Oversight Report

CONTRACTOR SELF-GOVERNANCE PROGRAMS

Report Number D-2000-6-006 April 25, 2000

Office of the Inspector General
Department of Defense

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Acronyms

AICPA	American Institute of Certified Public Accountants
CAS	Cost Accounting Standard
DCAA	Defense Contract Audit Agency
DCAM	DCAA Contract Audit Manual
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DLA	Defense Logistics Agency
FAR	Federal Acquisition Regulation
SAS	Statement on Auditing Standards

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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April 25, 2000

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation Report on Contractor Self-Governance Programs
(Report No. D-2000-6-006)

We are providing this evaluation report for your information and use.

Because this report contains no recommendations, no written comments were required, and none were received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the staff throughout the evaluation. Questions should be directed to Mr. Wayne C. Berry at (703) 604-8789 (wberry@dodig.osd.mil) or Ms. Diane H. Stetler at (703) 604-8737 (dstetler@dodig.osd.mil). See Appendix B for the report distribution. The evaluation team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2000-6-006 **April 25, 2000**
(Project No. 9OC-9006)

Contractor Self-Governance Programs

Executive Summary

Introduction. DoD prime contract awards for more than $25,000 totaled $125 billion during FY 1998. A properly implemented and effective contractor self-governance program allows DoD to limit its oversight of the acquisition process. Self-governance, also known as corporate governance, is a process through which a company takes responsibility for implementing and enforcing legal and ethical conduct. The key component of self-governance is a strong and effective ethics program. An ethics program consists of policies and procedures that define and implement the company's code of conduct. An ethics program should establish a culture within a company that promotes prevention, detection, and resolution of instances of conduct that do not conform to Federal, State, and local law; Federal and DoD contract regulations; and the company's own internal ethical and business policies and procedures.

Evaluation Objectives. The objective of the evaluation was to determine the adequacy of the Defense Contract Audit Agency reviews and reports on contractor self-governance programs.

Evaluation Results. The Defense Contract Audit Agency performs a review of a contractor's ethics program as part of its internal control system review of the control environment and accounting system. The review did not, however, cover all elements of a management control system as defined in the Defense Federal Acquisition Regulation Supplement subpart 203.70, "Contractor Standards of Conduct." Therefore, although the internal control review covered the areas noted in the auditing standards, it did not address the additional areas unique to the DoD business environment. In addition, the audit coordination process between audit offices cognizant of certain contractor corporate offices and those cognizant of related contractor entities needed improvement. Finally, improvements could have been made to the testing of controls for certain audit steps. For details of the evaluation results, see the Finding section of the report.

Management Actions. In May 1999, the Defense Contract Audit Agency clarified its audit guidance for testing controls. Management agreed to revise existing audit guidance to ensure appropriate coverage of the criteria in Defense Federal Acquisition Regulation Supplement 203.7001, "Procedures." Management will also clarify guidance on audit coordination between offices cognizant of certain contractor corporate offices and those cognizant of related contractor entities. These actions are fully responsive to our concerns; therefore, no recommendations have been made.

Management Comments. We provided a draft of this report on March 13, 2000. Because this report contains no recommendations, no written comments were required, and none were received. Therefore, we are publishing this report in final form.

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Background

DoD annually conducts business with thousands of prime contractors and hundreds of thousands of other suppliers, vendors, and subcontractors. In FY 1999, DoD prime contract awards for more than $25,000 totaled $125 billion. The top 25 contractors and their subsidiaries received $58 billion, or 46.4 percent of all contract awards for more than $25,000. The top 100 DoD contractors and their subsidiaries received $75.5 billion, or 60.3 percent of all awards, primarily for aircraft, missile/space systems, ships, and electronics and communications equipment. For DoD to successfully procure and distribute all the goods and services it requires, DoD and its contractors must work harmoniously with each other. No matter how many auditors, inspectors, investigators, and procurement or contracting officials DoD employs, they cannot fully oversee DoD contractors and completely protect DoD and the taxpayers' interests on their own. Although DoD oversight is needed, the process can work efficiently and effectively only if contractors implement appropriate self-governance activities.

Self-governance, also known as corporate governance, is a process through which a company takes responsibility for implementing and enforcing legal and ethical conduct. The key component of self-governance is a strong and effective ethics program. An ethics program consists of policies and procedures that define and implement the company's code of conduct. As part of the process, a company should also implement compliance monitoring systems. An ethics program should establish a culture within a company that promotes prevention, detection, and resolution of conduct that does not conform to Federal, State, and local law; Federal and DoD contract regulations; and the company's own internal ethical and business policies and procedures.

