

*O*versight
*R*eport



DEFENSE CONTRACT AUDIT AGENCY
QUALITY ASSURANCE PROGRAM

Report Number D-2002-6-001

December 6, 2001

Office of the Inspector General
Department of Defense

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Acronyms

APPS	Automated Planning and Performance System
CAM	DCAA Manual 7640.1, "DCAA Contract Audit Manual"
DCAA	Defense Contract Audit Agency
ESC	Executive Steering Committee
FAO	Field Audit Office
GAS	Government Auditing Standards
ICAPS	Internal Control Audit Planning Summary
MRD	Memorandum for Regional Directors
PCIE	President's Council on Integrity and Efficiency
RQA	Regional Quality Assurance Division
SAS	Statement on Auditing Standards



INSPECTOR GENERAL
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December 6, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Oversight Report on Defense Contract Audit Agency Quality Assurance Program (Report No. D-2002-6-001)

We are providing this oversight report for review and comment. This is one in a series of reports on the Defense Contract Audit Agency internal quality assurance program. We considered management comments on a draft of this report when preparing the final report.

As a result of management comments, we request that the Defense Contract Audit Agency reconsider its position to Recommendations A.4., B.1., and C.1. and provide additional comments in response to the final report. We request that management provide the comments by February 4, 2002.

We appreciate the courtesies extended to our staff. Questions on the review should be directed to Mr. Wayne C. Berry at (703) 604-8789 (DSN 664-8789) (wberry@dodig.osd.mil) or Ms. Diane H. Stetler at (703) 604-8737 (DSN 664-8737) (dstetler@dodig.osd.mil). See Appendix C for the report distribution. The evaluation team members are listed inside the back cover.

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Report No. D-2002-6-001

Project No. D2000OA-0238

December 6, 2001

Defense Contract Audit Agency Quality Assurance Program

Executive Summary

Introduction. This is the first in a series of reports on the Defense Contract Audit Agency quality assurance program. The Defense Contract Audit Agency internal quality control system is implemented at all levels of the organization and is multi-functional, covering elements of vulnerability assessment, internal control review, external audit followup, audit quality review, and management improvement efforts. The "Government Auditing Standards," June 1994, issued by the Comptroller General of the United States, requires that each audit organization have an appropriate quality control system. For FY 2000, the Defense Contract Audit Agency completed 41,722 reviews, valued at \$194.8 billion, with net savings of \$2.4 billion. The Defense Contract Audit Agency incurred \$364.3 million in total operating costs to provide the audit services.

Objectives. The objective for this evaluation was to review the Defense Contract Audit Agency's quality assurance program and to assess how the Defense Contract Audit Agency performed the internal quality assurance review of forward pricing assignments, which was the first agency-wide review conducted by the new headquarters Quality Assurance Division. Subsequent evaluations will assess how the Defense Contract Audit Agency performs internal quality assurance reviews of internal control reviews and incurred cost audits, as well as all other assignments.

Results. The Defense Contract Audit Agency quality assurance program incorporates many of the elements needed for an effective review of an internal quality control system. Since the program was announced in October 1998, the Defense Contract Audit Agency has been refining its quality assurance program to include the fundamental elements of a mature program. The Defense Contract Audit Agency can improve the capability of the program to provide a thorough agency-wide evaluation of whether its audits are performed in compliance with auditing standards and Defense Contract Audit Agency policies and procedures by implementing recommended actions, suggested improvements, and enhancements (finding A).

The Defense Contract Audit Agency selected forward pricing assignments as the first category of audits to be reviewed. The internal quality assurance review of forward pricing assignments identified some areas needing improvement for which the Defense Contract Audit Agency had either implemented or initiated corrective action. To resolve the remaining issues, the Defense Contract Audit Agency should revise

guidance on the delegating authority to sign audit reports and documenting reliance on data from computer-based systems. Timely resolution of issues will ensure that the Defense Contract Audit Agency internal quality assurance program is effective (finding B).

The Defense Contract Audit Agency used a checklist it developed based on the President's Council on Integrity and Efficiency "Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General," April 1997, to document its internal quality assurance review of the individual forward pricing assignments. However, the documents generated by the quality assurance staff did not completely explain the work performed or fully document conclusions reached. In addition, the Quality Assurance Division did not fully evaluate whether the reviewed audits met certain auditing standards. The Defense Contract Audit Agency needs to modify its procedures for future internal quality assurance reviews so an external reviewer can place greater reliance on the Defense Contract Audit Agency work when conducting oversight reviews. If the Defense Contract Audit Agency adequately documents the internal quality assurance reviews, the external reviewers may use the results as direct evidence to support its overall opinion of the internal quality assurance program (finding C).

Summary of Recommendations. We recommend that the Defense Contract Audit Agency formalize its policies and procedures for conducting internal quality assurance reviews before starting the next review; monitor the internal quality assurance program to ensure that the program is completed as planned during the 3-year cycle; institutionalize formal procedures for tracking corrective actions to include timely implementation; and conduct independent reviews of all the field audit offices within the 3-year cycle. In addition, we recommend revising policy to prohibit supervisory auditors, when acting as field audit office managers, from signing audit reports issued on audit assignments they supervised as well as issuing clarifying guidance for documenting reliance on data from computer-based systems.

We recommend that the Defense Contract Audit Agency sufficiently document all auditor conclusions when performing internal quality assurance reviews. In addition, we recommend revising checklist questions to more fully assess reliance on data from computer-based systems, the understanding of internal controls, and cross-referencing of draft reports; revising the standard audit programs for forward pricing assignments to include audit steps that address assessment of audit risk; modifying agency guidance to provide additional guidance on proper cross-referencing of reports; and establishing criteria for rating field audit offices.

Management Comments. The Defense Contract Audit Agency generally concurred with the recommendations to formalize its policies and procedures; monitor the program to ensure that it is completed as planned; institutionalize formal procedures for tracking corrective actions; conduct independent reviews of all the field audit offices; issue clarifying guidance for documenting reliance on data from computer-based systems; consider revising checklist questions; revise the standard audit programs; modify guidance on proper cross-referencing of reports; and establishing rating criteria.

The Defense Contract Audit Agency nonconcurred with conducting an independent review of Field Detachment, stating that to appropriately plan, supervise, analyze, and report the results would require that several additional personnel obtain the appropriate security clearances. The Defense Contract Audit Agency nonconcurred with revising policy on delegation of signature authority, stating that precluding an acting field audit office manager from signing his or her own reports when required by the circumstances would further complicate an already complex policy without significant benefit. The Defense Contract Audit Agency nonconcurred with sufficiently documenting all auditor conclusions that do not identify a deficiency, stating that it would not be prudent to commit the limited quality assurance resources to providing sufficient documentation in support of all determinations of compliance with a given auditing standard or element of agency policy.

A discussion of management comments to the findings is in Appendix B. A discussion of management comments to the recommendations is in the Findings section of the report and the complete text is in the Management Comments section.

Evaluation Response. The Defense Contract Audit Agency comments are generally responsive. However, we do not fully agree with their positions on conducting an independent review of Field Detachment, revising policy on delegation of signature authority, and sufficiently documenting auditor conclusions. On conducting an independent review of Field Detachment, we believe that such a review is still necessary. On revising policy on delegation of signature authority, our position is that requiring the independent review of audit reports deemed sensitive by Defense Contract Audit Agency management is an important management control procedure and helps ensure that higher level managers are satisfied with the overall quality of the product and that the message is sound, addresses the objectives, and meets customer needs. On sufficiently documenting all auditor conclusions, our position is that for an external reviewer to understand how the quality assurance reviewer concluded that a particular standard was complied with requires some indication of the reviewer thought process and the documentation that led him to such a conclusion. In addition, for the external reviewer, an internal quality assurance reviewer conclusion that auditing standards are met is as significant as a conclusion that standards are not met. For us to place maximum reliance on Defense Contract Audit Agency work, we need an audit trail from significant findings and conclusions discussed in trip reports to the working papers that support them. We request that the Defense Contract Audit Agency provide comments to the final report by February 4, 2002.

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Background

This is the first in a series of reports on the Defense Contract Audit Agency (DCAA) quality assurance program. The “Government Auditing Standards” (GAS), issued by the Comptroller General of the United States, requires that each audit organization have an appropriate quality control system. The organization’s internal quality control system should provide reasonable assurance that it has adopted and is following applicable auditing standards and has established and is following adequate auditing policies and procedures.

President’s Council on Integrity and Efficiency. The President’s Council on Integrity and Efficiency (PCIE) was established to identify, review, and discuss areas of weakness and vulnerability in Federal programs and operations; to develop plans for coordinated, Government-wide activities that address those issues; and to promote economy and efficiency in Federal programs and operations. As part of that mandate, the PCIE developed the “Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General” (PCIE Guide), April 1997, as a tool to promote consistency in conducting quality control reviews in accordance with GAS. The PCIE Guide is advisory and is not intended to replace a reviewer’s professional judgment regarding the approach or scope of a review. The PCIE Guide includes a variety of checklists that organizations can use as tools when conducting quality control reviews.

