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Can Truly Independent Auditors Be Co-opted?



The Defense Contract Audit Agency (DCAA) plays a critical role in protecting the interests of taxpayers by monitoring financial aspects of federal defense procurement contracts and subcontracts. The DCAA provides auditing, accounting, and financial advisory services in connection with negotiation, administration, and settlement of contracts and subcontracts to the Department of Defense (DOD) and other federal agencies. These

services must comply with generally accepted government auditing standards (GAGAS) promulgated by the U.S. Government Accountability Office (GAO). The standards provide guidance to auditors performing government audits and other reviews to maintain competence, integrity, objectivity, and independence.

On July 22, 2008, the GAO issued a disturbing report, *DCAA Audits: Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, that illustrates how the objectivity of auditors, who are expected to function on a truly independent basis, can be co-opted by pressures from the contractor and DOD contracting community as well as other factors.

Whistleblower complaints on the GAO's FraudNet hotline triggered investigations of 14 DCAA audits and forward-pricing audit issues in three California DCAA field offices. The GAO review involved more than 100 interviews and included cooperation with the DOD Office of Inspector General and its Defense Criminal Investigative Service. The DCAA audits in question were issued from 2003 to 2007.

Founded in 1965, the DCAA is under the overall authority, direction, and control of the Under Secretary of Defense (Comptroller and Chief Financial Officer), who is one of only five Under Secretaries reporting directly to the Secretary of Defense. The Under Secretary of

Defense (Acquisition, Technology, and Logistics) oversees the Defense Contract Management Agency (DCMA), which actually administers contracts relating to the DOD acquisition system, research and development, installation management, military construction, procurement, and more. This high-level reporting relationship should provide sufficient independence for auditors of the DCAA to report effectively on any ethical missteps.

Unfortunately for taxpayers, ethical transgressions in defense contracting have been with us for decades. The Packard Commission was created more than 20 years ago to develop solutions to continuing scandals that had eroded public confidence in the defense industry, including reported instances of waste, fraud, and abuse within both the industry and the DOD. One of the Packard Commission's major recommendations was to improve the industry environment and public confidence by placing greater emphasis on self-governance. The Commission's January 1986 report notes:

"To assure that their houses are in order, defense contractors must pro-

mulgate and vigilantly enforce codes of ethics that address the unique problems and procedure incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance.”

The Defense Industry Initiative on Business Ethics and Conduct (DII), a voluntary organization consisting of virtually all of the major defense contractors, was organized later in 1986 to coordinate and facilitate these efforts. This organization continues to function today (www.dii.org), requiring annual certification of a signatory company’s compliance with the DII’s six principles of business ethics and conduct:

1. Each company will have and adhere to a written code of business ethics and conduct.
2. A company’s code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.
3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code without fear of retribution for such reporting.
4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.
5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.
6. Each company must have pub-

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lic accountability for its commitment to these principles.

The DCAA appears to use many quality and ethical control strategies. In addition to supervisory and other reviews, methods include the independence standards of GAGAS, reliance on contractor ethics initiatives, and the mandatory requirements contained in the Truth in Negotiations Act. All seemed ineffective in the audits reviewed by the GAO in July’s report. The allegations of failure to meet standards were all substantiated: (1) Work papers didn’t support reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes, and (3) sufficient audit work wasn’t performed to support audit opinions and conclusions. Seven contractors were involved, two of which are among the top five in terms of contract value.

One of the most glaring examples of a lack of independence cited in the GAO report was the finding of collusion. The GAO found that “contractor officials and the DOD contracting community improperly influenced

the audit scope, conclusions, and opinions of some audits—a serious independence issue.” In other words, there was an upfront agreement between the resident auditor and contractor executives regarding which records would be selected for audit and the decision that the audit opinion would be based on final and corrected documents after several DCAA reviews. Even after all this advance effort, there was sufficient evidence to support a determination of systems inadequacy.

