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

December 15,2003

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Comments and Observations on the Quality Control Review of Defense contract Audit Agency Audit Operations (Report No. D-2004-6-003)

We have reviewed the Defense Contract Audit Agency (DCAA) audit operation's system of quality control for the 3.-year period ended September 30,2002, and have issued our report D-2004-6-003 dated December 15, 2003- The report contained an unqualified opinion, This memorandum, along with the reports identified in the attachment to the opinion report, should be read in conjunction witb that report.

An audit organization's quality control policies and procedures should be appropriately comprehensive and suitably designed to provide reasonable assurance that the objectives of quality control will be met. We tested compliance with the DCAA system of quality control to the extent we considered appropriate.

Our review would not necessarily disclose all weaknesses in the system or all instances of noncompliance with it because our review was based on selective tests. There are inherent limitations that should be recognized in considering the potential effectiveness of any quality control system. In performing most control procedures, departures can result from misunderstandingof instructions, mistakes of judgment, carelessness, or other personal factors. Projection of any evaluation of a quality control system to future periods is subject to the risk that one or more procedures may become inadequate because of changes in conditions or that the degree of compliance with procedures may deteriorate. As a result of our review, Attachment 1 contains comments and observations that were considered but did not affect our overall opinion. The DCAA response to a draft of the recommendations related to the comments and observations indicated concurrence or proposed an acceptable alternative. A copy of the November 12,2003, DCAA response to the draft memo is included as Attachment 2 to this document.

Please call me or Ms. Patricia A. Brannin, Assistant Inspector General for Audit Policy and Oversight at (703) 604-8802 if you have any questions.

L. Jerry Hansen
Deputy Inspector General
Inspections and Policy

Attachments

Comments and Observations

As a result of our review, we have the following comments and observations that were considered but did not affect our overall opinion.

Noteworthv Accomplishments

From FY 1999 through FY 2003, DCAA dedicated an average of 17.3 staff years annually to implement the new quality assurance program. This significant time and effort was spent on planning and performing the quality assurance reviews; following up on the identified deficiencies at certain field audit offices (FAOs); formulating corrective actions such as revised risk assessment procedures; and coordinating with the OIG on every phase of their review program. During the 3-year cycle, DCAA visited almost all field audit offices and reviewed more than 400 audit assignments in the 4 major audit areas—forward pricing, internal control reviews, incurred cost audits, and "all other" audits. DCAA also conducted a separate review of General Standards (Qualifications and Independence). As we completed our reviews and identified various deficiencies, improvements, and enhancements to the quality assurance program, the headquarters Quality Assurance Division worked with us in a constructive manner to implement our recommendations and suggestions. Over the last 4 years, the quality assurance staff has gained extensive experience and demonstrated a highly professional approach to performing the internal quality assurance function. Their efforts in identifying deficiencies, formulating and expediting corrective actions, briefing management, and following up on deficiencies have significantly improved the DCAA quality control system and DCAA audits.

Issues Identified in Quality Assurance Reviews and IG DoD Reports

The DCAA quality assurance reviews and the IG DoD reports (listed in Opinion Report D-2004-6-003, Attachment, dated December 15,2003) identified significant issues related to compliance with Government Auditing Standards (GAS). In response to the identified issues, DCAA implemented numerous and extensive corrective actions. The main issues related to:

- audit planning,
- audit evidence,
- working papers,
- continuing professional education (CPE),
- supervision,
- noncompliances and illegal acts,
- quality control, and
- reporting on agreed upon procedures.

The corrective action they took included developing training, revising the DCAA Contract Audit Manual (CAM), revising standard audit programs, changing and improving the Automated Planning and Performance System, developing a new working paper checklist, and emphasizing documentation requirements and quality control procedures.

Our quality control reviews of single audits found that DCAA did not adequately plan and perform the review of internal controls over compliance and compliance with the requirements for major Federal programs. We had to obtain significant oral explanations as well as perform additional review procedures to determine that the audit of Federal programs met the intent of Office of Management and Budget Circular No. A-133 requirements. Recommendations and corrective actions specific to the reviewed audits were addressed in our reports.

Details on the issues and corrective actions taken are discussed in the body and appendixes of the IG DoD reports. Continued diligence in these areas is necessary to maintain an effective quality system.