DCAA Organization and Functions. DoD Directive 5105.38, “Defense Contract Audit Agency,” June 9, 1965, established DCAA as a separate organization under the direction, authority, and control of the Under Secretary of Defense (Comptroller).¹ The primary mission of DCAA is to perform contract audits for DoD. In addition, DCAA is responsible for providing accounting and financial advisory services regarding contracts and subcontracts to DoD Components that perform procurement and contract administration duties. Also, DCAA provides contract audit services for non-DoD Federal organizations on a reimbursable basis. For FY 2000, DCAA completed 41,722 reviews, valued at \$194.8 billion,² with net savings of \$2.4 billion. DCAA incurred \$364.3 million in total operating costs to provide the audit services. DCAA audit guidance is contained in DCAA Manual 7640.1, “DCAA Contract Audit Manual” (CAM).³ Specifically, CAM Section 2-101 states that GAS is applicable to DCAA. DCAA ensures compliance with the applicable auditing standards throughout audit planning and performance activities by supplementing audit guidance in the CAM with standard audit programs and internal control matrices. Between CAM updates, DCAA

¹Formerly the Assistant Secretary of Defense (Comptroller).

²The amount represents dollars examined or reviewed by DCAA for forward pricing assignments, incurred cost audits, and special audits (for example, terminations, claims, and Government facility rentals).

³DCAA Manual 7640.1 is updated every six months. As of November 2000, the most recent version is July 2001.

headquarters notifies managers of new and revised audit guidance by issuing Memorandums for Regional Directors (MRD) that are usually incorporated in the next CAM update.

DCAA Quality Assurance Program. DCAA MRD 98-P-147(R), “Establishment of Quality Assurance Division,” October 23, 1998, established a Quality Assurance Division at DCAA headquarters and in each of the five regions and Field Detachment.⁴ The headquarters and Regional/Field Detachment Quality Assurance Divisions are responsible for developing and executing an agency-wide program to provide reasonable assurance that DCAA has adopted and follows applicable auditing standards, and has established and follows adequate auditing policies and procedures. Additional functions include assessing the need for new or revised guidance, supporting external quality control reviews, accompanying external auditors on field visits, serving on process action teams, assisting in responding to inquiries, and identifying “best-in-class” processes for use throughout DCAA.

Executive Steering Committee. The Executive Steering Committee (ESC) is responsible for providing overall management and direction for the DCAA total quality management program. In addition, the ESC is responsible for establishing the DCAA vision and strategic goals; identifying quality improvement projects; evaluating quality improvement projects suggested by others; approving/disapproving DCAA process action teams; and maintaining active communication and coordination with the quality management boards regarding their process action team activities and recommendations. Committee members include the Director, Deputy Director, assistant directors of the headquarters components, directors of the five regions and Field Detachment, and General Counsel. The ESC meets quarterly and is briefed on issues such as the Director’s performance contract, strategic plan, advanced degrees and certifications, procurement plans, and the DCAA internal quality assurance program. If necessary, the ESC establishes action items for tasks to be completed or information to be provided. A listing of action items is maintained for the Director, DCAA, by the Executive Officer.

Headquarters Quality Assurance Division. The DCAA headquarters Quality Assurance Division performs formal internal quality assurance reviews based on the PCIE Guide and other quality assurance-related reviews throughout DCAA. When conducting the reviews, the Quality Assurance Division assesses compliance with applicable auditing standards and audit policies and procedures, the need for enhanced or new audit policy guidance, and best practices for use throughout the agency.

Regional Quality Assurance Divisions. The Regional Quality Assurance Divisions (RQA), including Field Detachment, assist the DCAA headquarters Quality Assurance Division in performing the agency-wide quality assurance reviews and other agency-wide quality assurance projects. At the direction of their respective regional directors, the RQAs also perform regional

⁴Field Detachment is responsible for the overall planning, management, and execution of worldwide DCAA contract audits of compartmented programs.

quality assurance reviews and projects to assess compliance with applicable policies and procedures, the need for enhanced or new audit guidance, and best practices for regional use. In addition, the RQAs perform special reviews as required by the regional directors. When performing regional quality assurance and special reviews, the RQA chiefs report directly to the directors of their respective regions. When performing agency-wide reviews under the direction of the headquarters Quality Assurance Division, the RQA staffs assigned to the review report indirectly to the chief of the headquarters Quality Assurance Division.

DCAA Internal Quality Assurance Reviews. Beginning in FY 1999, DCAA established a 3-year cycle for conducting internal quality assurance reviews. DCAA determined that its workload fell into four major categories—forward pricing assignments, internal control reviews, incurred cost audits, and all other assignments.⁵ DCAA decided to conduct separate internal quality assurance reviews for each of the major audit categories. DCAA plans to have all reviews completed by April 2002 and to brief the ESC in June 2002.

Objectives

The objective for this evaluation was to review the DCAA quality assurance program and to assess how DCAA performed the internal quality assurance review of forward pricing assignments, which was the first agency-wide review conducted by the new headquarters Quality Assurance Division. Subsequent evaluations will assess how DCAA performs internal quality assurance reviews of internal control reviews and incurred cost audits as well as all other assignments. See Appendix A for a discussion of the evaluation scope, methodology, management control program review, and prior coverage.

⁵Examples of other assignments include defective pricing audits, progress payment audits, operations audits, and termination audits.

A. Defense Contract Audit Agency Quality Assurance Program

The DCAA quality assurance program incorporates many of the elements needed for an effective review of an internal quality control system. Since the program was announced in October 1998, DCAA has been refining its quality assurance program to include the fundamental elements of a mature program. DCAA can improve the capability of the program to provide a thorough agency-wide evaluation of whether DCAA audits are performed in compliance with auditing standards and DCAA policies and procedures by implementing the recommended actions, suggested improvements, and enhancements.

Quality Assurance Policies

Government Auditing Standards. The GAS are standards for audits that are performed on Government organizations, programs, activities, and functions. The standards also apply to audits of Government assistance that contractors, nonprofit organizations, and other non-Government organizations receive. GAS 3.31 requires that, “Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place.” In addition, GAS requires that an organization’s internal quality control system provides reasonable assurance that the organization has adopted and follows applicable auditing standards and has established and follows adequate audit policies and procedures. GAS states that the nature and extent of an organization’s internal quality control system is dependent on factors such as size, the degree of operating autonomy among offices and personnel, the nature of the work, organizational structure, and appropriate cost/benefit considerations. Therefore, the internal quality control systems established by organizations will vary, as will the extent of the documentation.

PCIE Guide. The PCIE Guide reiterates the guidance in GAS and provides additional guidance on the internal quality control system as well as guidance for conducting internal quality assurance reviews. The PCIE Guide states that an organization’s internal quality control policies and procedures encompass, at a minimum, the elements of staff qualifications, independence, audit performance, and internal review. In addition, the PCIE Guide outlines the characteristics of an internal quality assurance review. Also, the PCIE Guide includes a “Checklist for Assessment of Internal Quality Assurance Program [PCIE Appendix C],” which can be used as a tool to evaluate an organization’s quality assurance program.

DCAA Internal Quality Control System

The DCAA internal quality control system encompasses the agency's organizational structure. The PCIE Guide states that an organization's internal quality control system should be comprehensive and designed to provide reasonable assurance that the organization has adopted and follows applicable auditing standards and has established and follows adequate audit policies and procedures. The DCAA internal quality control system is implemented at all levels of the organization and is multifunctional, covering elements of vulnerability assessment, internal control review, external audit followup,⁶ audit quality review, and management improvement efforts. Organizationally, DCAA is divided into a headquarters, 5 regions, Field Detachment, and 81 field audit offices (FAOs⁷). DCAA considers all the organizational layers to be part of its internal quality control system.

DCAA-Wide Quality Control System. The DCAA-wide quality control system is defined in the CAM and in DCAA regulations and instructions. DCAA-wide quality controls include use of standard audit programs and standard checklists for reviewing audit reports; fact-finding visits by DCAA headquarters program managers who use tools such as centrally directed surveys and internal checklists; headquarters desk reviews; onsite reviews of internal systems by DCAA specialists such as industrial engineers; and reviews by peers outside the organization being reviewed. In addition, the DCAA quality assurance program is an integral part of the quality control system.

Regional and Field Detachment Quality Control Systems. Regional quality control systems implemented by the regional directors and managed by the RQAs, including the Field Detachment Quality Assurance Division, are an integral part of the DCAA quality control system. Regional policies and procedures set forth quality controls that include delegation of authority; separation of duties; accountability of resources; recording, documenting, and resolving audit findings; pre-issuance reviews of sensitive or significant audit reports by regional audit managers; post-audit quality reviews by the regional audit manager; and monthly post-issuance review of audit reports. The RQAs also perform compliance reviews as requested by regional directors.

FAO Quality Control System. Within each region, DCAA has established between 11 and 16 FAOs. The FAOs are responsible for implementing a sound quality control system based on headquarters and regional guidance. Peer review processes are an integral part of the FAO-level quality control system. FAO quality controls include mandatory pre-issuance review of audits by supervisory auditors and pre-issuance reviews of sensitive or significant audits

⁶This function includes following up on findings and recommendations in General Accounting Office and Inspector General, DoD, reports.

