Policy and Oversight Report

Financial and Performance Audit Directorate

Continuing Review of Audit Reports Issued by the Air Force Audit Agency

Report Number PO 97-002 January 17, 1997

Office of the Inspector General
Department of Defense

Additional Copies

To obtain additional copies of this evaluation report, contact the Secondary Reports Distribution Unit of the Analysis, Planning, and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or FAX (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Planning and Coordination Branch of the Analysis, Planning, and Technical Support Directorate at (703) 604-8939 (DSN 664-8939) or FAX (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: APTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, Virginia 22202-2884

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@DODIG.OSD.MIL; or by writing to the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

AFAA	Air Force Audit Agency
GAS	Government Auditing Standards
IAM	Internal Audit Manual

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

January 17, 1997

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Continuing Review of Audit Reports Issued by the Air Force Audit Agency (Report No. 97-002)

We are providing this evaluation report for your information and use. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the evaluation staff. Questions about the evaluation should be directed to Ms. Barbara Smolenyak, Program Director, at (703) 604-8810 or Mr. Tom Heacock, Project Manager, at (703) 604-9103. See Appendix D for report distribution.

Donald E. Davis
Deputy Assistant Inspector General
Audit Policy and Oversight

Office of the Inspector General, DoD

Report No. 97-002
(Project No. 5IPO-035)

January 17, 1997

Continuing Review of Audit Reports Issued by the Air Force Audit Agency

Executive Summary

Introduction. We reviewed 75 audit reports issued by the Air Force Audit Agency during FY 1995. We also reviewed selected aspects of working papers for 20 of the 75 reports. The Air Force Audit Agency issued 125 reports on centrally directed audits and 2,032 reports on installation audits during FY 1995.

Evaluation Objectives. Our objective was to determine compliance of Air Force Audit Agency audit reports with selected provisions of the Government Auditing Standards and the Internal Audit Manual.

Evaluation Results. Generally, the auditors prepared reports that complied with selected reporting standards. Specifically, reports adequately identified the scope of the audit or review, reports included an appropriate statement on the auditing standards followed during the audit, and reported audit findings generally included a statement of the effect or potential effect of the adverse conditions identified. We found some conditions that warrant management's attention. While Air Force-level reports generally explained the adverse effect of the finding, the installation-level reports for 8 of the 15 audits reviewed used potential effect (Finding A).

Auditors did not adequately document their reviews and assessments of internal controls. In addition, the auditors did not review management implementation of the management control program (Finding B).

Improved reporting of the effect of audit findings and additional emphasis on reviews of internal controls and the management control program will improve the audit reports provided to management. Appendix B summarizes the potential benefits of the evaluation.

Summary of Recommendations. We recommend that the Auditor General, Department of the Air Force, reemphasize existing audit guidance to report and document the actual effect of audit findings and reviews of internal controls.

Management Comments. We received comments on a draft of this report from the Auditor General, Department of the Air Force. The Auditor General concurred with our recommendations and issued a memorandum reemphasizing the need to determine and report the effect of audit findings and to document efforts to determine whether an adverse effect occurred because of the reported condition. The Auditor General also reemphasized internal control review guidance during regional workshops. See Part I for a discussion of management comments and Part III for the complete text of the comments.

Table of Contents

Executive Summary i

Part I - Evaluation Results

Evaluation Background 2
Evaluation Objectives 2
Finding A. Reporting the Effect of Audit Findings 3
Finding B. Documentation of Reviews of Internal Controls and Assessments of the Management Control Program 5

Part II - Additional Information

Appendix A. Scope and Methodology 10
Audit Report Presentation 10
Working Papers 10
Summary 10
Appendix B. Summary of Potential Benefits From Evaluation 11
Appendix C. Organizations Visited or Contacted 12
Appendix D. Report Distribution 13

Part III - Management Comments

Air Force Audit Agency Comments 16

Part I - Evaluation Results

Evaluation Background

As part of our continuing review of audit reports issued by the DoD Central Audit Organizations, we reviewed 75 audit reports issued by the Air Force Audit Agency (AFAA) during FY 1995. We also reviewed selected aspects of working papers for 20 of the 75 reports. The results of the review are presented below and in the findings.

