Inspector General

United States Department of Defense

Hotline Review October 6, 2011

Hotline Complaint Involving Auditor Independence at a Field Audit Office in the Defense Contract Audit Agency Western Region

Report No. DODIG-2012-002

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Acronyms and Abbreviations

DCAA	Defense Contract Audit Agency
GAGAS	Generally Accepted Government Auditing Standards
FAO	Field Audit Office

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

October 6, 2011

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Report on Hotline Complaint Involving Auditor Independence at a Field Audit Office in the Defense Contract Audit Agency Western Region (Report No. DODIG-2012-002)

We are providing this report for your information and use. We performed the review in response to a DOD Hotline complaint. While we did not substantiate the Hotline complaint, we found that Defense Contract Audit Agency (DCAA) management failed to adequately and timely remove an auditor's independence impairment in accordance with generally accepted government auditing standards. DCAA implemented several corrective actions following the issuance of our Notice of Concern on May 6, 2011, such as the implementation of revised training on auditor independence impairments.

In preparing this report, we considered management comments and actions taken in response to the nine recommendations contained in our Notice of Concern. We request that DCAA provide additional comments for Recommendations 5, 7, and 9. We should receive the comments by November 7, 2011.

DOD Directive 7650.3 requires that recommendations be resolved promptly. Please provide comments that state whether you agree or disagree with the findings and recommendations. If you agree with our recommendations, describe what actions you have taken or plan to take to accomplish the recommendations and include the completion dates of your actions. If you disagree with the recommendations or any part of them, please give specific reasons why you disagree and propose alternative action if appropriate.

If possible, send a .pdf file containing your comments to the address cited in the last paragraph of this memorandum. Copies of your comments must have the actual signature of the authorizing official for your organization. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to our staff. Questions should be directed to Ms. Carolyn R. Davis at (703) 604-8877 (DSN 664-8877), carolyn.davis@dodig.mil.

Randolph R. Stone, SES
Deputy Inspector General
Policy and Oversight

Results in Brief: Hotline Complaint Involving Auditor Independence at a Field Audit Office in the Defense Contract Audit Agency Western Region

What We Did

We reviewed a DOD Hotline complaint concerning the relocation of an auditor in the Defense Contract Audit Agency (DCAA) Western Region for independence reasons. According to the complaint, the auditor's independence was not impaired, and management should not have acted on a DOD contractor's request to relocate the auditor.

What We Found

We determined that the relocation of the auditor was justified. However, our review disclosed that DCAA field audit office management failed to take measures necessary to eliminate the auditor's independence impairment in accordance with generally accepted government auditing standards. DCAA did not reassign three audits affected by the independence impairment to another auditor for completion. In addition, DCAA field audit office management did not initiate an investigation of DOD contractor complaints made against the auditor, even though some of the complaints would have constituted misconduct. In May 2011, we issued a Notice of Concern to the Director of DCAA, recommending several corrective actions for eliminating the independence impairment and improving related controls. (See Appendix B)

Management Actions and Our Response

In response to our Notice of Concern, DCAA took several actions. Among them, DCAA management:

- rescinded an audit report issued on one of the audits affected by the impairment, and assigned the audit to another field audit office to redo and supervise;
- assigned the other two audits affected by the impairment to another field audit office for completion;
- issued an alert to all DCAA employees which emphasized the need to fully eliminate independence impairments in a timely manner; and
- revised its training on the identification and removal of auditor independence impairments.

In addition, DCAA plans to implement procedures for investigating contractor complaints of auditor misconduct and consider appropriate administrative action. However, we do not consider the management actions to be fully responsive to three of the nine recommendations contained in our Notice of Concern.

Management Comments

We request that the Director of DCAA provide additional comments in response to this final report. Please see the recommendations table on the following page.

Recommendations Table

Management	Recommendations Requiring Comment
Director, Defense Contract Audit Agency	5, 7, and 9

Please provide comments by November 7, 2011.

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Introduction

Objectives

We conducted this review to determine the validity of a complaint received by the DOD Hotline concerning DCAA management's decision to relocate a DCAA auditor to another office location because management believed the auditor's independence had been impaired. The complainant disagrees with management's decision that the auditor's independence had been impaired, and believes management should not have acted on a DOD contractor's request to relocate the auditor. See Appendix A for details of our scope and methodology.

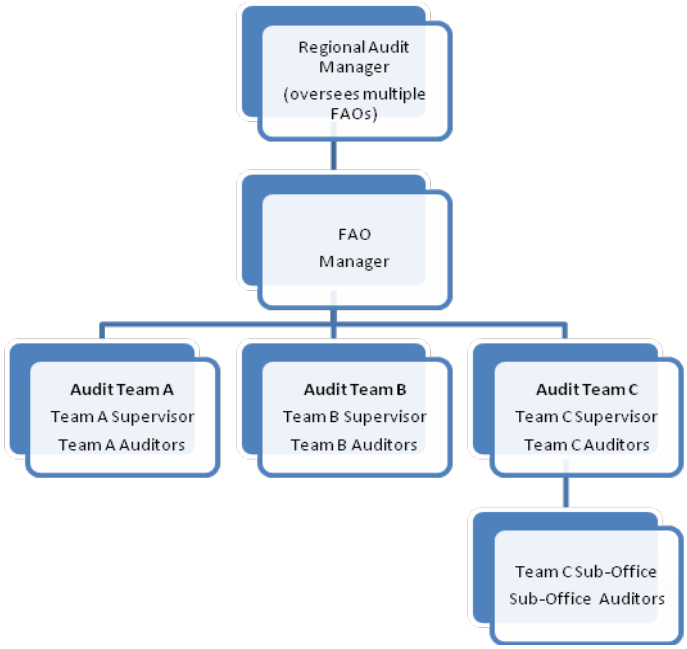
Background

Defense Contract Audit Agency (DCAA)

DCAA performs contract audits and provides accounting and financial advisory services in connection with the negotiation, administration and settlement of DOD contracts and subcontracts. DCAA operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller).