⁷An FAO can be either a resident office or a branch office. A resident office is established at a contractor's facility whenever the amount of audit work justifies assignment of a permanent staff of auditors and support elements. A branch office is not located in a contractor's facility and performs reviews of several contractors.

by FAO managers. The results of peer reviews are used to identify process improvements within FAOs and are forwarded to the region and headquarters for use in identifying trends throughout DCAA. FAOs may institute other quality control procedures, such as participatory work teams and pre-issuance review of all audit reports.

DCAA Headquarters Quality Assurance Program Review Process

The PCIE Guide describes the characteristics that an organization's quality assurance program should integrate into any review of its quality control system. Those characteristics include formal quality assurance review procedures, adequate staffing, independence, thorough scope of review, sufficient evidence, written results, written responses, and an effective followup process.

The DCAA quality assurance program contains elements of each of those characteristics. However, DCAA is still in the process of refining its quality assurance program based on experience gained from the completed internal quality assurance reviews. As a result, DCAA has not yet fully implemented all of the needed elements of a mature program. The DCAA methodology for preparing written results and written responses meets the intent of the PCIE Guide. However, the characteristics of formal quality assurance review procedures, staffing, independent review, evidence, followup procedures, and scope of review in the DCAA internal quality assurance program need improvement to ensure that the program will operate effectively. DCAA has either taken corrective action or plans to take corrective action that will improve many of the characteristics.

Formal Quality Assurance Review Procedures. Organizations conducting internal quality assurance reviews should have formal policies and procedures. DCAA has completed two headquarters-led reviews and is in the process of conducting a third. DCAA has not prepared formal policies and procedures for conducting the reviews. DCAA has informal procedures in the form of Microsoft PowerPoint slides dated March 31, 1999. The slides explain the structure and makeup of the quality assurance divisions, general information on how the internal quality assurance reviews will be performed, examples of quality assurance work, and basic information on how the internal quality assurance review of forward pricing assignments would be conducted. DCAA recognizes the need for formal policies and procedures and plans to issue an instruction by December 31, 2001. However, DCAA began the review of all other assignments during October 2001, the last review for the first 3-year cycle. DCAA needed to develop formal policies and procedures before beginning that review for the external reviewer to evaluate the adequacy of the policies and procedures as part of its overall evaluation of the DCAA quality assurance program.

Staffing. The PCIE Guide recommends that review teams be led by a senior manager and that the reviewers have an appropriate level of experience. The DCAA quality assurance staff consists of about 35 auditors. The headquarters Quality Assurance Division consists of one GS-15 division chief and four GS-14 program managers. In addition, each RQA staff consists of one GS-14 supervisor and four GS-13 auditors. Each RQA staff reports to a regional director. DCAA requires that the quality assurance staffs comply with continuing professional education requirements outlined in GAS.

When DCAA established its quality assurance divisions in October 1998, it reassigned personnel from other divisions within the organization. As of December 17, 1998, DCAA had reassigned a total of 7 employees to the quality assurance divisions and by March 31, 1999, DCAA had reassigned a total of 20 employees to the quality assurance divisions. The initial staffing was adequate for performing the internal quality assurance review of forward pricing assignments. The headquarters Quality Assurance Division, RQAs, and Field Detachment Quality Assurance Division were staffed with 31 employees as of December 16, 1999. The original staff level of 35 appeared adequate to perform the original assigned duties.

DCAA established the headquarters Quality Assurance Division primarily to develop and execute an agency-wide quality assurance program. DCAA has subsequently added responsibilities, such as providing assistance in preparing the DCAA FY 2000 financial statements. The headquarters Quality Assurance Division expended 1,500 staff-hours on the unplanned task. DCAA needs to closely monitor the status of the quality assurance workload to ensure that the quality assurance program is accomplished within the 3-year cycle.

Independent Review. The PCIE Guide recommends that the review team leader report to an individual or a level within the organization that will ensure independence and objectivity in the performance of internal quality assurance reviews. The headquarters Quality Assurance Division reports to the Assistant Director, Policy and Plans. In addition, when DCAA established the process for assigning the auditors to the internal quality assurance reviews, DCAA determined that personnel from the RQAs would not be allowed to review any FAOs within their own regions. DCAA made that decision to ensure that the auditors maintained independence because auditors assigned to RQAs report to the respective regional directors. However, the same reasoning was not applied to the assessment of Field Detachment. DCAA decided that the Field Detachment Quality Assurance Division would conduct the internal quality assurance review of Field Detachment audits. DCAA decided not to independently assess Field Detachment because of workload, security considerations, and because DCAA considers the Field Detachment Quality Assurance Division independent because it is separate from Field Detachment audit operations.

Field Detachment Workload. DCAA decided not to independently assess Field Detachment because of “the low relative significance” of the Field Detachment workload. However, as shown by the following table, Field Detachment roughly equals one-half of a DCAA region with almost an equal number of FAOs.

Table 1. Relationship of Field Detachment to Overall DCAA

	<u># FAOs¹</u>	<u>Staffing²</u>	<u>Hours³</u>
Eastern	14	677	1,403,752
Northeastern	15	598	1,247,754
Western	16	740	1,572,799
Central	12	671	1,376,908
Mid-Atlantic	13	781	1,531,615
Field Detachment	11	335	640,587
Headquarters/ Miscellaneous	<u>0</u>	<u>370</u>	<u>427,024</u>
Total	81	4,172	8,200,439

¹DCAA Publication 5100.1, “Directory of DCAA Offices,” January 2000, except for Field Detachment.

²DCAA MRD 99-OWD-087, “Fiscal Year 2000 Planning and Staff Allocation Document,” July 23, 1999.

³DCAA report, “Comparative Statistics – Major Workload Categories September 1997, 1998, 1999.”

Field Detachment was allocated about 8 percent of the total DCAA staff and expended about 8 percent of the total hours. On average, each of the five regions was allocated about 17 percent of the total staff. In addition, we believe that assignments conducted by Field Detachment have the potential to be high risk because the assignments get less visibility outside of Field Detachment because they are audits of classified programs. Also, DCAA did not consider how the geographic dispersion of FAOs affects implementation of quality controls such as oversight. For example, the FAO that we visited had 46 auditors in 9 separate locations in 4 states. In addition, while the five regions are organized geographically, FAOs within Field Detachment are dispersed nationwide, providing less opportunity for oversight.

Field Detachment Security Considerations. DCAA determined that it was in the best interest of DoD for the Field Detachment Quality Assurance staff, with existing clearances, to perform the PCIE-based reviews at Field Detachment FAOs rather than maintaining a cleared contingent within the headquarters Quality Assurance Division. DCAA made that decision based on the low relative significance and high security aspects of Field Detachment audit work. In addition, DCAA anticipated that the external reviewer would evaluate and perform some retesting of the Field Detachment quality assurance work and provide feedback on the results of that effort. DCAA should not assume that

external reviewers will always retest Field Detachment Quality Assurance Division work. DCAA has responsibility for ensuring that its internal quality assurance program is performed independently and objectively. Only one or two DCAA auditors with clearances would be needed because of the limited time spent on the quality assurance reviews at each FAO. For example, only three Field Detachment FAOs were assessed and DCAA internal review teams consisting of two or three staff conducted each site visit over a 5-day period. In addition, only four of the seven assignments that we reviewed as part of this review contained classified information; therefore, a noncleared auditor could review the unclassified Field Detachment assignments in certain situations.

Field Detachment Quality Assurance Division Structure. The Quality Assurance Divisions for all five regions and Field Detachment are structured the same. The Field Detachment Quality Assurance Division chief, like the RQA chiefs, reports directly to the respective director. The Field Detachment Quality Assurance staff, like the RQA staffs in the five regions, are physically located at various FAOs. The Director, Field Detachment, like the other regional directors, is responsible for the overall management of the Field Detachment audit operations that the Field Detachment quality assurance staff is reviewing. Therefore, the Field Detachment quality assurance staff is only minimally independent from the field audit operations.

For the headquarters-led quality assurance review, Field Detachment was treated differently than the five regions. Specifically, the Field Detachment Quality Assurance staff reviewed FAOs within their own region while the RQA staffs were not allowed to review any FAO within the region to which they were assigned. In addition, the Director, Field Detachment, signed the memorandums that transmitted the review results to the three FAO managers in Field Detachment while the Assistant Director, Policy and Plans, signed the memorandums that transmitted the review results to the five regional directors. Also, the lead reviewer from the Field Detachment Quality Assurance Division signed the memorandums for record that detailed the review results for the 3 FAOs in Field Detachment while either the Chief or the lead reviewer of the DCAA headquarters Quality Assurance Division signed the memorandums for record that detailed the review results for the 15 FAOs in the 5 regions. While the headquarters Quality Assurance Division performed some oversight of the Field Detachment work by reviewing trip reports, the headquarters Quality Assurance Division did not have sufficient information to determine whether the assessment conducted by the Field Detachment Quality Assurance Division was consistent with the reviews of the five regions. Therefore, the quality assurance reviews performed on Field Detachment audits were not independently conducted and had limited additional headquarters oversight to help ensure an independent assessment.