OIG Issues Not Previously Reported

- Scope of DCAA Quality Assurance Review of General Standards

Our review identified a deficiency in the planning and implementation of the DCAA quality assurance review of the GAS General Standards. DCAA covered some of the aspects of the General Standards (Qualifications, Independence, and Due Professional Care) as part of their four headquarters-led internal quality assurance reviews of forward pricing, internal controls, incurred cost, and "all other" audits. DCAA included questions on its review checklists covering due professional care, external impairments to independence, and staff qualifications. In addition, during its headquarters-led internal quality assurance review of "all other" audits, DCAA tested CPE and specialized training. DCAA planned to cover certain other aspects of Independence and Qualifications standards during the sevarate review of GAS General Standards. DCAA collected information on the various policies and procedures that implemented the selected aspects of the Oualifications and Indevendence standards and analyzed the procedures to determine-what other oversight mechanisms were in place to monitor the applicable policies and procedures. DCAA did not perform any independent testing to determine whether they were complying with the various requirements specified in the Qualifications and Independence standards. Recommendation: The Director, Defense Contract Audit Agency revise the quality control program to include testing or monitoring of the various policies and procedures relating to hiring, career development, staff qualifications and assignment, ethics program, auditor rotation program, and auditor independence requirements.

- **Staff Qualifications**

Our review of staff qualifications found that 3 of 26 new supervisory auditors failed to take Course 8562, "DCAA Personnel Management" (or the previously required course if applicable) within their first 6 months as supervisors as required by the Supervisory Development Curriculum listed in Chapter 21, Training and Development, of the DCAA Personnel Management Manual. **Recommendation:** The Director, Defense Contract Audit Agency review the requirement to obtain supervisory training within the first 6 months to determine whether this time frame is practicable and to ensure that newly promoted supervisors obtain the required training within the time frame established.

- **Continuing Professional Education**

During our initial review of the DCAA quality assurance program, we identified deficiencies in how DCAA granted and documented CPE for staff conferences and that DCAA did not track or have CAM guidance on the requirement that 24 hours of the required 80 hours be in a subject directly related to the government environment and to government auditing. Based on discussions with DCAA, they corrected the deficiency on granting and documenting CPE; however, the CAM still does not address the 24-hour requirement. **Recommendation:** The Director, Defense Contract Audit Agency revise the Contract Audit Manual to add the requirement that 24 of the 80 continuing professional education hours be in subjects directly related to government environment and to government auditing.

- **DCAA Ethics Program**

We reviewed the DCAA ethics program in the external peer review because DCAA references the DoD Directive 5500.7, "Joint Ethics Regulations" (JER) in its general audit guidance on complying with the GAS on Independence (CAM 2-203 b). Also, DCAA audits nongovernmental entities (Defense contractors); therefore, issues addressed in the various ethics laws and regulations can directly relate to the requirements in GAS on personal impairments to auditor independence. The DCAA ethics program needs greater emphasis and visibility to ensure that all employees understand the requirements of the various laws and regulations related to ethical behavior. Our review identified some requirements of the ethics program that DCAA did not consistently comply with. Specifically, DCAA needed to ensure that the required letters of delegations were issued, that all new employees entering covered positions filed the required OGE Form 450 (Confidential Financial Disclosure Report) timely, and that required documentation for initial ethics training for new hires is properly maintained. The Designated Agency Ethics Official (DAEO) has already acted to correct these deficiencies. In addition, we identified some best practices that would improve the visibility and effectiveness of the DCAA ethics program. The DAEO has informed us

that many of the best practices such as an employee survey, written policies and procedures on responsibilities, articles for the DCAA Bulletin, a Web site for the ethics program on the DCAA intranet, enhancements to new employee initial ethics orientation, employee self-certification of annual ethics training, and an ethics segment as part of appropriate DCAA courses are already planned for implementation or being considered.

Additionally, we consider enhancements to the DCAA ethics training program to be of utmost importance. Specifically, the JER requires an agency to provide an annual ethics briefing to all employees in a covered position **(JER** 11-301). Currently, DCAA requires an annual ethics briefing only for those employees required to file a financial disclosure form (GS-13s and above and impact card holders). However, two regions have recognized the importance of annual ethics training and instituted the requirement that all auditors and supervisors receive an annual ethics briefing or training. The **JER** (Chapter 11) allows the agency to provide ethics training to noncovered employees, and one recognized best practice is to train nonfilers as well. **Recommendation:** The Director, Defense Contract Audit Agency adopt annual ethics training for all employees.

- **Professional Standards and Ethical Issues**

DCAA also needs to improve the process for monitoring auditor independence. The new GAS on independence, Amendment No. 3, imposed additional requirements effective January 1,2003. Although our review covered audits performed before the implementation date of this revision, discussions with DCAA identified the need for a point of contact for Independence and other professional auditor ethics issues separate **from** the DAEO. DCAA should designate a specific agency headquarters position responsible for providing guidance and answering questions related to auditor independence and other professional ethics issues. The appointee should coordinate closely with the DAEO since conflicts of financial interest and impairments to independence are closely related for DCAA employees. All DCAA employees should be notified and periodically reminded of who to contact and what the procedures are for obtaining information and advice on independence and professional ethics issues. **Recommendation:** The Director, Defense Contract Audit Agency designate a specific agency headquarters position responsible for providing guidance and answering questions related to auditor independence and other professional ethics issues.