Organizationally, DCAA includes a Headquarters, Field Detachment, and five regions: Central, Eastern, Mid-Atlantic, Northeastern, and Western. Each region maintains several field audit offices (FAOs), and each FAO is comprised of multiple audit teams. In addition to having a main office location, some FAOs maintain sub-offices at larger DOD contractor facilities. An FAO manager oversees each field audit office, and a supervisor leads each audit team. The FAO manager reports to a regional audit manager. Depicted below is a simplified organization chart of a typical FAO.

Figure: Typical FAO Organization Chart



The allegations addressed in this report involve one FAO in the Western Region.

Generally Accepted Government Auditing Standards (GAGAS)

DCAA must comply with GAGAS, which are issued by the Comptroller General of the United States. GAGAS incorporates certain standards issued by the American Institute of Certified Public Accountants. We used the GAGAS standards contained in the "July 2007 revision" as criteria for this review. Although the Comptroller General issued a "2011 Internet Version" of the standards on August 19, 2011, the new standards do not take effect until December 15, 2012.

The DCAA Contract Audit Manual prescribes auditing policies and procedures for performing audits in support of the DCAA mission. The Contract Audit Manual incorporates GAGAS into its guidance.

Finding. Relocation of an Auditor for Independence Reasons

We did not substantiate the complainant's allegation. The auditor's independence was impaired, requiring that DCAA management relocate him from a sub-office to the main field audit office. However, DCAA management failed to take other actions necessary to remove the independence impairment in accordance with GAGAS. After management had identified the impairment, they did not reassign the audits affected by the impairment to another auditor, or document the actions they took to eliminate the impairment. DCAA management also failed to properly investigate allegations of wrongdoing made against the auditor. In response to our May 6, 2011, Notice of Concern, DCAA is taking steps to resolve the independence impairment, improve related procedures, and impose appropriate administrative action.

Allegation

The complainant alleged that DCAA management at a field audit office (FAO) removed an auditor from a DCAA sub-office without justification. The complainant disagrees with management's decision that the auditor's independence toward the DOD contractor had been impaired, which management cited as the reason why they relocated the auditor. The complainant believes DCAA management violated the auditor's own independence, by relocating the auditor at the request of the DOD contractor.

Background

On October 6, 2010, the FAO auditor and his supervisor met with representatives of a DOD contractor to discuss an outstanding request for information. Following the meeting, one of the contractor representatives met privately with the supervisor to advise him that the auditor had exhibited inappropriate behavior toward several contractor employees. Later that day, the supervisor told the auditor about his private discussion with the contractor representative, and counseled him to be professional at all times. The next day, the auditor sent an email to the contractor's Chairman to express his frustration over the claims of inappropriate behavior. Within the email, the auditor wrote in part:

> [The contractor] has a termination claim that is filled with frivolous costs and I have been diligently working to analyze and question this claim….I also hope you speak to [the contractor's legal counsel] and make him realize that his slanderous accusations will only **increase my diligence**. (names omitted and emphasis added)

The auditor did not include his supervisor on the distribution of this email.

On November 1, 2010, the DOD contractor's legal counsel met with the supervisor to discuss his concern that the auditor might not be objective in performing audits of his company. The legal counsel provided the supervisor with a copy of the auditor's email he sent to the contractor Chairman, and statements from 11 unnamed contractor employees who allegedly witnessed the auditor's inappropriate behavior.

The supervisor advised the FAO manager and the Regional Audit Manager of his meeting with the contractor's legal counsel. They mutually agreed that the auditor's independence had been impaired based on the email he sent to the contractor's Chairman. On November 2, 2010, the supervisor verbally advised the auditor that DCAA management believed his independence had been impaired and directed the auditor to move his office from the DOD contractor facility sub-office to the main FAO location. However, the supervisor also directed the auditor to continue working on audits of that contractor which had already been assigned to him. The Regional Auditor Manager advised the Acting Deputy Regional Director of the actions taken to resolve the perceived independence impairment.

Our Review

We interviewed the auditor, his supervisor, the FAO manager, two Regional Audit Managers and the remaining members of the auditor's audit team. We placed most interviewees under oath, we recorded the interviews, and we obtained a transcription of the interviews. In addition, we reviewed applicable auditing standards, regulations, and agency procedures. We also reviewed written communications and other agency documents.

Objectivity and Independence Requirements

Generally accepted government auditing standard (GAGAS) 2.10, "Objectivity," states:

> The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional duties. Objectivity includes being independent **in fact and appearance** when providing audit and attestation engagements, **maintaining an attitude of impartiality**, having intellectual honesty, and being free of conflicts of interest. Avoiding conflicts that may, in fact or appearance, impair auditors' objectivity in performing the audit or attestation engagement is essential to retaining credibility. **Maintaining objectivity includes a continuing assessment of relationships with audited entities** and other stakeholders in the context of the auditors' responsibility to the public. (emphasis added)

Further, GAGAS 3.02 states:

> In all matters relating to the audit work, the audit organization **and the individual auditor**, whether government or public, must be free from **personal**, external, and organizational **impairments to independence**, and must avoid the appearance of such impairments of independence. (emphasis added)

An example of a personal impairment listed in GAGAS 3.07 includes "Preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit."

We agree with the FAO management decision that the auditor's independence toward the contractor had been impaired. The auditor's October 7, 2010, email clearly reflects a lack of objectivity and independence. His characterization of the Termination Claim

(hereafter referred to as Termination Settlement Proposal) as being "filled with frivolous costs" before completion of the audit process indicates an element of bias. Moreover, the auditor's statement that the "slanderous allegations would only increase my diligence," demonstrates that his objectivity and impartiality toward the contractor had been impaired either in fact or appearance. Moving the auditor's office location from the contractor's facility was one of the necessary steps in eliminating the independence impairment.