Packard Commission. In response to reported DoD contractor abuses, the President's Blue Ribbon Commission on Defense Management (the Packard Commission) was formed in 1985 to review DoD industry relations and make recommendations for improvements. In 1986, the Packard Commission issued its final report, which stated that major improvements in contractor self-governance were essential. The report recommended that contractors issue and enforce written codes of conduct addressing their unique situations; establish procedures for employees to report apparent misconduct directly to senior management or the audit committee; provide training to employees on internal policies and procedures relating to ethics; establish compliance monitoring systems; develop and implement a system of internal controls relating to its ethics program; and give the independent audit committee the responsibility for overseeing corporate compliance programs.

Defense Industry Initiatives on Business Ethics and Conduct. In response to the Packard Commission report, DoD industry leaders committed themselves to adopting and implementing principles of business ethics and conduct that address their corporate responsibilities under Federal procurement laws. Many large DoD contractors joined and pledged to establish and adhere to written codes of ethics; train their employees in these codes; encourage employees to report violations of the codes without fear of retribution; monitor compliance with laws relating to DoD procurement; adopt procedures for voluntary disclosure of violations and take needed corrective actions; participate in an

annual best practices forum to share experiences in implementing the initiatives; and have outside or nonemployee members on their boards of directors review compliance with the initiatives.

Management Controls for an Ethics Program. The Defense Federal Acquisition Regulation Supplement (DFARS) subpart 203.70, "Contractor Standards of Conduct," provides elements of a system of management controls for a contractor ethics program. These elements closely parallel those established by the Defense Industry Initiatives, including:

- a written code of business ethics and conduct and an ethics training program for all employees;
- periodic reviews of company business practices, procedures and policies, and internal controls for compliance with standards of conduct;
- a mechanism such as a hotline for employees to report suspected improper conduct, and instructions that encourage employees to make such reports;
- internal and external audits, as appropriate;
- disciplinary action for improper conduct;
- timely reporting to appropriate Government officials of any suspected or possible violation of law in connection with Government contracts or any other irregularities in connection with such contracts; and
- full cooperation with any Government agencies responsible for either investigation or corrective actions.

If properly implemented, these elements should promote an effective ethics program.

Contract Awards. Federal Acquisition Regulation (FAR) subpart 9.1, "Responsible Prospective Contractors," provides policies, procedures, and standards for determining whether a prospective contractor is responsible. The FAR requires contracting officers to determine that prospective contractors are responsible. One of the seven standards in FAR 9.104-1 for determining responsibility is that the contractor must have a satisfactory record of integrity and business ethics.

DoD Use of Contractor Ethics Program Information. Current regulations do not require other DoD agencies and departments, such as the Defense Contract Management Agency (DCMA), to routinely review or use information directly related to a contractor's ethics program during the contracting process. Contracting officers can consider relevant information, if available, during determination of a prospective contractor's present responsibility or evaluation of a contractor's past performance. In the past, the Defense Logistics Agency (DLA) Office of General Counsel has reviewed some contractor ethics programs on request. However, the DLA Office of General Counsel headquarters personnel have not been requested to perform an ethics program review since 1996. In general, DoD officials responsible for establishing settlement

agreements make the most direct use of information about a contractor's ethics program. These officials may review a contractor's ethics program before and after developing a settlement agreement in lieu of suspension or debarment. As part of this process, DoD officials may use Defense Contract Audit Agency (DCAA) internal control system reports containing information on a contractor's ethics program. Such information may also be helpful if a situation arises involving application of the Federal sentencing guidelines.

Objectives

The overall evaluation objective was to determine the adequacy of the DCAA reviews and reports on contractor self-governance programs. Specifically, we determined whether DCAA appropriately assessed and reported on the adequacy of contractor self-governance programs, such as employee awareness training, contractor hotlines, and voluntary disclosures. See Appendix A for a discussion of the evaluation scope and methodology and prior coverage.