Audit Scope. In reporting the audit scope, auditors should describe the depth and coverage of work conducted to accomplish the audit's objectives. Each report shall tell the reader what the auditors did. The scope should clearly indicate the relationship between the universe and what was audited; identify organizations, geographic locations, the period covered, and the time during which the audit was conducted; report the kinds and sources of evidence; and explain any quality or other problems with the evidence. Auditors should also explain constraints imposed by data limitations or scope impairments.

Auditing Standards. The audit report shall state, "The audit was made in accordance with generally accepted Government Auditing Standards (GAS)." The statement of compliance refers to all standards that the auditors should have followed during the audit. The statement should be qualified when the auditors did not follow an applicable standard. The auditors should modify the statement to disclose the required standard that was not followed, the reasons, and the known effects on audit results.

Cross-referencing and Independent Referencing. No audit should be considered complete until the working paper files are thoroughly and accurately cross-referenced. At a minimum, working papers should be cross-referenced to other related papers, the audit program, summaries, and the draft audit report. Cross-referencing should be in sufficient detail to allow someone unfamiliar with the audit to trace support for the facts and conclusions in the audit report to the appropriate working papers. Independent referencing is an internal quality assurance procedure. Management assigns an auditor who was not associated with the audit to determine whether the working papers support the audit report. Independent referencers work from the cross-referenced report and trace facts and conclusions to the working papers. Use of independent referencing assures that the working papers support the facts and conclusions in the audit report.

Evaluation Objectives

Our objective was to determine compliance of AFAA reports with selected provisions of the GAS and the Internal Audit Manual (IAM). See Appendix A for our scope and methodology.

Finding A. Reporting the Effect of Audit Findings

Auditors did not always determine whether adverse conditions had resulted in an adverse effect. Air Force-level reports generally included an explanation of the adverse effect of the finding. However, the installation-level reports for 8 of the 15 audits reviewed used potential effect. The auditors did not take the extra steps necessary to determine whether the potential effect had actually occurred. Some auditors believed they were not given sufficient time to fully develop the findings. As a result, management may not have been given sufficient information to judge the seriousness of the findings.

Development of the Effect of Audit Findings

Criteria for Reporting. The IAM describes "effect" as the element of a finding that shows the risk or exposure management faces because the area being audited is not working as planned. The significance of a condition is usually judged by its effect. Shortfalls in obtaining program objectives or reductions in available resources are appropriate measures of effect and can usually be quantified in terms such as dollars, number of personnel, units of production, elapsed time, or some other readily understood quantity. The IAM does allow using potential effect to show the significance of a condition. Air Force Audit Agency Regulation 175-101 requires that effect or impact be reported in every finding when an adverse condition is reported. The regulation also states that impact should be stated in positive terms when possible and that without impact, either actual or potential, there is no reportable finding.

Developing Audit Effect. Developing the actual effect for some findings may be difficult and time consuming. However, we did not find working papers that indicated efforts went beyond describing the potential effect. For example, in one audit of an Airlift Services Division, the auditors determined that Aerial Port personnel did not adequately maintain control over cargo shipments. The effect was reported as "Improper recording, movement, or reporting of cargo significantly increases the workload of Aerial Port personnel and could result in delayed or lost cargo." Although the audit report described some examples of the problems identified that further illustrated the condition, nothing in the report or in the working papers indicated the auditors tried to quantify the actual impact in terms of the cost to the Air Force to complete the additional workload or the costs as a result of lost or delayed shipments.