Because of the isolation of Field Detachment created by security requirements and how DCAA has decided to perform headquarters-led internal quality assurance reviews, DCAA has less assurance that the quality control system within Field Detachment is operating effectively. In addition, best practices or lessons learned may not be as readily shared between Field Detachment and the rest of DCAA.

Evidence. The PCIE Guide recommends that competent evidential matter be gathered and, where applicable, sufficient testing accomplished to determine whether the organization is in compliance with applicable auditing standards, policies, and procedures. DCAA developed an understandable, methodical process for selecting which FAOs and audit assignments to review. The selection criteria varied depending on the audit type being reviewed. See Finding B for a description of the process used on the internal quality assurance review of forward pricing assignments.

DCAA gathered what it considered sufficient evidence to evaluate whether its auditors were complying with applicable auditing policies and procedures. However, in conducting our review of forward pricing assignments, we had to do significant retesting because additional documentation was needed for us to form an opinion on the quality assurance work performed. See Finding C for a discussion of this issue.

Written Results. The PCIE Guide recommends the preparation of written results for each review that include recommendations for corrective actions when applicable. DCAA prepared trip reports that summarized the results of the review at each FAO and provided the trip reports to the FAO manager and the regional directors. The trip reports also function as the summary working paper. DCAA prepared and presented a briefing to the ESC in December 1999 that summarized the results of the review and the proposed corrective actions. That approach meets the intent of the characteristic outlined in the PCIE Guide. DCAA could enhance its program by issuing a summary report for each quality assurance review performed.

Written Responses. The PCIE Guide recommends that written responses be provided on each recommendation which should include proposed corrective actions or corrective actions already taken. Each FAO that DCAA reviewed provided written responses to draft trip reports, which DCAA considered and included in final trip reports. Agreement on what deficiencies need to be addressed is the first step toward improving audit performance. That approach incorporates the characteristic outlined in the PCIE Guide.

Followup Procedures. The PCIE Guide recommends that procedures be established for resolution and followup of recommended corrective action. A good followup system should provide information on the improvements made as a result of the work and whether the improvements achieved the desired result. Determining actions that were taken on recommendations requires continual monitoring of the status of recommendations. DCAA has two separate followup processes for monitoring the status of actions taken as a result of issues found during the headquarters-led internal quality assurance reviews. The specific followup process used depends on which division is assigned the responsibility for the corrective action established by the ESC. Any corrective action adopted by the ESC is assigned an action item number and is included in a database maintained by the Executive Officer for the Director, DCAA. If the ESC assigns the responsibility for a corrective action to a headquarters component, that component is responsible for followup. If the regions are assigned the responsibility, then the regional directors are responsible.

Headquarters Followup Process. As part of the management and execution of the quality assurance program, the headquarters Quality Assurance Division briefs the ESC on the various significant issues identified during the internal quality assurance reviews. As part of this process, headquarters Quality Assurance Division recommends potential corrective actions. If the ESC adopts a corrective action and assigns the action to a headquarters element, that component is responsible for followup. The ESC and the headquarters Quality Assurance Division are responsible for monitoring the followup. Most corrective actions that fit into that category are for agency-wide issues that require revisions to either DCAA policy or audit guidance.

RQA Followup Process. In general, each region, including Field Detachment, is responsible and accountable for implementing the corrective actions taken as a result of its regional quality assurance program and for maintaining appropriate documentation on the implementation. For each headquarters-led quality assurance review, the regional directors are required to prepare corrective action plans that discuss issues noted in the trip reports for the FAOs and to submit the plans to the Director, DCAA. In addition, the ESC can adopt a corrective action and assign the action to the regions for either implementation or followup. The action items are tracked through the ESC database. For action items assigned to the regions, DCAA relies on the regional directors to independently ensure that corrective action is taken. The regional directors can task the RQAs to verify that a corrective action has been properly implemented. However, the headquarters Quality Assurance Division performs no additional followup action until the next internal quality assurance review of the same type audit. DCAA stated:

Until the ESC Meeting in March 2001, no formal process existed at the Headquarters or ESC level for individually tracking the completion of each region's planned action. At that meeting, a new DCAA Strategic Plan objective was established entitled *Compliance with GAGAS*. Steps 3 & 7 of the milestone plan for this objective require the regions (and Field Detachment) to respectively:

- Implement (by May 2001) previously established regional action plans resulting from improvement areas identified by FY 1999 PCIE-based reviews.
- Brief (by December 2001) the ESC on status of progress on previously established regional action plans resulting from improvement areas identified by FY 1999 PCIE-based reviews.

DCAA should institutionalize the process described for future quality assurance reviews. Failure to properly implement corrective actions can cause a reviewer to discover repeat findings or issues during the next round of internal quality assurance reviews. Identification of repeat findings can lead to a qualified opinion on the internal quality control system depending on the significance of the issue. Therefore, regional directors should be required to notify the headquarters Quality Assurance Division when its corrective action plan has been implemented. Once DCAA establishes formal followup procedures, those procedures should be included in the written policies and procedures for conducting internal quality assurance reviews.

Scope of Headquarters-Led Quality Assurance Reviews

DCAA structured its internal quality assurance review program using the PCIE Guide as the primary framework for evaluating whether its auditors were complying with GAS and CAM. The PCIE Guide recommends that the scope of internal quality assurance reviews include a determination about the degree of compliance with GAS, applicable PCIE audit policy statements, and applicable statutory provisions. In addition, the PCIE Guide states that a thorough review would include methods for testing compliance with audit policies and procedures established at all levels of an organization. Also, the PCIE Guide recommends that an internal quality assurance program cover each of the audit offices issuing audit reports and an appropriate cross-section of the types of audits performed.

Compliance with Auditing Standards and Audit Guidance. DCAA used the PCIE Guide as a basis for its reviews. Specifically, DCAA drafted its own checklist (DCAA Checklist) by adapting questions from PCIE Appendix E, “Financial Statement Presentation and Disclosure Checklist,” (PCIE Checklist E), and PCIE Appendix F, “Checklist for Review of Individual Performance Audits” (PCIE Checklist F). In addition, DCAA used its own “Audit Report Quality Review Sheet for Audit Reports of All Types” (Audit Report Checklist) to review the selected audit reports. The DCAA Checklist questions contain references to GAS and CAM for most questions. However, because of the wording of certain questions or the criteria cited, DCAA did not properly evaluate compliance with certain auditing standards, specifically:

Due Professional Care. DCAA generally agreed that the questions for assessing due professional care did not adequately address compliance with the standard and agreed to modify the question.

Internal Controls. DCAA agreed that the questions could be reworded to resolve some of our concerns and increase the value and consistency of the answers. At a minimum, for future PCIE-based quality assurance reviews, DCAA will ensure that the reviewers sufficiently explain and/or document why the reviewers believe an auditor has demonstrated an adequate understanding of the internal controls despite not appropriately documenting that understanding. DCAA will also further examine our proposed changes that relate to checklist questions 6.1 and 6.2 to ensure that the significant data that need to be captured by these questions are captured.

Irregularities, Illegal Acts, and Other Noncompliances. Current DCAA audit guidance for forward pricing assignments does not require the auditor to fully assess audit risk resulting from fraud or other illegal acts because the DCAA standard audit programs for forward pricing assignments do not include all of the necessary audit steps. Therefore, the criteria that the DCAA reviewers used to answer the DCAA Checklist questions were incomplete. DCAA has stated that the risk of fraud is generally inherently less in pre-award audits because fraud requires that the Government be harmed and the Government cannot be harmed until contract award. DCAA agreed to

reconsider its position and review each of its forward pricing audit programs to determine where it might best add appropriate steps to more directly cover those concerns.

See Finding C for detailed discussion of the DCAA Checklist issues. In addition, DCAA did not fully consider regional and FAO quality control policies and procedures in its internal quality assurance review of forward pricing assignments. DCAA planned to start a review of compliance with the general standards of staff qualifications and independence for its overall quality assurance program in October 2001 and to complete the review by March 2002.

Qualifications and Independence. The GAS general standards of qualifications and independence serve as the foundation for other auditing standards. The importance of complying with the fieldwork and reporting standards rests on the presumption that the audit organization is in compliance with the general standards. The internal quality assurance review process that DCAA initially developed included plans to review compliance with the general standards of qualifications and independence throughout the agency. Those plans did not include testing at the FAO level.

Qualifications. Subsequent to the start of the 3-year cycle, DCAA decided to postpone its review of qualifications—specifically continuing professional education—until FY 2002 because DCAA was in the process of revising guidance on continuing professional education requirements. DCAA plans to complete the review by March 2002. However, a complete review of qualifications covers more than continuing professional education requirements. The review should include hiring and promotion policies and procedures and the use of external consultant and internal experts. The DCAA headquarters Quality Assurance Division plans to gather relevant documentation on qualifications before the end of the 3-year cycle.