When the contractor objected to the draft findings at the exit conference, the DCAA resident auditor replaced the original supervisor and senior auditor and threatened personnel action if the senior auditor didn’t change the work papers and draft opinion. According to the senior auditor, whom GAO interviewed, he initially refused to make the changes but later did so after being pressured by the resident auditor, who didn’t want the report to differ from other recent opinions. An Air Force official told GAO that he advised the DCAA senior auditor not to “lose his job” over the dis-

agreement and to go ahead and make the necessary changes to the working papers.

Another disturbing finding reported by the GAO is the lack of available experienced staff to complete the analysis of complex cost data required by the Federal Acquisition Regulation (FAR) and other audits. According to DCAA data, planned downsizing has decreased the number of auditors from almost 6,000 in 1989 to about 3,500 in fiscal 2007—despite significant increases in military spending during that period for the Gulf war and Iraq war. Further, the DOD strategy of outsourcing functions previously performed by military personnel increased the proportion of total defense spending allocated to contractors. DCAA auditors told the GAO that the limited number of hours allowed for their audits and the number required to be completed directly affected the sufficiency of audit testing.

Perhaps most disturbing is that the GAO identified a pattern of frequent management actions that served to intimidate the auditors being interviewed and to create an abusive environment. In this environment, some auditors “were hesitant to speak to [the GAO] even on a confidential basis.” An ethical culture in the organization is critical to the proper functioning of controls.

According to a July 23, 2008, press release from Senators Joseph Lieberman (I.D.-Conn.) and Susan Collins (R.-Maine), the two Senate addressees of the GAO report, mismanagement of federal contracts is one of the biggest operational challenges facing the federal government. The two Senators coauthored comprehensive legislation, passed by the Senate, to address the weak over-

sight and lack of competition in contracting. The website of the report’s House of Representatives addressee, Henry Waxman (D.-Calif.), didn’t contain any information about his reaction to the GAO findings.

There are several lessons to be learned from this situation. The first is that even a very comprehensive control system may be unable to assure successful outcomes if those charged with oversight—in this case, Congress—fail to perform their function effectively and on a timely basis. The GAO refers to a January 2007 report, *High-Risk Series: An Update*, which states, “[The] DOD is not able to assure that it is using sound business practices to acquire the goods and services required to meet the needs of U.S. warfighters.” The phrase “high risk” in the report’s title refers to a greater vulnerability to fraud, waste, abuse, and mismanagement.

The second lesson is that cost-pinching reductions in resources devoted to auditing efforts may have counterproductive results. Although the current report notes that non-compliance with GAGAS has had an unknown effect on the government, “downsizing of contract oversight staff in the 1990s coupled with hundreds of billions of dollars in increased contract spending since 2000 has exacerbated the risks associated with DOD contract management.” Perhaps the cost-saving business model of stationing a resident auditor at many contractor locations provides too much of an opportunity for auditors to become familiar with contractors, resulting in loss of independence.

The DCAA website notes that there are 300 field audit offices (FAO) and suboffices located throughout the United States and overseas. An FAO is

identified as either a branch office or a resident office. Suboffices are established by regional directors as extensions of FAOs when required to furnish contract audit service more economically. With so many auditors based in such close proximity to their audit clients, employing traveling auditors assigned to audit multiple contractors is possibly the only way auditors can function with independence. This structure would prevent auditors from having constant contact with the same set of contractor executives and military officers and would provide a base removed from all contractor organizations, where independence can be regularly reinforced.

The third lesson to be learned is the importance of regularly reinforcing an ethical culture. The federal government provides considerable guidance for achieving ethical success. Beyond GAGAS, available governmental guidance includes the work of the DOD Standards of Conduct Office and the U.S. Office of Ethics. Despite these efforts, however, the DCAA seems to need a much more vibrant ethical culture to sustain sufficient independence to perform its mission.

Ethics is a matter of the heart and not just legal rules of the head. ■

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