Findings that identify and quantify the actual effect of the condition are more readily accepted by management and more clearly show the impact of the adverse condition than those that only include the potential effect. Continued management emphasis on developing effect will improve management acceptance of audit findings.

Recommendations and Management Comments

A. We recommend that the Auditor General, Department of the Air Force:

1. Reemphasize to auditors the need to determine and report the actual effect of audit findings.

2. Require auditors to prepare working papers that show their efforts to determine the actual effect in those cases where only potential effect is reported.

Management Comments. The Auditor General, Department of the Air Force, concurred with the recommendations and issued a memorandum emphasizing the need to determine the actual effect of audit findings when an adverse effect exists. The memorandum also included a requirement that auditors document their efforts to determine whether an adverse effect occurred because of the reported condition.

Finding B. Documentation of Reviews of Internal Controls and Assessments of the Management Control Program

Auditors did not adequately document reviews of the internal controls that were relevant to the audit as required by GAS. Also, auditors did not assess management's implementation of the Management Control Program. We identified problems in 11 of the 25 sets of working papers reviewed. These conditions occurred because AFAA management did not emphasize addressing internal controls in every audit. As a result, the Air Force has no assurance that the proper level of audit work was performed based on the internal control risks.

Criteria for Internal Control Reviews

The GAS require that auditors obtain an understanding of the management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls. In addition, on each audit, auditors are to assess management's implementation of the internal management control program as it related to the scope of the audit. The IAM requires auditors to determine whether the DoD Internal Management Control Program had been implemented.

Documentation of Internal Control Coverage

Auditors did not adequately document the reviews of internal controls. Audit reports usually stated that the audit included such tests of the internal controls as were considered necessary under the circumstances. We reviewed the working papers to determine how the internal controls were tested and whether the conclusions in the working papers supported the audit report.

In one audit, the audit program included six questions to assess the adequacy of the internal controls. The auditor answered four of the six questions negatively. Although a fifth question was answered positively, the area it addressed was the subject of one of the audit findings. The sixth question was answered positively. The reported audit conclusion was that the internal controls were adequate. We questioned whether the conclusion was appropriate.

In an audit that was part of a centrally directed audit, the auditors did not perform or document reviews of internal controls to determine the nature and extent of the work necessary for the audit. The auditors were not provided any time in the centrally directed audit program for reviews of internal controls.

In at least two audits, we were unable to find any working papers to support audit report statements on the specific controls assessed. The auditors believed that completion of the audit was sufficient evidence that internal controls were reviewed. The auditors should document their conclusions, their logic, and the facts used to develop those conclusions. They should include that documentation in the working papers and cross-reference the report appropriately.

Assessment of Implementation of the Management Control Program

Auditors did not assess management's implementation of the Management Control Program as required by DoD Directive 5010.38, "Internal Management Control Program. We found no evidence of an assessment in 8 of the 25 sets of working papers reviewed. We were advised that the AFAA did not require such reviews because a specific audit is completed each year during which the auditors assess internal controls Air Force-wide. The results of the annual audit are then used to develop the Secretary of the Air Force assurance statement. We did not review the annual audit as part of this review. However, the scope and purpose of the annual audit are significantly different from those of the reviews required during other audits. The annual audit is specifically to provide support for the annual assurance statement. The required reviews during routine audits are intended to provide Commanders with an assessment of their organizations' implementation of the DoD Management Control Program.

The Act focused on managements' need to strengthen internal controls and directed the Secretary of Defense to establish a program of continuous evaluation of DoD systems of internal control, follow Office of Management and Budget guidance in evaluating the system of internal controls, and provide an annual report to the President and Congress. The report should state whether the Department has established systems of internal control and whether the controls provide reasonable assurance as to the financial condition of the Department.