Furthermore, we found no evidence suggesting that the DOD contractor had unduly influenced FAO management's decision to relocate the auditor from the FAO sub-office. According to the supervisor's notes of his meeting with the contractor's legal counsel, the contractor wanted to make the supervisor aware of the employee complaints and the auditor's October 7, 2010, email sent to the contractor's Chairman, but the contractor did not ask DCAA to relocate the auditor. The evidence reflects that FAO management's decision to move the auditor was based on their independent concern over the auditor's objectivity and independence as a result of his October 7, 2010, email. Accordingly, we did not substantiate the complainant's allegation.

DCAA Management Failure to Adequately Remove the Independence Impairment

We strongly disagree with DCAA management's decision to have the auditor continue working on audits of the contractor affected by the impairment. That decision is inconsistent with management's responsibility to resolve independence impairments in accordance with GAGAS 3.09, which states:

> When the audit organization identifies a personal impairment to independence prior to or during an audit, the audit organization should take action to resolve the impairment in a **timely manner**. In situations in which a personal impairment is applicable only to an individual auditor or a specialist on a particular audit, the audit organization may be able to eliminate the personal impairment. For example, the audit organization could remove that auditor or specialist from **any work on that audit**….(Emphasis added)

Based on the nature of the impairment, all of the auditor's assignments involving the contractor were impacted by the impairment. To resolve the impairment, FAO management had an obligation to reassign all of the auditor's assignments involving that contractor to another auditor in a timely manner, and determine the extent to which additional work should be performed or steps redone. FAO management's failure to take these steps resulted in a noncompliance with the GAGAS independence requirement. FAO management also did not comply with DCAA Contract Audit Manual (CAM) 2-S103.1b.(5), fourth bullet, which states:

> No auditor with a personal impairment will be permitted to work on any assignment that is affected by the impairment.

On November 2, 2010, shortly after management verbally notified the auditor of his independence impairment, the auditor asked his supervisor to assign his current audit to another auditor due to the perceived impairment.

In his email to the supervisor, the auditor wrote:

> …I would also request that someone else finalize the 4600.002 termination. I have lost respect for this company due to its recent personal attack and think that they could use this fact against DCAA in negotiations because my removal will be viewed as an independence issue.

Yet, FAO management still failed to take action. As of November 2, 2010, the auditor had three assignments involving the contractor. As shown below, our review of the auditor's time charges disclosed that he charged 443 hours to these three audits after management notified him of the independence impairment (from November 2, 2010 to April 9, 2011).

Table: Auditor Hours Charged on Impaired Audits

Audit Description	Assignment No.*	Hours Charged (11/2/10 – 4/9/11)
Termination Settlement Proposal	XXXX-2010E17100001	280
Floor Check	XXXX-2010E10310001	133
Paid Voucher	XXXX-2011E11015001	30
	Total Hours	443

*The first four digits of the actual assignment number have been omitted.

This represented 71 percent of the auditor's total direct hours charged for that period. On March 24, 2011, the FAO manager issued the report on the Termination Settlement Proposal and questioned 92 percent of proposed costs. FAO management allowed the auditor to conduct the exit conference with the contractor on his own, despite the impairment determination and the contractor's allegations of inappropriate auditor behavior.

Finally, we noted that FAO management did not document the steps they took to resolve the independence impairment (such as the transfer of the auditor to the FAO main office), either in FAO files or in written communications with the auditor. CAM 2-S103.1(5) states, "The supervisor/FAO manager's resolution of any impairment should be documented." FAO management should have prepared a memorandum to the auditor which included their rationale for the independence impairment determination.

Our Interviews with DCAA Management

We interviewed the FAO manager and supervisor to determine why they had the auditor continue working on the three audits after their independence impairment determination. Both the FAO manager and the supervisor stated that most of the work on the Termination Settlement Proposal audit had already been completed before they identified the impairment. The FAO manager also commented that the auditor had spent hundreds of hours on the assignment and said, "I don't want to lose those hundreds of hours or, you know, affect the successful completion of the audit." In addition, the supervisor pointed out that "because it (the Termination Settlement Proposal audit) was going to go through

many levels of review, it would be acceptable for him to complete that audit." (clarification added)

Regarding the Floor Check, both the FAO manager and supervisor felt that having the auditor continue working on this audit was acceptable because major parts of the audit were being conducted as an assist audit by another DCAA office.

We also interviewed the Regional Audit Manager who had cognizance of the FAO on November 2, 2010 (hereafter referred to as the first Regional Audit Manager). He agreed with the FAO manager and supervisor that the auditor could continue performing the Termination Settlement Proposal based on their assertion that the field work had been completed. He stated that he instructed the FAO manager and supervisor to review the impact of the independence impairment on the Termination Settlement Proposal and, if necessary, disclose the impairment in the resulting audit report, in accordance with GAGAS. His understanding was that the FAO manager would reassign the Floor Check and Paid Voucher reviews to another auditor because significant field work still had to be performed. On January 30, 2011, cognizance of the FAO transferred to a second Regional Audit Manager. The second Regional Audit Manager told us he approved the issuance of the Termination Settlement Proposal audit report, but that neither the FAO manager nor the first Regional Audit Manager advised him of the auditor's independence impairment.

The explanations provided by the FAO manager, the supervisor, and the first Regional Audit Manager do not justify their actions. Their actions also reflect a fundamental misunderstanding of the underlying GAGAS objectivity and independence standards. In resolving an independence impairment before or during an audit, GAGAS does not allow the agency to consider the hours incurred, or the degree to which the field work has been completed. DCAA management's concern over lost auditor hours or other matters must not override their obligation to timely resolve an impairment of independence in accordance with GAGAS 3.09. In addition, simply subjecting the audit to a thorough review upon completion would not have eliminated the appearance that the auditor lacked objectivity and independence.

Effect on the Failure to Comply with GAGAS

Because management failed to take appropriate and timely action, the legitimacy of any audit findings impacted by the impairment could be challenged on the basis that the auditor lacked objectivity and impartial judgment in conducting the audit. Given their actions in this case, we questioned whether FAO management in this case should be relied upon for resolving the impairment in a satisfactory manner. To help ensure objectivity and independence to the extent possible, we recommended that DCAA reassign any ongoing audits impacted by the impairment to another FAO for completion. Regarding the audit report issued on the Termination Settlement Proposal, we recommended that DCAA rescind the report and notify the requester in writing that it should not be relied upon for any purpose. We further recommended that another FAO re-perform and supervise the Termination Settlement Proposal audit.