Independence. The DCAA headquarters Quality Assurance Division plans to gather relevant documentation on independence before the end of the 3-year cycle and to complete the review of independence by March 2002. The DCAA Quality Assurance Division can either test whether the applicable controls are in place and operating as expected for independence or refer to the review work performed by another DCAA component that they relied on.

DCAA needs to conduct a complete review of the general standards of qualifications and independence during the 3-year cycle as planned to have reasonable assurance that its audits are being performed in compliance with GAS and CAM. GAS 1.14 places the responsibility on the audit organization for ensuring that qualified personnel conducted the audits and that independence is maintained.

Assessment of DCAA Multi-Level Quality Control Procedures. The DCAA quality assurance review of forward pricing assignments did not fully consider regional and FAO quality control policies and procedures. The DCAA quality control system includes quality control procedures implemented at headquarters, the regions, and the FAOs. CAM 2-S10 states:

Direct responsibility for quality in all audit and resource management functions is vested in the line and staff managers and supervisors at all levels of DCAA. . . . Quality control review planning considers the universe of all audit and resource management functions at all organizational levels.

To fully assess the adequacy of the DCAA quality control system as described in CAM, DCAA should have tested compliance with policies and procedures issued by the regions and the FAOs in addition to DCAA-wide policies and procedures. However, when completing the DCAA Checklist, the reviewers did not indicate that they considered anything other than DCAA-wide quality control policies and procedures. The DCAA staff stated that the internal review of the quality control system was being conducted in accordance with the PCIE Guide and believed that the PCIE Guide does not require an evaluation of regional and FAO-specific quality control policies and procedures. In addition, the DCAA staff expressed concern that including regional and FAO-specific quality control procedures would result in the FAOs not being evaluated using the exact same criteria for each FAO. For the DCAA quality control system to be considered properly implemented and operating effectively as required by GAS, regional and FAO-specific quality control policies and procedures must be included in any internal quality assurance review.

DCAA has taken corrective action to ensure that its quality control system will be fully evaluated. DCAA has added the question, “Were the quality control procedures, forms, and checklists required by Regional/FAO policy appropriately completed/complied with?” to the January 2001 version of the DCAA Checklist that was being used for the review of incurred cost audits. Because DCAA has taken corrective action, we have no recommendation.

Review of FAOs. The PCIE Guide recommends that an internal quality assurance program include all of the audit offices that issue audit reports. All of the FAOs issue audit reports; however, DCAA never planned to ensure the review of every FAO in a given 3-year cycle. Although DCAA did not plan to prohibit two reviews of any FAO during the same 3-year cycle, DCAA has tried not to review an FAO twice. In addition, DCAA never planned to include the two overseas FAOs in the headquarters-led quality assurance reviews. DCAA should revise its planning process to ensure that each FAO is included in at least one headquarters-led quality assurance review during each 3-year cycle. For the first 2 quality assurance reviews, DCAA evaluated 36 FAOs. For the third review, DCAA plans to evaluate 28 FAOs, one of which had already been included. DCAA currently has 81 FAOs. To ensure coverage of the FAOs, the fourth quality assurance review should either include the 18 FAOs not previously reviewed or specifically state why the risk at an excluded FAO did not warrant inclusion in a quality assurance review.

Overseas FAOs. DCAA has two FAOs that are physically located overseas. The European Branch Office is in Germany, with suboffices in Saudi Arabia and Israel, and reports to the Regional Director, Northeastern Region. The Pacific Branch Office is in Japan, with suboffices in Hawaii and Korea, and reports to the Regional Director, Western Region. For the review of the two overseas FAOs, the regional audit managers conducted self-assessments

whenever they visited those locations. However, the self-assessment does not satisfy the need for an independent review. The workload at the two offices is significant. In FY 2000, DCAA expended an average of 47,374 audit hours and issued an average of 515 reports per FAO. By comparison, in FY 2000, the European Branch Office expended 27,328 audit hours and issued 395 reports, and the Pacific Branch Office expended 14,071 audit hours and issued 456 reports. In addition, each FAO has an average staff⁸ of 47 staff members, while the European FAO had 43 staff members and the Pacific FAO had 21 staff members. Therefore, while the two overseas FAOs are not as large as an average FAO, they are still responsible for a considerable number of assignments. In addition, the types of reviews performed may be more sensitive at those locations because DCAA is normally reviewing foreign entities. The Western Region RQA staff has included the Pacific Branch Office in its regional quality assurance reviews since FY 1999, the year that the Western Region RQA was established. In FY 2000, an RQA reviewer visited the Pacific Branch Office for reviews of management information data integrity and computer-assisted audit techniques. In addition, the Western Region RQA had the Pacific Branch Office mail the data to be included in reviews of defective pricing audits in FY 1999 and of nonmajor incurred cost audits in FY 2000. The Regional Director, Northeastern Region, is considering including the European Branch Office in its regional quality assurance reviews.

We consider workload of this magnitude to require some independent review. If field visits are not practical, other means can be used, such as mailing the selected audit files to DCAA headquarters for review in a process similar to that now being used by the Western Region RQA. With most DCAA audit work now documented with electronic working papers, this option is more easily implemented than before. In response to a discussion draft of this report, DCAA reconsidered its position as to whether the overseas FAOs should be included in the internal quality assurance reviews. On March 30, 2001, DCAA notified us that they would begin to include both overseas FAOs in the universe of offices potentially selected for future reviews.

Cross-Section of Audits Reviewed. In designing its headquarters-led quality assurance program, DCAA concentrated on ensuring that it covered a broad cross-section of audit work. DCAA was concerned that the audit coverage not be so broad as to preclude gathering sufficient data to draw meaningful conclusions. Beginning in FY 1999, DCAA established a 3-year cycle for conducting internal quality assurance reviews that would cover the various types of contract audits that DCAA routinely performs. DCAA initially determined that its workload fell into three major categories—forward pricing assignments, incurred cost audits, and all other assignments. DCAA planned to conduct separate internal quality assurance reviews for each of these audits. Subsequently, DCAA decided to separately review its audits of contractor internal controls instead of including them when reviewing the incurred cost audits. Therefore, in total, the DCAA headquarters Quality Assurance Division

⁸Staff includes supervisors, administrative, and regional office staff.

planned to conduct four quality assurance reviews during the 3-year cycle. That method of performing internal quality assurance reviews should provide adequate coverage of the routine audits performed by DCAA.

Summary

The goal of a quality assurance program is to assess whether an organization carries out its work in accordance with GAS and established policies and procedures. In addition, a quality assurance program may include an objective to assess whether the work was carried out economically, efficiently, and effectively. The purpose of reviewing a quality assurance program is to determine whether the program is adequately designed to meet the objectives of quality assurance and whether it produces reports on which the external reviewer can rely. While the use of the results of internal reviews as direct evidence can reduce the nature or extent of testing performed by the external review team, the external reviewer's opinion on the quality control system should not be based solely on evidence provided by the internal reviews. Once the quality assurance program is refined and issues discussed above are addressed, DCAA should have reasonable assurance that its internal quality control system is comprehensive and suitably designed to ensure that DCAA is complying with all applicable standards, policies, and procedures.

Management Comments on the Finding and Evaluation Response

Summaries of management comments on the finding and our evaluation response are in Appendix B.

Recommendations, Management Comments, and Evaluation Response

A. We recommend that the Director, Defense Contract Audit Agency, as part of the quality assurance program:

1. Develop written policies and procedures for conducting internal quality assurance reviews before starting the next review.

Management Comments. DCAA concurred in principle. DCAA acknowledged that the general policies and procedures on Microsoft PowerPoint slides should be formalized. However, DCAA stated that assigning additional resources to have the formalization completed by July 2001 would adversely

impact the current PCIE-based review plans and schedule. Therefore, DCAA planned to formalize the policies and procedures by December 31, 2001,⁹ prior to the start of the next cycle of internal quality assurance reviews. DCAA believes that the schedule will allow the Inspector General, DoD, to review DCAA policies and procedures well before the completion of its review of DCAA's first cycle of PCIE-based quality reviews.

Evaluation Response. The DCAA comments meet the intent of the recommendation.

2. Monitor the work assigned to the headquarters Quality Assurance Division to ensure that the internal quality assurance program reviews are accomplished during each 3-year cycle.

Management Comments. DCAA concurred with the recommendation.

3. Institutionalize procedures established at the March 2001 Executive Steering Committee meeting for tracking corrective actions for internal quality assurance reviews to include timely implementation.

Management Comments. DCAA concurred with the recommendation.

4. Conduct independent internal quality assurance reviews of all field audit offices, including the two overseas field audit offices and Field Detachment, within the 3-year cycle.

Management Comments on Review of All FAOs. DCAA concurred in part. Regarding the review of all FAOs during each 3-year cycle, including the two overseas FAOs, DCAA stated that they do not believe that it is good policy to firmly commit at the beginning of each PCIE-based 3-year review cycle to cover all of the FAOs. Nevertheless, under the DCAA current methodology for conducting the PCIE-based reviews and given the DCAA revised position relating to its two overseas offices, it is very likely that every FAO will be covered during the first and subsequent review cycles.