The IAM requires that the auditors assess management's implementation of the program on each audit. That assessment is only for the specific areas covered by the objectives of the audit. In November 1993, the Assistant Auditor General, Directorate of Operations, AFAA, issued Policy Letters 94-101-01 and 94-102-02 requiring a stated objective in each audit to "evaluate the Air Force internal control structure applicable to the subject area audited." The guidance required auditors to evaluate and report on the internal control structure applicable to the organization, program, activity, or function audited. The guidance also stressed that internal controls are to be reviewed during all audits and the audit reports are to identify the specific controls reviewed. In February 1994, the Secretary of Defense issued a letter to the Secretaries of the Military Departments that reinforced the need to implement the Act. One of the "Directions" appended to that letter addressed the need for the Office of the

Inspector General, DoD, to "arduously pursue the complete implementation" of guidance issued to the audit community. That guidance required the subject assessments.

A separate but related condition was found in one audit. While documenting the cause for a finding, the auditors determined that the internal management control program had not been implemented in the management area. However, the audit report made no reference to management's failure to implement the program.

Recommendations and Management Comments

B. We recommend that the Auditor General, Department of the Air Force:

1. Reemphasize the guidance issued in November 1993, Subject, Air Force Audit Agency Policy Letters 94-101-01 and 94-102-02, Internal Control Reviews.

2. Require auditors to document in working papers the steps taken to review internal controls. Those working papers should clearly identify the controls reviewed and include any facts and logic used to develop the audit conclusions on the quality of internal controls.

Management Comments. The Auditor General, Department of the Air Force, concurred with the recommendations. Management reemphasized the internal control review guidance at the region workshops and included additional guidance in recent revisions to Audit Agency instructions. In addition, the Audit Agency developed a formatted template with standard internal control elements for use in reviewing internal controls.

Part II - Additional Information

Appendix A. Scope and Methodology

Audit Report Presentation

We reviewed report presentation in three areas: the scope of the audit, the statement on auditing standards, and the identification of effect. We performed a desk review of 75 reports that were judgmentally selected from the 2,157 FY 1995 reports issued. We selected 25 Air Force-level reports and 50 installation reports issued by the selected installations. Appendix C lists orgnizations visited or contacted.

Working Papers

Our review of working papers included documentation for the three areas above, as well as reviews of the cross-referencing of key elements of the report, the independent referencing process, and the internal control reviews performed during audits.

Summary

Generally, the auditors prepared reports that properly included the elements that were the subject of this review. Specifically, the reports reviewed adequately identified the scope of the audit or review. All reports that were selected for review included an appropriate statement on the auditing standards followed during the audit. The reported audit findings generally included a statement of the effect or potential effect of the adverse conditions identified. Air Force-level reports generally explained the adverse effect of the finding. However, the installation-level reports for 8 of the 15 audits reviewed used potential effect. The auditors did not take the extra step to determine whether the potential effect had actually occurred. Additional management emphasis is also required in the area of cross-referencing audit reports to documentation of audit work in the working papers. Auditors did not always cross-reference significant facts and "auditor conclusions" to working papers to clearly show the source or logic the auditor used. Independent referencing of audit reports had not been fully implemented at the installation level by the time reports selected for this review were published. As a result, we cannot address how well independent referencing was done at every installation we visited. We did not find significant problems with independent referencing in the cases where it was done. Auditors did not adequately document their reviews and assessments of internal controls. In addition, the auditors did not review management implementation of the management control program.

Appendix B. Summary of Potential Benefits From Evaluation

Recommendation Reference	Description of Benefit	Amount and Type of Benefit
A.1., A.2.	Program Results. Improves the impact of the audit findings.	Nonmonetary.
B.1.	Program Results. Improves the documentation of the processes followed during an audit.	Nonmonetary.
B.2.	Compliance with Government Auditing Standards.	Nonmonetary.