GAGAS 3.08 states that audit organizations should establish procedures for ensuring compliance with the independence standards, including the establishment of a

disciplinary mechanism to promote compliance. CAM 2-S103.1b.(5) notes that deviations from the agency's procedures for ensuring compliance with the GAGAS independence requirements are subject to appropriate disciplinary action. Accordingly, we suggested that DCAA consider appropriate administrative action for the failure to exercise proper professional judgment and to comply with GAGAS and applicable agency procedures.

We do not know the extent to which other significant failures to comply with the GAGAS independence standard have occurred within DCAA. DCAA needs to assess its current training and procedures for ensuring compliance with the independence standards.

Inappropriate Management Response to Contractor Complaints

The FAO manager and supervisor (in consultation with the first Regional Audit Manager) chose not to investigate the contractor complaints against the auditor. They also did not show the complaints to the auditor to obtain his account of the alleged behavior. The supervisor had consulted with a Regional Human Resources Specialist who recommended that the FAO investigate the complaints. If accurate, some of the complaints would constitute misconduct and be subject to disciplinary action.

On January 27, 2011, 3 months after the supervisor received the complaints from the contractor's legal counsel, the auditor met with the FAO manager and supervisor to discuss the independence issue. The FAO manager stated to the auditor that, "people do not lie" when referring to the contractor complaints. This statement was inappropriate since the FAO manager and supervisor had chosen not to investigate the complaints. We also question why the FAO manager waited 3 months after receiving the contractor complaints to discuss them with the auditor.

An appropriate and timely investigation of the contractor complaints would have established whether there was sufficient evidence of misconduct on the part of the auditor. It would have also demonstrated that DCAA management took proper action in response to the complaints, rather than ignore them. DCAA should consider appropriate administrative action for management's failure to take appropriate action in response to the allegations of misconduct.

Our review disclosed that DCAA does not have formal procedures for investigating contractor complaints of inappropriate auditor behavior. We do not know the frequency in which DOD contractors complain about such behavior. However, in an April 22, 2011 report, we noted that DCAA's Internal Review Department reported a similar incident which occurred in the Northeastern Region. According to the report, a DCAA Northeastern Region FAO manager and a supervisor treated an auditor disrespectfully and unprofessionally when they failed to provide the auditor with DOD contractor complaints against him and failed to conduct an inquiry into the complaints. The report recommended that the DCAA Headquarters Policy Directorate issue formal guidance on the proper handling of complaints from contractors. DCAA should make the issuance of this guidance a priority.

Notice of Concern, Management Actions, and Our Response

On May 6, 2011, we issued a "Notice of Concern"* to the Director of DCAA covering the failure to adequately resolve the independence impairment and to investigate the allegations of misconduct (see Appendix B). We identified nine recommendations to address these failures. In a May 24, 2011 memorandum, the Director concurred with the recommendations and provided a plan for implementing them (see Appendix C). Discussed below is a status of actions that DCAA has taken or planned on each recommendation, and our response to those actions.

1. **Recommendation:** Direct the FAO not to assign any new audits of the contractor to the auditor who has an independence impairment associated with that contractor.

   Management Action: The Deputy Regional Director took the recommended action on May 6, 2011.

   Our Response: This action satisfies the intent of the recommendation. No additional response to this recommendation is required.

2. **Recommendation:** Reassign the Floor Check and Paid Voucher audits referenced above to another DCAA region for completion.

   Management Action: As an alternative, DCAA management reassigned the audits to another FAO within the same region to perform and supervise. In addition, cognizance of all future audit effort of the DOD contractor transferred to this FAO on June 20, 2011.

   Our Response: This action satisfies the intent of the recommendation. No additional response to this recommendation is required.

3. **Recommendation**: Rescind the report issued on the Termination Settlement Proposal, and advise the requester in writing not to rely on its results.

   Management Action: In a May 9, 2011, memorandum, the second Regional Audit Manager took the recommended action.

   Our Response: The management action satisfies the intent of the recommendation. No additional response to the recommendation is required.

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* A Notice of Concern is issued to alert DOD management of significant findings that require immediate attention. By issuing a Notice of Concern, DOD management officials can take proactive steps to mitigate the reported issue.

4. **Recommendation:** Direct another DCAA Region to re-perform and supervise another audit of the Termination Settlement Proposal without relying on any work performed by the auditor.

   Management Action: On May 12, 2011, DCAA initiated a new audit of the Terminal Settlement Proposal that is being independently performed and supervised by another FAO.

   Our Response: The management action satisfies the intent of this recommendation. No additional response to this recommendation is required.

5. **Recommendation:** Issue a memorandum to the auditor which explains the rationale for determining that his independence had been impaired and the actions taken to resolve the impairment.

   Management Action: On May 20, 2011, the second Regional Audit Manager issued a memorandum to the auditor which explains why the auditor's independence toward the DOD contractor had been impaired. In addition, the memorandum commented that the auditor's actions resulted in the rescission of the Termination Settlement Proposal, unnecessary duplication of audit effort, and the waste of audit resources.

   Our Response: This action does not fully satisfy the intent of the recommendation. The May 20, 2011, memorandum, gives an inaccurate impression concerning who was primarily responsible for having to rescind the Termination Settlement Proposal report and expend additional audit resources. FAO management bears the primary responsibility because, had they acted promptly to reassign the impaired audits, the agency would have avoided the need to rescind the report and expend the additional resources they did to rectify the impairment. The auditor had only incurred 51 hours on the impaired audits between the time the impairment surfaced on October 7, 2010, and management discovered the impairment on November 1, 2010. Rather than take appropriate action at that time, FAO management directed the auditor to work on the impaired audits for an additional 443 hours (as depicted in the Table on Page 6). Since it omits material facts, DCAA management should rescind the memorandum and reissue it after making appropriate corrections to it.