Evaluation Response on Review of All FAOs. The DCAA comments related to reviewing all FAOs meet the intent of the recommendation. While the PCIE Guide does not specifically require that all of the offices issuing reports be reviewed, the PCIE Guide states that the selection of offices to be reviewed should take into consideration the number, size, and geographic distribution of the offices; number, type, and importance of reports issued by location; and the degree of centralized control over regional and branch offices. In addition, General Accounting Office Guide GAO/OP-4.1.6, "An Audit Quality Control System: Essential Elements," August 1993, recommends that, "Over time, all organizational units should be reviewed and their products tested." Therefore, it would be prudent if DCAA reviewed every FAO during each of its 3-year cycles.

⁹The DCAA comments state that DCAA planned to formalize its policies and procedures by September 30, 2001. However, via email of October 30, 2001, DCAA revised its milestone date.

Management Comments on the Required Clearances of DCAA Reviewers for Field Detachment. DCAA agreed that only two additional DCAA staff auditors need to obtain the appropriate security clearances to review Field Detachment. However, DCAA believes that to appropriately plan, supervise, analyze, and report the results would require that several additional personnel obtain the appropriate security clearances.

Evaluation Response on the Required Clearances of DCAA Reviewers for Field Detachment. We agree that management involved in planning, supervising, analyzing, and reporting the results need the appropriate security clearances. However, DCAA still needs to conduct an independent review of Field Detachment. We request that DCAA reconsider its position and provide comments to the final report.

B. Internal Quality Assurance Review of Forward Pricing Assignments

DCAA selected forward pricing assignments¹⁰ as the first category of audits to be reviewed. DCAA developed and implemented a reasonable methodology for selecting FAOs and audit assignments to be reviewed. The DCAA internal quality assurance review of forward pricing assignments identified some areas needing improvement for which DCAA had a process in place to ensure corrective action, had implemented corrective action, or had initiated corrective action. Specifically, DCAA identified issues related to:

- quality of audit reports and supervision for which DCAA determined that no additional corrective actions were needed;
- preparing risk assessments and setting up audit assignments for which DCAA implemented corrective actions;
- delegating authority to sign audit reports for which DCAA implemented corrective action, but a potential area for improvement still exists;
- properly documenting reliance on data from computer-based systems for which DCAA established an action item for implementation of corrective action; and
- audit execution issues for which the regions and Field Detachment were required to prepare corrective action plans.

DCAA identified issues that were important for ensuring that quality audits were performed and quality audit reports were issued and DCAA took corrective action to resolve many of the issues. To resolve the remaining issues, DCAA should implement revised guidance on delegating the authority to sign audit reports and documenting reliance on data from computer-based systems. Timely implementation of corrective actions will ensure that the DCAA internal quality assurance program is effective.

Review of Forward Pricing Assignments

DCAA initiated its internal quality assurance program in February 1999 and selected forward pricing assignments as the first category to be reviewed because those assignments made up a significant portion of its workload. For

¹⁰Examples of forward pricing assignments include price proposals, integrated product teams, specified cost elements, agreed-upon procedures, and forward pricing rate agreements.

example, in FY 1999 DCAA completed forward pricing reviews covering \$64.9 billion. DCAA developed a two-tiered selection methodology for determining which FAOs and assignments to review. First, DCAA selected the FAOs to visit based on the dollar volume of price proposals reviewed. Once the FAOs were selected, DCAA selected the assignments to be reviewed.

Selection of FAOs. DCAA selected and visited 18 FAOs, 3 per region. The 18 FAOs represented 22.2 percent of the universe of 81 FAOs in existence as of January 2000. DCAA developed a standard methodology to be used to judgmentally select the three FAOs to be reviewed in each region. Specifically, DCAA selected the FAO with the highest number of forward pricing reports issued, the FAO with the most dollars examined, and the FAO with the most audit hours expended. DCAA ensured that each region included at least one branch office and one resident office.

Selection of Forward Pricing Assignments. DCAA selected and reviewed 126 forward pricing assignments, 7 assignments per FAO. The 126 assignments represented 3.2 percent of the universe of 3,931 assignments completed by all of the FAOs, 3,413 assignments completed by the 5 regions as of February 28, 1999, and 518 assignments completed by Field Detachment as of May 31, 1999. DCAA developed a standard methodology to be used to judgmentally select the 7 assignments to be reviewed at each of the 18 FAOs. The seven assignments were an;

- audit of a price proposal of less than \$5 million with the most dollars examined,
- audit of a cost-type-price proposal with the most dollars examined,
- audit of a fixed-price proposal with the most dollars examined,
- audit of a proposal that resulted from an integrated product team with the most dollars examined,
- audit of a forward pricing rate proposal on which the FAO expended the most hours,
- audit of specified cost elements with the most dollars examined, and
- agreed-upon procedures review of a proposal on which the FAO expended the most hours.

In addition, DCAA developed a methodology for substituting assignments for FAOs that had not completed assignments in the sampling methodology.

Based on the results of its internal quality assurance review of forward pricing assignments, DCAA identified areas for improvement and presented that information, along with proposed corrective actions, to the ESC in December 1999.

Corrective Action Processes in Place

Quality of Audit Reports. DCAA identified issues relating to the quality of audit reports, but determined that no separate action was needed because a process was already established that should ensure corrective action took place. DCAA established an audit report quality review program in 1995 that included the use of the Audit Report Checklist. The regions were required to review a sample of reports and submit the results to DCAA headquarters semiannually. DCAA summarized the results in an MRD that was provided to the regional directors and the Director, Field Detachment. During the internal quality assurance review of forward pricing assignments, DCAA used the Audit Report Checklist to evaluate the quality of the 126 reports. DCAA found what they considered to be significant noncompliances for the following six questions:

- Question No. 1. Is the draft report cross-referenced to the working papers?
19 occurrences (15.1 percent)
- Question No. 9. Does the qualifications paragraph summarize the adverse conditions having a significant impact on the conduct or audit scope and reference the detailed explanation of the impact on the audit results?
32 occurrences (25.4 percent)
- Question No. 10. Does the results of audit paragraph express or disclaim an overall audit opinion? (Several variations of the question were present depending on the type of assignment being conducted.)
17 occurrences (13.5 percent)
- Question No. 36. Does the results of audit section provide details on the exit conference to include a description of the contractor's reaction to the audit findings or refer to where the contractor's reaction is discussed?
17 occurrences (13.5 percent)
- Question No. 38. If required, does the "Contractor Organization and Systems" section provide information on the contractor's organization and systems, or refer to a prior report or other correspondence where information was provided?
16 occurrences (12.7 percent)
- Question No. 40. Are the appropriate restrictions on release of the audit report and any attachments included on the "Audit Report Distribution and Restrictions" page?
16 occurrences (12.7 percent)

DCAA determined that they did not need to propose corrective action to reduce future occurrences of cited noncompliances because the regions and the FAOs were already required to meet the strategic plan objective of, "By calendar year 1999, 2000, and 2001, improve audit report quality by increasing 'zero error'

audit reports to 75%, 85%, and 95% respectively.” For calendar year 1999, DCAA determined that the “zero error” rate was 73.4 percent and for calendar year 2000 the rate was 80.6 percent. However, for the 126 forward pricing reports reviewed, DCAA found that 34 (27.0 percent) reports had zero errors.

Supervision. DCAA identified issues related to the supervision of assignments, but determined that no corrective action was needed because a process was being established to ensure that corrective action took place. DCAA found that most of the audits with significant problems (technical/compliance related or unjustified hours or rework) lacked the minimum documentation indicating supervisory involvement. Specifically, DCAA found that supervisors were not signing (approving) risk assessments and audit program steps prior to the performance of the audit steps and were not signing (approving) summary working papers prior to issuance of the audit report. In addition, DCAA found instances where working paper files were not put together, audit programs or key elements were missing from the working papers, or the working papers did not support the number of hours expended on the audit or the type of report issued. DCAA anticipated that the new supervisory documentation requirements resulting from implementation of the Audit Planning and Performance System (APPS) would resolve those issues. APPS is an automated working paper package that includes standard audit programs and standard report formats for various types of assignments. In addition, DCAA required that the regions and Field Detachment place renewed management emphasis and attention on supervision.

Corrective Actions Completed

Risk Assessments. DCAA identified an issue related to preparing adequate risk assessments and took corrective action. Specifically, DCAA determined that auditors preparing risk assessments for forward pricing assignments did not always:

- set control risk properly or link it to the level of substantive testing performed,
- determine how prior findings would impact the current audit,
- consider the materiality of a proposal in total and by cost element, or
- consider the proposal type and how it would affect the audit scope.

To resolve those issues, DCAA developed a revised format for risk assessments, released in April 2000, and a presentation package on preparing adequate risk assessments for price proposals. In addition, DCAA revised the standard audit programs by adding preliminary audit steps to complete a risk assessment and to coordinate with contracting officers to ensure an understanding of the audit request. Also, DCAA presented briefings on the new risk assessment format in May 2000 and provided training sessions beginning in September through

November 2000. Initially, DCAA was requiring the RQAs to assess the effectiveness and adequacy of the revised risk assessments and to present the results at the June 2001 ESC meeting. However, at the December 2000 ESC meeting, DCAA extended the deadline to the September 2001 ESC meeting.