Appendix C. Organizations Visited or Contacted

Department of the Air Force

Air Force Audit Agency, Dover Air Force Base, DE
Air Force Audit Agency, Eglin Air Force Base, FL
Air Force Audit Agency, McChord Air Force Base, WA
Air Force Audit Agency, Wright-Patterson Air Force Base, Dayton, OH

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Non-Defense Federal Organizations and Individuals

Office and Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office
Chairman and ranking minority member of each of the following congressional committees and subcommittees:
- Senate Committee on Appropriations
- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- House Committee on Appropriations
- House Subcommittee on National Security, Committee on Appropriations
- House Committee on Government Reform and Oversight
- House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
- House Committee on National Security

Part III - Management Comments

Air Force Audit Agency Comments

DEPARTMENT OF THE AIR FORCE
AIR FORCE AUDIT AGENCY

21 October 1996

MEMORANDUM FOR DODIG AUDIT POLICY AND OVERSIGHT (OAIG-P&O)

FROM: HQ AFAA/DO
1125 Air Force Pentagon
Washington DC 20330-1125

SUBJECT: Continuing Review of Audit Reports Issued by the Air Force Audit Agency (Project No. 5IPO-035)

Attachments 1 and 2 provide our response to Recommendations A and B in the subject report. Please feel free to contact Ms. Lee Battershell, (703) 696-8025, or me at (703) 696-8026, if you have any additional questions.

THOMAS F. BACHMAN
Assistant Auditor General
(Operations)

Attachments:
1. Response, Recommendation A
2. Response, Recommendation B

PROPOSED AFAA MANAGEMENT RESPONSES TO
OAIG-P&O DRAFT REPORT ON THE
CONTINUING REVIEW OF AUDIT REPORTS
ISSUED BY THE
AIR FORCE AUDIT AGENCY
PROJECT 5IPO-035
23 AUGUST 1996

Recommendation A. We recommend that the Auditor General, Department of the Air Force:

(1) Reemphasize to auditors the need to determine and report the actual effect of audit findings.

Concur. We issued a memorandum on 21 October 1996 emphasizing the need to determine and report the actual effect of audit findings when an adverse effect exists. (Closed)

(2) Require auditors to prepare working papers that show their efforts to determine the actual effect in those cases where only potential effect is reported.

Concur. We included in our 21 October 1996 memorandum a requirement that auditors document their efforts to determine whether an adverse effect occurred because of the reported condition. (Closed)

Attachment 1

PROPOSED AFAA MANAGEMENT RESPONSES TO
OAIG-P&O DRAFT REPORT ON THE
CONTINUING REVIEW OF AUDIT REPORTS
ISSUED BY THE
AIR FORCE AUDIT AGENCY
PROJECT 5IPO-035
23 AUGUST 1996

Recommendation B. We recommend that the Auditor General, Department of the Air Force:

(1) Reemphasize the guidance in November 1993, Subject, Air Force Audit Agency Policy Letter 94-101-01 and 94-102-02, Internal Control Reviews.

Concur. We reemphasized the internal review guidance at two region workshops during June and July 1996. We also included additional internal control guidance in our recent revisions to Audit Agency Instruction 65-101, Internal Audit Procedures; and Audit Agency Instruction 65-102, Centrally Directed Audits. (Closed)

(2) Require auditors to document in working papers the steps taken to review internal controls. Those working papers should clearly identify the controls reviewed and include any facts and logic used to develop the audit conclusions on the quality of internal controls.

Concur. AFAA conducted in-depth reviews of individual audit projects in response to the OAIG-P&O Recommendation 1, in Report on the Oversight Review of Internal Quality Control Program of the Air Force Audit Agency (16 March 1995, p. 5). As a result of our reviews, we issued memorandums to AFAA field offices emphasizing the need to document steps taken to review internal controls. In addition, we developed a formatted template with standard internal control elements for use in reviewing internal controls. (Closed)

Attachment 2

Evaluation Team Members

This report was prepared by the Financial and Performance Audits Directorate, Office of the Assistant Inspector General for Policy and Oversight, DoD.

Barbara E. Smolenyak
Martin T. Heacock