6. **Recommendation:** Issue an "Audit Alert" covering management's responsibility for timely and appropriately resolving independence impairments in accordance with GAGAS.

   Management Action: On July 7, 2011, DCAA Headquarters issued the recommended "audit alert," which emphasized the steps that supervisors must promptly take to eliminate independence impairments in accordance with GAGAS.

   Our Response: This action satisfies the intent of the recommendation. No additional response to this recommendation is required.

7. **Recommendation:** Assess the adequacy of the agency's ongoing training and procedures for resolving independence impairments in accordance with GAGAS, and make improvements to help ensure future compliance.

   Management Action: On August 3, 2011, DCAA issued revised training on GAGAS independence standards.

   Our Response: This action does not fully satisfy the recommendation. Although DCAA changed its training on the independence standards, DCAA has provided no evidence indicating that it has assessed related procedures or made procedural improvements to help ensure future compliance.

   In addition, we take exception to two aspects of the revised training. First, the new training does not adequately address the steps supervisors should take when evaluating the impact of an independence impairment relative to work already done on in-process audits. The revised training only indicates that the supervisor must either require the auditor to eliminate the impairment or assign another auditor to perform the work. Second, while DCAA Contract Audit Manual, section 2-S103.1, requires that FAO managers and supervisors coordinate with the regional office (and DCAA Headquarters if necessary) when eliminating *any* personal impairments, the revised training notes this requirement only for impairments which are identified after report issuance.

   On a related note, DCAA should consider requiring FAOs to coordinate the elimination of all personal impairments with DCAA Headquarters, as well as the regional office, to help ensure compliance and consistency. The guidance provided by the Western Regional Office (first Regional Audit Manager) in this case was ineffective for ensuring compliance with GAGAS.

8. **Recommendation:** Develop and issue formal policies and procedures on the proper handling of complaints from contractors.

   Management Action: By September 30, 2011, DCAA will develop and implement the recommended policies and procedures.

   Our Response: The planned management action is responsive to the recommendation. No additional response to this recommendation is required.

9. **Recommendation:** Consider appropriate administrative action for the failure to (a) resolve an independence impairment in accordance with GAGAS and agency policy, and (b) investigate a DOD contractor's allegations of auditor misconduct.

   Management Action: By September 30, 2011, DCAA will consider appropriate administrative action for the failure to adequately resolve the independence impairment. On May 12, 2011, DCAA's Internal Review Directorate established a formal case to investigate the contractor complaints.

Our Response: The planned management action is not fully responsive to our recommendation. The May 24, 2011 memorandum we received from the Director of DCAA does not indicate whether the agency agrees to consider administrative action for the failure of FAO management and the Regional Audit Manager to investigate the complaints of auditor misconduct.

In addition, we discovered that the supervisor included a highly inappropriate comment concerning the contractor complaints in the auditor's performance evaluation for the period ended June 30, 2011. The supervisor commented in the evaluation that the contractor employee statements "corroborated" the initial contractor complaints made against the auditor. This comment is highly inappropriate and improper because DCAA has not conducted an independent investigation and the supervisor did not have adequate evidence to corroborate the complaints. While DCAA's Internal Review Directorate established a formal case to investigate the complaints in May 2011, the Directorate has not yet established an approved plan for conducting the investigation. DCAA should modify the auditor's appraisal to remove any reference to the contractor's complaints.

Accordingly, we request that the Director of DCAA provide additional comments with respect to Recommendations 5, 7, and 9.

Appendix A. Scope and Methodology

We performed this review from January 2011 through September 2011. We reviewed the DOD Hotline complaint to determine if we could substantiate the allegations. As part of our review, we:

- interviewed appropriate DCAA personnel at the cognizant DCAA FAO and the Western Regional Office;
- obtained and reviewed documents pertinent to the complaint, including those maintained by the DCAA FAO, the complainant, and other DCAA personnel; and
- reviewed and applied applicable laws, regulations, and professional standards.

We conducted the review in accordance with the Quality Standards for Inspection and Evaluation.

Use of Computer-Processed Data

We did not rely on computer-processed data to perform this review.

Prior Coverage

In the past 5 years, the DOD Inspector General has issued the following six reports involving Defense Hotline complaints of DCAA:

- Report No. D2011-6-011, Report on Hotline Allegation Regarding Lack of Agency Guidance on the Currency of Audit Testing in the Defense Contract Audit Agency, September 21, 2011
- Report No. D2011-6-010, Failure of Defense Contract Audit Agency, Santa Ana Branch Office to Provide Adequate Support in Response to a Request for Review of Interim Public Vouchers, September 2, 2011
- Report No. D2011-6-008, Hotline Complaint Regarding a Defense Contract Audit Agency Employee Conducting Private for-Profit Tax Business Activity on Government Time and Using Government Equipment, June 28, 2011
- Report No. D-2011-6-007, Hotline Allegations Involving a Field Audit Office in the Defense Contract Audit Agency Central Region, April 15, 2011
- Report No. D-2011-6-003, Hotline Complaint Regarding Allegations of Abusive Behavior by a Supervisor in the Defense Contract Audit Agency Northeastern Region, February 10, 2011

- Report No. D-2011-6-001, Hotline Allegations Involving Management Harassment of a Complainant in the Defense Contract Audit Agency Western Region, October 29, 2010

Appendix B. DOD Inspector General Notice of Concern

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

MAY - 6 2011

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Notice of Concern - Noncompliance Involving Auditor Independence at Defense Contract Audit Agency [redacted] Branch Office

We are issuing this Notice of Concern to alert you of actions taken by the Defense Contract Audit Agency (DCAA), [redacted] Branch Office, which resulted in a significant noncompliance with Generally Accepted Government Auditing Standards. During our review of a Defense Hotline complaint, we learned that Branch Office management allowed an auditor to continue performing audits of a DOD contractor, despite determining that his independence with that contractor had been impaired. DCAA should take immediate steps to resolve the noncompliance, improve related procedures, and take appropriate administrative action.