Defense Contract Audit Agency Audit Coverage of Contractor Ethics Program

Since FY 1995, the DCAA has performed reviews of a contractor's ethics program as part of its internal control system reviews of the control environment and accounting system. The review did not, however, cover all elements of a management control system as defined in the DFARS. Therefore, although the internal control system review covered the areas noted in the auditing standards, it did not address the additional areas unique to the DoD business environment. The audit coordination between DCAA offices cognizant of corporate locations and those offices cognizant of associated contractor entities also needed improvement. Finally, we identified instances at each of the three offices visited where improvements could have been made to the testing of internal controls. Procedures for coordinating audit work did not adequately address some situations involving corporate offices and associated contractor entities. Weaknesses in performing compliance testing when needed were caused by unclear audit guidance; however, during our evaluation, DCAA management clarified the pertinent guidance, resolving the issue. Enhanced audit coverage of a contractor's control environment will lead to improved risk assessments and allow DCAA to better allocate its limited audit resources to higher-risk contractors with inadequate ethics programs. In addition, by performing additional audit work to include the DFARS criteria, DCAA can provide information to contracting officers and DoD officials that can be used to evaluate a contractor's past performance and present responsibility. This additional information can also be the basis for increasing or decreasing Government oversight at a contractor location.

Internal Control System Audit and Risk Assessment

Government auditing standards require auditors to obtain a sufficient understanding of the contractor internal control structure as a basis for assessing risk. The auditor uses this assessment of control risk to properly plan the audit and to determine the nature, timing, and extent of the testing needed.

Internal Control System Review Process. In FY 1995, DCAA instituted a new process for assessing and documenting the control risk for major contractors. The new process incorporated the requirements of the Statement on Auditing Standards (SAS) No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit," for assessing control risks. The DCAA determined that 10 common accounting and management systems existed in the contract audit environment. The 10 systems selected for standard internal control reviews included: control environment and overall accounting controls, general electronic data processing system, budget and planning system, purchasing system, material system, compensation system, labor system, indirect and other direct cost system, billing system, and estimating system.

The DCAA then established standard control objectives and associated audit procedures for each system. DCAA included the following factors in its assessment of the control environment:

- integrity and ethical values,
- board of directors or audit committee participation,
- organizational structure, and
- assignment of authority and responsibility.

SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55"

The American Institute of Certified Public Accountants (AICPA) auditing standards define internal control as a "process--effected by an entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations." Internal control consists of the control environment, risk assessment, control activities, information and communication, and monitoring.

Control Environment. The control environment functions as the foundation for the other four components. It establishes the organizational tone that influences employee values and decisionmaking and provides discipline and structure. The auditor should consider the following factors in evaluating an entity's control environment:

- integrity and ethical values,
- commitment to competence,
- board of directors or audit committee participation,
- management philosophy and operating style,
- organizational structure,
- assignment of authority and responsibility, and
- human resource policies and practices.

Other Considerations. The auditor must also assess internal controls in light of the entity's size; organizational and ownership characteristics; the nature of the entity's business; the diversity and complexity of the entity's operations; the entity's methods of transmitting, processing, maintaining, and accessing information; and applicable legal and regulatory requirements.

An effective control environment should reduce the chance of improper conduct by management. Custom, corporate culture, and the corporate governance

system can hinder, but not completely prevent, management from performing irregularities. A control environment consisting of an effective board of directors, audit committee, and internal audit department should also diminish the possibility of irregularities. On the other hand, a control environment or corporate culture can minimize the effectiveness of other elements of the internal control system. For instance, management incentives based on increases in stock value could result in irregularities.

Tests of Controls. The auditor should consider both the essence of the controls and their impact as a whole. Because entities may write policies establishing controls but not properly implement the controls, auditors should concentrate on understanding the substance of the controls (how they are implemented) versus their form (what the policies say).

DCAA Audit Guidance

Current DCAA audit guidance does not consider all the criteria listed in DFARS 203.7001 as applicable to a good management control system. The standard audit guidance in the "DCAA Contract Audit Manual," DCAAM 7640.1 (DCAM) partially addresses five elements and does not cover the remaining two elements. By revising the audit guidance to include all the elements listed in the DFARS, DCAA internal control reviews and the associated risk assessments will provide a more complete picture of a DoD contractor's control environment. Specifically, we asked DCAA management to consider the following revisions:

- Enhancing guidance, to include requesting a system description from the contractor, if available. (DFARS 203.7001[a])

- Adding guidance to verify that a contractor's ethics training program covers all employees. (DFARS 203.7001[a][1])

- Adding guidance to verify that the contractor has policies and procedures in place that require timely reporting to appropriate Government officials of any suspected or possible violation of law or suspected irregularity in connection with a Government contract. (DFARS 203.70001[a][6])

- Adding guidance to verify that the contractor has policies and procedures that require full cooperation with any Government agency responsible for investigations or corrective actions. (DFARS 203.7001[a][7])

