 31, 1994—that summarized the case after its closure did state that five additional allegations had been received. However, E-Systems did not send this report to the Army because, according to a senior legal assistant, the Memcor Agreement had expired. The report identified one allegation as needing "corrective action." It described that allegation as improper charging of bid-and-proposal costs and noted that erroneous instructions

had been given to employees, resulting in about $30,000 of the employees' time being improperly charged.

Defense Logistics Agency's 1994 Compliance Review Summary

DLA in its 1994 compliance review reached the following conclusions:

Allegation 4—DLA concurred with both the hotline investigator's and the Ethics Committee's reports.

Allegation 5—DLA did not concur with either the hotline investigator's or the Ethics Committee's reports, saying that the matter, though not illegal, should have resulted in a voluntary refund under company policy. DLA noted that E-Systems' policy had been violated and that the hotline investigation disclosed that training, valued at more than $125,000, had not been performed even though a government representative signed a form indicating that it had. DLA reported that the investigation found no indication of deception on behalf of the company, rather that the government had mishandled the situation.

Allegation 6—DLA concurred with the hotline investigator's report that the allegation was substantiated. However, it did not concur with the company's corrective actions regarding the labor charging, including its lack of disciplinary action against the individuals and supervisors identified in the mischarging. According to DLA's report, the hotline investigator specifically questioned the Vice President, Finance, on his directions regarding bid-and-proposal costs. DLA reported that, at a minimum, it was the vice president's responsibility to ensure proper charging of costs. DLA concluded that further inquiry into and elaboration of employee statements may, in fact, demonstrate intentional direction to employees to mischarge.

Allegation 7—DLA did not concur with the Ethics Committee's report that no action be taken. According to DLA's report, the extent of apparent subcontractor mischarging—1,000 hours—merited further examination and formal reporting to the appropriate government authority. Further, although the company hotline file included a statement to the effect that the government's Contracting Officer had been notified, DLA noted that nothing had been presented in writing.

Allegation 8—DLA concurred with the hotline investigation and the Ethics Committee's report saying that the facts in the allegation were correct and

that the investigation did not disclose any apparent violation of law, regulation, or company policy.

Overall, DLA disagreed with E-Systems' actions regarding hotline case 226. The report noted that individuals and supervisors identified in the mischarging allegations should have been significantly disciplined. The report also stated that E-Systems should have (1) requested DCAA and the Defense Plant Representative Office to participate in E-Systems' review of the hotline investigation and (2) made disclosure to the government due to the apparent intentional misconduct involved. The report also noted that the Corporate Counsel's summary appeared to conflict with the information obtained during the course of the hotline investigation.

Air Force Office of Special Investigations

In an October 18, 1995, report, AFOSI confirmed the hotline investigator's findings related to the employee mischarges (allegation 6). The report noted that DCAA estimated that E-Systems' actions cost the government about $228,000 because of the manner in which the company had charged labor rates on contracts negotiated prior to and after the allegations were raised. The report acknowledged the original $33,000 that E-Systems had credited to its overhead accounts, saying that DCAA believed the amount was inadequate.

After the Department of Justice declined to pursue either criminal or civil action regarding the mischarging, AFOSI and DLA referred the matter to the Defense Plant Representative Office at E-Systems' Greenville Division for "appropriate contractual action." As of April 18, 1996, according to a DLA official, resolution of the matter was pending.

Methodology

The then Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, asked us to investigate allegations presented by the former chief investigator for E-Systems' Greenville Division.[10] We conducted our investigation from June 1994 to December 1995.

To obtain the information in this report, we examined Federal Acquisition Regulations, Defense Federal Acquisition Regulations and related guidance, Federal Criminal Code and Rules, the DCAA Contract Audit Manual, the Department of Defense OIG Indicators of Fraud in Defense Procurement, the President's Blue Ribbon Commission on Defense Management Report, the Defense Industry Initiatives, and Department of Defense documents. We also examined the Memcor Agreement, which recognized the establishment of E-Systems' Standards of Business Conduct and Ethics and the company's compliance with the Defense Industry Initiative on Business Ethics and Conduct. We examined written communications and reports of interviews between the company, DLA, DCAA, and the Army on the Memcor Agreement's requirements, the company's performance under that agreement, and the 1994 administrative agreement. We also examined AFOSI reports regarding all three hotline cases.

We interviewed E-Systems corporate and Greenville Division officials and staff, including the former chief investigator and Greenville's Ethics Program Director for 1989-92. We also interviewed responsible AFOSI, Army, DLA, DCAA, Defense Plant Representative Office, and Defense OIG officials and obtained documents pertaining to the oversight of E-Systems' activities. However, two knowledgeable employees of the Greenville Division Facilities Protection and Investigations Division—a second former Ethics Program Director and a hotline investigator—would not meet with us. In addition, three corporate employees—one of whom had been an Ethics Program director for the Greenville Division—declined to answer certain questions pertinent to our investigation.

We reviewed E-Systems' synopses contained in its hotline log and quarterly reports of the 260 cases opened between June 1987 and November 1994. E-Systems' former chief investigator at the Greenville Division, who had alleged E-Systems' mismanagement of hotline investigations, provided us copies of his investigative reports and records

[10]According to the former chief investigator, he had previously served 20 years as an investigator and supervisor for the Army's Criminal Investigations Division Command and 7 years as an investigator and supervisor for E-Systems' Facilities Protection and Investigations Division at E-Systems' Greenville Division

and background relative to investigations that he and his investigative staff had conducted on three hotline complaints. We reviewed hotline case file documents obtained from E-Systems' hotline case files and the Army Procurement Fraud Division. We focused our review on the three cases that had been brought to the Subcommittee's attention and DLA's April 1994 report related to them.

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