Background

On October 6, 2010, a [redacted] Branch Office supervisor and an auditor held a meeting with representatives of a DOD contractor to discuss an outstanding request for information. Following the meeting, one of the contractor representatives met privately with the supervisor to advise him that the auditor had exhibited inappropriate behavior toward several contractor employees. Later that day, the supervisor told the auditor about his private discussion with the contractor representative, and counseled him to be professional at all times. The next day, the auditor sent an email to the contractor's President to express his frustration over the claims of inappropriate behavior. Within the email, the auditor wrote in part:

> *[The contractor] has a termination claim that is filled with frivolous costs and I have been diligently working to analyze and question this claim....I also hope you speak to [the contractor's legal counsel] and make him realize that his slanderous accusations will only* ***increase my diligence.*** (names omitted and emphasis added)

The auditor did not include his supervisor on the distribution of this email.

On October 28, 2010, the contractor's legal counsel met with the Branch Office supervisor to discuss his concern that the auditor was no longer objective in performing audits of his company. The legal counsel provided the supervisor with a copy of the auditor's email sent to the contractor President. In addition, the legal counsel provided the supervisor with affidavits from 11 contractor employees who allegedly witnessed the

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auditor's inappropriate behavior. [redacted]

The Branch Office supervisor advised the Branch Manager and Regional Audit Manager of his meeting with the contractor's legal counsel. They mutually agreed that the auditor's independence had been impaired as a result of the email he sent to the contractor's President. On November 2, 2010, the supervisor verbally advised the auditor that DCAA management believed his independence had been impaired and directed the auditor to move his office from the contractor's facility to the Branch Office. However, the supervisor also directed the auditor to continue working on audits of that contractor which had already been assigned to him. The Regional Auditor Manager advised the Acting Deputy Regional Director of these actions taken to resolve the noncompliance.

Independence Impairment

We agree with the Branch Office decision that the auditor's independence toward the contractor had been impaired, based on our review of applicable Generally Accepted Government Auditing Standards (GAGAS). GAGAS 2.10, "Objectivity," states

> *The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional duties. Objectivity includes being independent* ***in fact and appearance*** *when providing audit and attestation engagements,* ***maintaining an attitude of impartiality****, having intellectual honesty, and being free of conflicts of interest. Avoiding conflicts that may, in fact or appearance, impair auditors' objectivity in performing the audit or attestation engagement is essential to retaining credibility.* ***Maintaining objectivity includes a continuing assessment of relationships with audited entities*** *and other stakeholders in the context of the auditors' responsibility to the public.* (emphasis added)

Further, GAGAS 3.02 states:

> *In all matters relating to the audit work, the audit organization* ***and the individual auditor****, whether government or public, must be free from* ***personal****, external, and organizational* ***impairments to independence****, and must avoid the appearance of such impairments of independence.*

An example of a personal impairment listed in GAGAS 3.07 includes "Preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit."

The auditor's email sent to the contractor's President (shown on Page 1 of this memorandum) clearly reflects a lack of objectivity and independence. His characterization of the Terminal Claim as being "filled with frivolous costs" before the completion of the audit process indicates an element of bias. Moreover, the auditor's statement that the "slanderous allegations would only increase my diligence," demonstrates that his objectivity and impartiality toward the contractor had been impaired either in fact or appearance. Moving the employee's office from the contractor's location was one of the necessary steps in eliminating the impairment.

However, we strongly disagree with management's decision to have the auditor continue working on audits of that contractor. This decision is inconsistent with management's responsibility to resolve independence impairments in accordance with GAGAS 3.09, which states:

> *When the audit organization identifies a personal impairment to independence prior to or during an audit, the audit organization should take action to resolve the impairment in a* ***timely manner****. In situations in which a personal impairment is applicable only to an individual auditor or a specialist on a particular audit, the audit organization may be able to eliminate the personal impairment. For example, the audit organization could remove that auditor or specialist from* ***any work on that audit****....*(Emphasis added)

Based on the nature of this personal impairment, all of the auditor's assignments involving the contractor were impacted by the impairment. To resolve the impairment, the Branch Office had an obligation to reassign all of the auditor's assignments involving that contractor to another auditor in a timely manner, and determine the extent to which additional work should be performed or steps redone. The failure of the Branch Office to take these steps resulted in a noncompliance with the GAGAS independence requirement. The Branch Office also did not comply with DCAA Contract Audit Manual (CAM) 2-S103.1b.(5), fourth bullet, which clearly states:

> *No auditor with a personal impairment will be permitted to work on any assignment that is affected by the impairment.*

On November 2, 2010, shortly after management notified the auditor of his independence impairment, the auditor acknowledged the impairment and asked his supervisor to assign his current audit to another auditor. In his email to the supervisor, the auditor wrote:

> *...I would also request that someone else finalize the 4600.002 termination. I have lost respect for this company due to its recent personal attack and think that they could use this fact against DCAA in negotiations because my removal will be viewed as an independence issue.*

Yet, Branch Office management still failed to take action. As of November 2, 2010, the auditor had three assignments involving the contractor. As shown below, our review of the auditor's time charges disclosed that the auditor charged 443 hours to these three assignments after management notified him of the independence impairment (from November 2, 2010 to April 9, 2011).

Assignment No.	Description	Hours Charged (11/2/10 – 4/9/11)
[redacted]2010E17100001	Termination Proposal (Claim)	280
[redacted]2010E10310001	Floor Check	133
[redacted]2011E11015001	Paid Voucher	30
	Total Hours	443

This represented 71 percent of the total direct hours charged by the auditor for this time period. On March 24, 2011, the Branch Office issued its report on the Termination Proposal and questioned 92 percent of proposed costs. DCAA Branch Office management allowed the auditor to conduct the exit conference with the contractor on his own, despite their prior impairment determination and the contractor's allegations of inappropriate behavior.

Finally, we noted that DCAA Branch Office management did not document the steps they took to resolve the independence impairment (e.g., transfer of the auditor to the Branch Office), either in Branch Office files or in communications with the auditor. CAM 2-S103.1(5) states, "The supervisor/FAO manager's resolution of any impairment should be documented." Branch Office management should have prepared a memorandum to the auditor which included their rationale for the independence impairment determination.