- Enhancing or clarifying existing guidance to specify that the auditor should determine whether the contractor has an internal reporting mechanism, such as a hotline, that employees can use to report suspected instances of improper conduct, and whether employees are encouraged to do so. (DFARS 203.7001[a][3])

- Enhancing or clarifying existing guidance to emphasize that the contractor should conduct periodic reviews of company business

practices, procedures, policies, and internal controls for compliance with standards of conduct and unique requirements of Government contracting. (DFARS 203.7001[a][2])

- Clarifying existing guidance of internal audits being performed. (DFARS 203.7001[a][4])

- Clarifying existing guidance of external reviews being performed relating to a contractor's ethics program instead of the internal control system. (DFARS 203.7001[a][4])

- Adding an audit step to determine whether the contractor posts the DoD Hotline poster if it does not have an internal reporting mechanism. (DFARS 203.7001[b])

DCAA Audit Coverage

Board of Directors, Audit Committee, and Internal Audit Staff. Our review found that at one of the three fieldwork locations, the audit coverage of this area could be improved with better audit guidance. Existing guidance does not differentiate between reviewing the board of directors and the audit committee. Each group performs different control activities. In addition, external groups such as the AICPA, the Institute of Internal Auditors, and the Securities and Exchange Commission have increased their emphasis on the importance of the audit committee, providing additional guidelines for audit coverage that may not have existed 4 years ago. Therefore, we suggested to DCAA management that they consider amending the existing audit guidance as follows:

- Revise guidance to provide a separate review of the board of directors and the audit committee. The review should concentrate on the audit committee and its interaction with the internal audit staff because additional emphasis is now being placed in this area. For instance, the audit committee should have a charter, be independent of company management, and take an active role in overseeing the internal audit department. The internal audit manager should meet privately at least once a year with the chair of the audit committee to discuss any sensitive issues.

- Revise coverage of the internal audit staff. The first audit step should be to determine whether the internal audit staff performed any reviews in this area. If the internal audit staff has not reviewed the ethics program, the review of its function should be minimal at this time. General areas to be covered should include independence, objectivity, scope of work, management of the department, and the followup system for audit recommendations.

DCAA Audit Process. DCAA classifies contractor entities as either major or nonmajor, depending on the annual auditable dollar amounts at each entity. For instance, a major contractor is one that has $80 million or more in annual auditable dollars. The audit risk assessment process for nonmajor contractors is different from the process DCAA uses for major contractors. For nonmajor contractors, the audit office may use a short form internal control questionnaire

or perform the internal control system review(s) already described. The short form internal control questionnaire is primarily an information-gathering device with no independent review required. Although the short form requires less audit effort, it provides less independently analyzed audit evidence. For many nonmajor contractors, the short form is acceptable; however, in certain cases, the complete internal control system review is beneficial. One example is when a corporate office is classified as nonmajor, but one or more of its divisions, subsidiaries, group offices, or other entities is considered a major contractor. Auditors located at the corporate office should obtain the information and perform the analyses required to properly complete some parts of the internal control system review for the control environment and the accompanying risk assessment that affects similar reviews for all of the contractor's entities.

Evaluation Results. Two locations we reviewed had nonmajor corporate offices audited by another DCAA office. One office requested an assist audit from the office cognizant of the corporate office. The other office obtained relevant information in a less formal manner. The audit office that used an informal process did not receive sufficient, relevant information for all of the required audit program steps. However, the audit office that requested an assist audit received an audit report addressing all of the requested audit program steps. The deficiencies identified at both offices in the information received were caused by the existing audit program or the method used to coordinate information requirements between the two offices. Audit coverage of nonmajor corporate entities could be improved by revising existing audit guidance to require the DCAA audit office cognizant of the major contractor entity to formally request an assist audit from the DCAA office cognizant of the nonmajor corporate office. By requesting an assist audit, the DCAA office responsible for performing the internal control system review could specify exactly the information required from the other DCAA office. This would result in a more thorough system review and risk assessment.

Compliance Testing During the Internal Control Review of the Control Environment. We noted improvements that DCAA could make in performing compliance testing at all three locations. At each location, DCAA auditors could have better executed certain audit steps if compliance testing had been done. For instance, at one location, the auditor accepted the contractor-provided list of employees who had attended ethics training without checking other records such as employee personnel files. The lack of compliance testing during certain internal control system reviews was reported previously in Evaluation Report No. PO 98-6-016, "Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors," August 8, 1998. DCAA management had agreed to clarify guidance dealing with compliance testing (tests of controls). On May 10, 1999, DCAA issued Memorandum for Regional Directors 99-PIC-057(R) that notified the regional offices of the revisions. In the January 2000 DCAM, DCAA revised chapter 5-108, "Test of Controls." We agree with DCAA management that the revision should improve implementation of the audit guidance in the field.