Setting Up Audit Assignments. DCAA identified an issue related to setting up audit assignments and took corrective action. Specifically, when receiving conflicting requests involving the audit or review of a proposal or an element of a proposal, the auditors did not contact the procurement officials to clarify the extent of audit work needed before setting up the assignments. As a result, assignments were established and work was performed that may not have met the needs of the procurement officials. In the December 1999 briefing to the ESC, DCAA proposed corrective action of establishing a team to research audit assignment issues and to provide clarifying guidance by April 14, 2000. On March 8, 2001, DCAA issued DCAA MRD 01-PPD-020(R), "Clarification of Guidance on Coordination of PCO [procuring contracting officer] Request for Field Pricing Support," which provided supplemental explanation of guidance in the CAM.

Corrective Action Completed but Potential for Improvement Exists

DCAA identified an issue related to the delegation of authority to sign audit reports and took corrective action. DCAA Regulation 5600.1, "Delegation of Signature Authority," November 27, 1995, authorized an FAO manager or resident auditor to redelegate the authority to sign any type of audit report, no matter how sensitive, to the supervisory auditor. DCAA found that regional audit managers and FAO managers were routinely delegating the authority to sign the more significant and sensitive reports to supervisory auditors. To correct that deficiency, DCAA issued a revised DCAA Regulation 5600.1, "Delegation of Signature Authority for Audit Reports and Other Audit Related Documents," June 28, 2000. Under the revised regulation, the FAO manager is not authorized to delegate authority to sign reports for various type of audits including:

- forward pricing audits when total dollars examined is \$100 million or more or costs questioned are \$1 million or more or exceed 10 percent of the dollars examined;
- incurred cost audits when the total dollars examined are \$80 million or more or when costs questioned are \$1 million or more or exceed 5 percent of the dollars examined;
- internal control audits with system opinion of inadequate or inadequate in part;
- operations audits with recommended cost avoidance;

-
- restructuring rate proposal audits;
 - terminations or other claims; and
 - audits pertaining to sensitive, controversial, complex, unusual, or significant matters.

The revised regulation corrected the identified issue. However, the revised regulation did not correct another previously existing deficiency. The revised regulation, like the previous version, allows a supervisory auditor, as acting FAO manager, to sign his own audit reports on issues listed above. That management control deficiency occurs because the revised regulation continues to grant acting FAO managers the same signature authority as FAO managers without that authority being considered a redelegation. Therefore, audits that DCAA determined to be significant or sensitive and subject to review by the FAO manager are not being reviewed by someone independent of the supervisory auditor when that supervisory auditor is the acting FAO manager. An independent review of audit reports provides a needed quality control over the audit logic and helps ensure the integrity of the audit reports. As a result of supervisors signing their own audit reports without an independent review when acting as FAO manager, the risk of sensitive or significant audit reports being issued with errors is increased in comparison to when such reports are issued after an independent or FAO manager review.

Corrective Actions Initiated

Documenting Reliance on Data From Computer-Based Systems. DCAA identified an issue related to properly documenting reliance on data from computer-based systems and has established an action item for the corrective action. Specifically, DCAA found that auditors reviewing price proposals from nonmajor¹¹ contractors did not obtain adequate evidence about the reliability of data from computer-based systems or did not document that they had obtained any evidence, and were not specifically required by DCAA guidance to do so. In the December 1999 briefing to the ESC, DCAA proposed corrective action for determining if and how DCAA guidance should be modified to suit the type of audits they perform and to issue clarifying guidance as appropriate by April 14, 2000. The ESC approved the proposed corrective action and established action item E99-12-13. However, as of September 2001, no clarifying guidance has been presented to the ESC or issued. The issue that DCAA identified during its internal quality assurance review and the corrective action proposed will not fully correct the issue found during our external review. See Finding C for a discussion of this issue.

¹¹A nonmajor contractor is a contractor where DCAA has less than \$80 million of contractor costs to audit in one fiscal year. The cognizant DCAA office can decide, based on the significance of an internal control system, whether to perform an internal control system review of a nonmajor contractor.

Audit Execution Issues at the Regional and Field Detachment Level. DCAA identified areas for improvement for which the regions and Field Detachment managers were required to submit corrective action plans. The corrective action plans have been submitted but have not yet been fully implemented. Specifically, DCAA identified the following issues in addition to supervision discussed above.

Auditor Support of Cost Realism Exercises. The auditors were not coordinating with the cognizant procurement liaison auditors when customers insisted on full audits for clear cost realism exercises.

Need for Technical Specialist Assistance. Some auditors and supervisory auditors were not following the policy to end routine/automatic requests for technical assistance.

Understanding Internal Controls and Documentation Thereof. Some FAOs did not have an internal control questionnaire or Internal Control Audit Planning Summary (ICAPS) forms that were reasonably complete or up to date. In addition, individual assignment working papers did not contain appropriate references or use of internal control questionnaires or ICAPS.

Redelegation of Signature Authority. Some supervisory auditors did not comply with regional and FAO redelegation of signature authority.

To resolve the issues, at the December 1999 ESC meeting DCAA established Action Item E99-12-14 that required the regional and Field Detachment management to analyze region results and to develop action plans by April 30, 2000. All of the action plans were submitted to the Director, DCAA, before April 30, 2000. At the March 2001 ESC meeting, DCAA established a milestone to “Implement previously established regional action plans resulting from improvement areas identified by FY 1999 PCIE-based reviews” by May 2001. In addition, DCAA established a milestone to “Brief ESC on status of progress on previously established regional action plans resulting from improvement areas identified by FY 1999 PCIE-based reviews” in December 2001.

Summary

The review of forward pricing assignments was the first DCAA internal quality assurance review. As such, DCAA did a credible job identifying several significant areas for improvement that required corrective action. However, DCAA has not implemented all of the proposed corrective actions. To maximize the potential for improvements from internal quality assurance reviews, DCAA should implement the corrective actions proposed by the headquarters Quality Assurance Division and approved by the ESC in a timely manner.

Recommendations, Management Comments, and Evaluation Response

B. We recommend that the Director, Defense Contract Audit Agency:

1. Revise Defense Contract Audit Agency Regulation 5600.1, “Delegation of Signature Authority for Audit Reports and Other Audit Related Documents,” June 28, 2000, so that supervisory auditors, acting as field audit office managers, cannot sign reports on audit assignments they supervised.

Management Comments. DCAA nonconcurred. Revising the policy to preclude an acting FAO manager from signing his or her own reports when required by the circumstances would further complicate an already complex policy without significant benefit. In addition, DCAA stated that only the most qualified supervisors should be designated to act as FAO managers and that less qualified supervisors should not be given the final authority to sign audit reports simply because they had no involvement with a particular audit. Also, DCAA stated that if data from future reviews indicate significantly more errors associated with reports signed out by acting FAO managers, DCAA will appropriately revisit its signature authorization policy.

Evaluation Response. DCAA misunderstands the nature of the management control weakness that we identified. A signature on an audit report is an indication that the report was reviewed by someone other than the supervisory auditor. Requiring the independent review of audit reports deemed sensitive by DCAA management is an extremely important management control procedure and will, in turn, assist DCAA in meeting its strategic plan goal of increasing the “zero error” rate for audit reports.

General Accounting Office Guide GAO/OP-4.1.6 states that an independent verification of the evidence supporting the product and review of the product can help ensure quality. Independent verification of the evidence, also known as referencing, is done by a person who is independent, objective, and experienced to verify whether facts and figures are correctly reported and that findings are adequately supported by the facts in the working papers. A product review helps ensure that higher level managers are satisfied with the overall quality of the product and that the message is sound, addresses the objectives, meets the customer’s needs, and is consistent with results in previous reports. However, DCAA does not require any region or FAO to perform a reference review of any audit report. In addition, DCAA does not require that every report be subject to a product review. DCAA has, however, granted the regions and FAOs the authority to conduct peer reviews of specific types of reports if desired. Therefore, review and signature by someone other than the audit supervisor is critical to ensure a quality product.

Finally, we do not consider the revised policy to be overly complex or difficult to implement. Our recommendation does not specify what alternative procedures DCAA should use in these circumstances. Formally designating

more than one acting FAO manager for report signing purposes is only one possibility. Unless an independent peer review is performed, a signature on an audit report by someone other than the supervisory auditor is the minimum indication of a product review, and, therefore an indication that the report meets the GAS standards for quality. We request that DCAA reconsider its position and provide comments to the final report.

2. Issue the clarifying guidance for documenting reliance on data from computer-based systems.

Management Comments. DCAA concurred, stating that they would issue new guidance on when and how DCAA audits of nonmajor contractors should obtain and appropriately document adequate evidence on the reliability of the contractor's computer-based data by November 30, 2001.¹²

¹²DCAA established April 14, 2000, as the initial milestone date for issuing this guidance. However, at the December 2000 ESC meeting, DCAA revised the milestone date to January 31, 2001. At the March 2001 ESC meeting, DCAA revised the milestone date to May 31, 2001. In the DCAA comments to a draft of this report, DCAA stated that they planned to issue the guidance by September 30, 2001. However, at the September 2001 ESC meeting, DCAA again revised the milestone date to November 30, 2001.