Interviews with Western Region Employees

We interviewed the supervisor and branch manager to determine why they had the auditor continue working on the three audits after their independence impairment determination. Regarding the Termination Proposal audit, both the supervisor and branch manager stated that most of the work had already been completed before they identified the impairment. The Branch Manager also commented that the auditor had spent hundreds of hours on the assignment and said, "I don't want to lose those hundreds of hours or, you know, affect the successful completion of the audit." In addition, the supervisor pointed out that "because it [the Termination Proposal audit] was going to go through many levels of review, it would be acceptable for him to complete that audit." (clarification added)

Regarding the Floor Check, both the branch manager and supervisor felt that having the auditor continue working on this audit was acceptable because major parts of the audit were being conducted as an assist audit by another DCAA field office.

We also interviewed the Regional Audit Manager who had cognizance of the Branch Office on November 2, 2010 (hereafter referred to as the initial Regional Audit Manager). He agreed with the Branch Office that the auditor could continue performing the Termination Proposal because the manager and supervisor told him that the field work had been completed. He stated that he instructed the Branch Office to review the impact of the independence impairment on the Termination Proposal and, if necessary, disclose the impairment in the resulting audit report, in accordance with GAGAS. Regarding the remaining audits, his understanding was that the Branch Office would reassign them to another auditor because significant field work still had to be performed. On January 30, 2011, cognizance of the Branch Office transferred to another Regional Audit Manager. The successor Regional Audit Manager told us he approved the issuance of the Termination Proposal audit report, but that neither Branch Office management nor the initial Regional Audit Manager advised him of the auditor's impairment associated with that contractor.

The explanations provided by the supervisor, the Branch Manager, and the initial Region Audit Manager do not justify their actions. Their actions also reflect a fundamental misunderstanding of the underlying GAGAS independence standard. In resolving an independence impairment before or during an audit, GAGAS does not allow the Agency to consider the hours incurred, or the degree to which the field work has been completed. Management's concern over lost auditor hours or other matters must never override their obligation to timely resolve an independence impairment in accordance with GAGAS 3.09. In addition, simply subjecting the audit to a thorough review upon completion would not have eliminated the appearance that the auditor lacked objectivity and independence.

Because management failed to take appropriate and timely action, the legitimacy of any audit findings impacted by the impairment could be challenged on the basis that the auditor lacked objectivity and impartial judgment in conducting the audit and reporting the results. Given their actions in this case, we question whether [redacted] Branch Office management and Western Region management should be relied upon for resolving this impairment in a satisfactory manner. To help ensure objectivity and independence to the extent possible, DCAA should assign any remaining audits impacted by the impairment to another Region for completion. No reliance should be placed on the auditor's work. Regarding the audit report issued on the Termination Proposal, DCAA should rescind the report and notify the requester in writing that it should not be relied upon for any purpose. The Termination Proposal should be redone by another Region, unless negotiations have been completed and another audit would serve no useful purpose.

GAGAS 3.08 states that audit organizations should establish procedures for ensuring the independence standards, including the establishment of a disciplinary mechanism to promote compliance with those procedures. CAM 2-S103.1b.(5) notes that

deviations from the Agency's procedures for ensuring compliance with the GAGAS independence requirements are subject to appropriate disciplinary action. Accordingly, DCAA should consider appropriate administrative action for the failure to exercise proper professional judgment and to comply with GAGAS and applicable Agency procedures.

We do not know the extent to which other significant failures to comply with the GAGAS independence standard have occurred within the Western Region or throughout the Agency. DCAA needs to reassess its current training and procedures for ensuring compliance with the independence standards.

Contractor Complaints

Branch Office management (in consultation with the initial Regional Audit Manager) chose not to investigate the contractor complaints against the auditor. Branch Office management did not even show the complaints to the auditor to obtain his account of the alleged behavior. The supervisor had consulted with a Regional Human Resources Specialist who recommended that the Branch Office investigate the complaints. If accurate, some of the complaints would constitute misconduct and be subject to disciplinary action (for example, [redacted]).

On January 27, 2011, the auditor met with the Branch Manager and supervisor to discuss the independence issue. According to accounts of the meeting from the auditor and supervisor, the Branch Manager suggested that the auditor might have a [redacted] The Branch Manager stated to the auditor that, "People do not lie" when referring to the contractor complaints. This statement was inappropriate since the Branch Office had chosen not to investigate the complaints. We also question why the Branch Manager waited 3 months after receiving the contractor complaints to discuss them with the auditor.

An appropriate and timely investigation of the contractor complaints would have established whether there was sufficient evidence of misconduct on the part of the auditor. It would have also demonstrated that DCAA management took proper action in response to the complaints, rather than seemingly ignore them. DCAA should consider appropriate administrative action for management's failure to take appropriate action in response to the contractor's allegations of misconduct.

Our review disclosed that DCAA does not have formal procedures for investigating contractor complaints of inappropriate auditor behavior. We do not know the frequency in which DOD contractors complain about such behavior. However, in an April 22, 2011 report, we noted that DCAA's Internal Review Department reported a similar incident which occurred in the Northeastern Region. According to the report, a DCAA Northeastern Region branch manager and a supervisor treated an auditor

disrespectfully and unprofessionally when they failed to provide the auditor with DOD contractor complaints against him and failed to conduct an inquiry into the complaints. The report recommended that DCAA Headquarters Policy issue formal guidance on the proper handling of complaints from contractors. DCAA should make the issuance of this guidance a priority.