Planned Management Actions

We met with DCAA management to discuss our findings, concerns, and potential recommendations. DCAA managers were open to suggestions for

improving its audit guidance. They agreed to revise existing DCAA guidance to ensure appropriate coverage of DFARS subpart 203.70. They have also agreed to revise the standard audit program to clarify the audit responsibilities for DCAA offices cognizant of both nonmajor contractor corporate offices with major entities and those offices cognizant of the associated major entities. We appreciate the timely action taken by DCAA management to address these issues. We consider the planned management actions to be fully responsive to our concerns; therefore, no recommendations have been made.

Summary

Government auditing standards require the auditor to obtain a sufficient understanding of the contractor's internal control structure as a basis for assessing audit risk. The auditor is to use this assessment to properly plan the audit and determine the nature, timing, and extent of testing needed. A key part of this process is the internal control system review and the associated risk assessment of the contractor's overall control environment. The control environment for a DoD contractor includes its ethics program and other self-governance activities. By enhancing audit coverage to ensure coverage of the management control system described in DFARS subpart 203.70, DCAA will improve its risk assessment of the control environment. This will allow DCAA audit offices to better use their limited audit resources to review high-risk contractors. DCAA will also be able to provide more detailed information on a contractor's ethics program in internal control system reports to contracting officers. Contracting officers can use this information during the preaward process to help evaluate a contractor's present responsibility or past performance. DoD may also be able to use this information to determine the appropriate level of DoD oversight needed at a particular contractor location.

Appendix A. Evaluation Process

Scope

The evaluation was reannounced under Project No. 90C-9006 on April 29, 1999. During the evaluation, we visited three DCAA audit offices responsible for major contractors and one office cognizant of a corporate office. We reviewed selected portions of various audit assignments relating to contractor ethics programs. We reviewed the following audit assignments and related documentation:

- reviews of internal controls for the control environment and overall accounting system;
- internal control audit planning summary forms for the control environment and overall accounting system;
- Cost Accounting Standard (CAS) audits, including CAS 405, "Accounting for Unallowable Costs," and CAS 418, "Allocation of Direct and Indirect Cost"; and
- audits and reports on incurred costs.

We met with the DCMA headquarters representatives to discuss reviews of contractors' ethics programs. We also met with the DLA Office of General Counsel to determine their level of involvement and information available on contractors' ethics programs and reviews conducted.

Our initial objectives included determining how DoD relies on contractor self-governance programs such as an ethics program. However, after performing fieldwork, we emphasized the DCAA role in evaluating and reporting on a contractor's ethics program. A summary of how DoD uses such information can be found in the Background section of this report.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Contract Management high-risk area.

Methodology

Use of Computer-Processed Data. We relied on data we received from the DCAA Agency Management Information System. Based on our previous reviews of the accuracy of DCAA data in the Inspector General, DoD, Semiannual Report to Congress and the actions DCAA has taken in response to conditions identified, we considered the data adequate for our review.

Universe and Sample Selection. We judgmentally selected three major contractor entities, each from a different DCAA region. We visited the three audit offices cognizant of the selected contractor entity and either visited or requested information from the audit office cognizant of the corporate records.

When selecting a contractor entity to be reviewed, we also considered a contractor's size (dollar amount of contract awards), participation in a voluntary disclosure program, and other information on its ethics program.

We also judgmentally selected, for a limited review, 25 additional major contractor entities that had nonmajor corporate offices. We obtained information from the DCAA office cognizant of the major contractor entity to determine how that office completed the portion of the control environment review dealing with corporate office functions.

We also judgmentally selected 14 SFs 1403, "Preaward Survey of Prospective Contractor (General)," from 3 DCMA locations. We reviewed the sampled surveys to determine whether the contracting officer had asked for or received any information about a contractor's ethics program.

Evaluation Type, Dates, and Standards. We performed this evaluation from February through October 1999 in accordance with standards issued and implemented by the Inspector General, DoD. We did not include tests of the management control program(s).

Contacts During the Evaluation. We visited or contacted individuals and organizations within the DoD. Further details are available on request.

Prior Coverage

No prior coverage has been conducted on the subject during the last 5 years.

Appendix B. Report Distribution

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This report was prepared by the Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Assistant Inspector General for Auditing, DoD.

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