Recommendations

We recommend that the Director, Defense Contract Audit Agency, take the following actions:

1. Direct the [redacted] Branch Office not to assign any new audits of the contractor to the auditor who has an independence impairment associated with that contractor.
2. Reassign the Floor Check and Paid Voucher audits referenced above to another DCAA Region for completion.
3. Rescind Audit Report No. [redacted] 2010E17100001, dated March 24, 2011, regarding an audit of a Termination Proposal, and advise the requester in writing not to rely on its results.
4. Direct another DCAA Region to re-perform and supervise another audit of the Termination Proposal without relying on any work performed by the auditor.
5. Issue a memorandum to the auditor which explains the rationale for determining that his independence had been impaired and the actions taken to resolve the impairment.
6. Issue an "Audit Alert" covering management's responsibility for timely and appropriately resolving independence impairments in accordance with Generally Accepted Government Auditing Standards.
7. Assess the adequacy of the Agency's ongoing training and procedures for resolving independence impairments in accordance with Generally Accepted Government Auditing Standards, and make improvements to help ensure future compliance.
8. Develop and issue formal policies and procedures on the proper handling of complaints from contractors.
9. Consider appropriate administrative action for the failure to:
    a. resolve an independence impairment in accordance with Generally Accepted Government Auditing Standards and Agency policy, and
    b. investigate a DOD contractor's allegations of auditor misconduct.

Closing Remarks

Please provide a written response to our recommendations by June 6, 2011, including planned corrective actions. We are continuing our review of the underlying DOD Hotline complaint. Once we complete our review, we will issue a report on the issues addressed in this memorandum along with any additional matters that might come to our attention. If you have any questions regarding this memorandum, please contact me at (703) 604-8877, or Ms. Meredith Long-Morin at (703) 604-8739 (meredith.morin@dodig.mil).

Carolyn R. Davis
Assistant Inspector General
for Audit Policy and Oversight

Appendix C. Defense Contract Audit Agency Comments to Notice of Concern

DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

May 24, 2011

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR POLICY AND OVERSIGHT, OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Response to Department of Defense Inspector General (DoDIG) Notice of Concern – Noncompliance Involving Auditor Independence at Defense Contract Audit Agency (DCAA), [redacted] Branch Office

Thank you for the opportunity to respond to the notice of concern.

We agree with the DoDIG concern, dated May 6, 2011, about the Field Audit Office (FAO) management allowing an auditor to continue performing audits of a DoD contractor even after the same management determined that the auditor's independence with that contractor had been impaired.

DODIG Recommendations.

1. Direct the [redacted] Branch Office not to assign any new audits of the contractor to the auditor who has an independence impairment associated with that contractor.

   DCAA Response. Concur. On May 6, 2011, the FAO was directed to remove the auditor from current work related to the subject contractor and to not assign him future work at that contractor. We confirmed that the auditor has been removed from all work at this contractor.

2. Reassign the Floor Check and Paid Voucher audits referenced above to another DCAA region for completion.

   DCAA Response. Concur. The DoDIG agreed with our alternative plan of using an audit team within the Western Region that had no prior involvement with this issue. On May 12, 2011, we finalized the establishment of an audit team to perform this function. The auditor, supervisory auditor, FAO manager, and Regional Audit Manager (RAM), are not associated with the management chain of command of the [redacted] Branch Office. In addition, neither the current Deputy Regional Director nor the Regional Director was implicated in the notice of concern.

May 24, 2011

SUBJECT: Response to Department of Defense Inspector General (DoDIG) Notice of Concern – Noncompliance Involving Auditor Independence at Defense Contract Audit Agency (DCAA), [redacted] Branch Office

3. Rescind Audit Report No. [redacted] 2010E17100001, dated March 24, 2011, regarding an audit of a Termination Proposal, and advise the requester in writing not to rely on its results.

   DCAA Response. Concur. We rescinded the subject audit report and advised the requester in writing not to rely on its result on May 9, 2011.

4. Direct another DCAA Region to re-perform and supervise another audit of the Termination Proposal without relying on any work performed by the auditor.

   DCAA Response. Concur. The DoDIG agreed with our alternative plan of using an audit team within the Western Region that had no prior involvement with this issue. On May 12, 2011, we finalized the establishment of an audit team to perform this function. The auditor, supervisory auditor, FAO manager, and Regional Audit Manager (RAM), are not associated with the management chain of command of the [redacted] Branch Office. In addition, neither the current Deputy Regional Director nor the Regional Director was implicated in the notice of concern.

5. Issue a memorandum to the auditor which explains the rationale for determining that his independence had been impaired and the actions taken to resolve the impairment.

   DCAA Response. Concur. On May 20, 2011, we issued a memorandum to the auditor that explained the rationale for determining that his independence had been impaired and the actions taken or to be taken to resolve the impairment.

6. Issue an "Audit Alert" covering management's responsibility for timely and appropriately resolving independence impairments in accordance with Generally Accepted Government Audit Standards (GAGAS).

   DCAA Response. Concur. We agree that by June 30, 2011, we will issue guidance on management's responsibility for timely and appropriately resolving GAGAS independence impairments.

7. Assess the adequacy of the Agency's ongoing training and procedures for resolving independence impairments in accordance with Generally Accepted Government Audit Standards, and make improvements to help ensure future compliance.

   DCAA Response. Concur. We will complete the assessment of the training and procedures by July 31, 2011. By September 30, 2011, we will implement any improvements identified to help ensure future compliance.

May 24, 2011

SUBJECT: Response to Department of Defense Inspector General (DoDIG) Notice of Concern – Noncompliance Involving Auditor Independence at Defense Contract Audit Agency (DCAA), [redacted] Branch Office

8. Develop and issue formal policies and procedures on the proper handling of complaints from contractors.

   DCAA Response. Concur. We will develop and issue guidance for handling complaints from contractor by September 30, 2011.

9. Consider appropriate administrative action for the failure to:
   a. resolve an independence impairment in accordance with Generally Accepted Government Auditing Standards and Agency policy.
   b. investigate a DoD contractor's allegations of audit misconduct.

   DCAA Response. Concur. By September 30, 2011, we will consider appropriate administrative action for the persons involved in the failure to appropriately resolve the independence impairment. On May 12, 2011, the DCAA Internal Review Directorate established a formal case to investigate the original allegations the contractor made against the auditor.

Please direct any questions or concerns to the undersigned at (703) 767-3200.

for Patrick J. Fitzgerald
Director

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Inspector General
Department of Defense