C. Implementation of the Internal Quality Assurance Review of Forward Pricing Assignments

DCAA primarily used the DCAA Checklist, FAO exit conference notes and trip reports to document its internal quality assurance review of the individual forward pricing assignments. However, the documents generated by the quality assurance staff did not completely explain the work performed or fully document conclusions reached. In addition, DCAA did not fully evaluate whether the reviewed audits met certain auditing standards. DCAA maintained limited documentation because management determined that only exceptions needed supporting documentation or explanations. The use of poorly worded checklist questions; ill-defined criteria for evaluating audit work; and incomplete guidance for assessing noncompliances, illegal acts, and other irregularities impacted the complete evaluation of certain auditing standards. DCAA needs to take corrective action on the internal quality assurance reviews so an external reviewer can place maximum reliance on the DCAA work when conducting oversight reviews. If DCAA adequately documents the internal quality assurance reviews, the external reviewers may use the results as direct evidence to support its overall opinion of the internal quality assurance program.

Documentation of the Quality Assurance Reviews

DCAA needs to improve its documentation of work performed when conducting internal quality assurance reviews. The DCAA quality assurance staff documented the results of the internal quality assurance review by completing a DCAA Checklist for each of the 126 assignments reviewed and writing exit conference notes and a trip report summarizing the results of the review for each of the 18 FAOs visited (7 assignments per FAO). As supporting documentation, the quality assurance reviewers obtained a copy of the audit report issued for each reviewed assignment, except for the four classified reports, and copies of working papers that the reviewer decided were needed. The working papers that the reviewers copied varied from none of the audit file to most of the audit file depending on how the reviewer completed the DCAA Checklist. DCAA generally maintained limited documentation because management determined that only exceptions to DCAA Checklist questions needed supporting documentation or explanations.

DCAA used the PCIE Guide as the primary framework for conducting its internal review and believed that this was the most critical factor for ensuring that an external reviewer could place maximum reliance on the results. The PCIE Guide requires that:

Competent evidential matter should be gathered. . . . Working papers should be prepared to document the work performed and the conclusions reached during the review. . . . The review team should exercise due professional care and sound professional judgment in all matters relating to planning, performing, and reporting the results.

The quality assurance documentation and supporting FAO working papers used by the quality assurance staff did not sufficiently document the work performed or all the conclusions reached during the review. To complete our evaluation of the internal quality assurance review of forward pricing assignments, we had to spend considerable time discussing each completed DCAA Checklist that we reviewed with the quality assurance staff. For some assignments, we had to discuss the audit with the FAO to complete the checklist questions. The adequacy of the internal quality assurance review documentation directly affects the extent to which an external reviewer can rely on the DCAA quality assurance program.

Documentation Supporting the DCAA Checklists. DCAA did not maintain sufficient documentation to support its conclusions on the DCAA Checklists. When planning the review, DCAA decided to obtain supporting documentation for only “no” answers to DCAA Checklist questions because “no” answers indicate a deficiency. The DCAA Checklist also contains a column for comments to each question; however, the reviewers did not always make comments. Without the comments, we were unable to evaluate the reviewer’s rationale for their responses without retesting and drawing our own conclusions. For 6 of the 21 DCAA Checklists that we retested, the DCAA quality assurance reviewers had adequately cross-referenced to applicable FAO working papers or provided appropriate notes in the comment column. We were generally able to use the information provided on the 6 checklists to understand reviewer rationale for conclusions. DCAA explained that, if the quality assurance reviewers were required to meaningfully document all of the “yes” answers, then DCAA would have to “significantly cut back on the number of audits reviewed.” According to DCAA, “the fewer audits reviewed, the less meaningful the results and the less likely existing problems/noncompliances will be accurately identified and satisfactorily addressed.”

When evaluating the adequacy of an internal quality assurance review, the external reviewer has to consider responses to all questions no matter whether the answer is “no,” “yes,” or “not applicable.” DCAA stated that because of the general nature of many of the checklist questions, “providing genuinely useful and meaningful (i.e. substance over form) documentation for the ‘yes’ responses would be very time consuming.” In addition, DCAA believes that “many of the key questions cannot be dealt with simply by reviewing and referencing a single working paper or working paper section.” The PCIE Guide recommends that competent evidential matter be gathered and, where applicable, sufficient testing be accomplished to determine whether the organization is in compliance with applicable auditing standards, policies, and procedures. Evidence includes documentation for “yes” answers. The documentation for “yes” and “not applicable” answers would not be as extensive as the documentation for “no” answers. The documentation could consist of brief notes in the comments section of the DCAA Checklist or a

predetermined set of criteria for a “yes” answer. In addition, tailoring the questions to more specifically address the way DCAA operates would help improve documentation and reduce the time needed to document reviewer conclusions. Additional documentation should not negatively impact the number of FAOs or assignments reviewed. Documentation is the key for an external reviewer being able to rely on DCAA work.

Cross-Referencing the Internal Quality Assurance Review Reports. DCAA wrote a trip report in the form of a Memorandum For Record for each of the 18 reviewed FAOs. The trip report summarized the major findings of the internal quality assurance review at that FAO and included an enclosure that summarized the DCAA Checklist answers by reviewed assignment. The major conditions discussed referenced the applicable reviewed assignment and the DCAA Checklist question, if pertinent. DCAA was not required to, and did not, cross-reference the 18 trip reports to the supporting quality assurance documents. Cross-referencing the trip report to the actual quality assurance documents would establish an audit trail showing that all facts in the trip report are supported by the quality assurance documents. Cross-referencing the report to the actual supporting working papers is a generally accepted practice. In fact, CAM 4-403(i)(3) provides guidance on cross-referencing that includes the requirement to cross-reference the summary results and notes in a DCAA draft report to the DCAA summary and lead working papers.

External Reviewer Reliance on DCAA Internal Quality Assurance Review Documentation. The DCAA working papers that support its internal quality assurance reviews must contain sufficient evidence to support each auditor conclusion for an external reviewer to place maximum reliance on the work. Although DCAA is not required to follow the CAM when conducting internal quality assurance reviews, proper cross-referencing would facilitate identifying supporting documentation for significant auditor conclusions. Because of inadequate comments, cross-referencing, and documentation we did not rely on the working papers when conducting our review. We retested the validity of the results of the DCAA internal quality assurance review of forward pricing assignments by judgmentally selecting three FAOs and evaluating the same seven assignments at each FAO that DCAA initially reviewed using the DCAA Checklist. Better documentation will allow the external reviewer to rely to a greater extent on the DCAA results. That reliance, in turn, will reduce the staff time that both agencies will have to expend on the reviews.

Assessment of Internal Quality Assurance Review Results for Forward Pricing Assignments

DCAA used the questions from the PCIE Checklist as the starting point for formulating the DCAA Checklist. DCAA revised 24 of the PCIE Checklist F questions because those questions did not specifically pertain to the DCAA audit environment. Of the 24 revised questions, DCAA significantly changed 5. DCAA used the DCAA Checklist questions to evaluate whether the selected

audit assignments met the auditing standards and complied with agency policy and procedures. The DCAA Checklist, dated July 9, 1999, contained eight sections that roughly equate to the various GAS. In total, the DCAA Checklist had 49 questions. Of the 49 questions, we identified 8 that, as implemented, impacted the complete evaluation of certain auditing standards. That situation occurred because of the use of poorly worded checklist questions; ill-defined criteria for evaluating the evidence of audit work; and incomplete guidance for assessing noncompliances, illegal acts, and other irregularities. The eight questions need revision to ensure that DCAA properly assesses whether an audit met that particular auditing standard. In addition, by tailoring the questions to evaluate compliance with standards based on the way DCAA operates, DCAA should be able to more efficiently document its conclusions. The questions needing improvement are quality control (one question); due professional care (two questions); data from computer-based systems (one question); internal controls (two questions); and noncompliances, illegal acts, and other irregularities (two questions). The question on quality control is addressed in Finding A, and DCAA has already revised the checklist question. In addition, we determined that one question relating to report cross-referencing on the Audit Report Checklist and the related CAM guidance need revision.

Due Professional Care. When DCAA evaluated compliance with due professional care, DCAA used questions 1.1 and 1.2 from PCIE Checklist F without adapting them for the way DCAA operates.

1.1 Did the auditors follow proper procedures when determining that an applicable government auditing standard was not to be followed?

1.2 Did the auditors adequately document the determination that certain government auditing standards did not apply?

Those two questions only partially address whether auditors met the due professional care standard as defined by GAS. Proper consideration of whether due professional care was exercised is required to adequately perform an internal quality assurance review. Due professional care, according to GAS, means using sound judgment in establishing the scope, selecting the methodology, and choosing the tests and procedures for the audit.

DCAA generally agreed that the questions from the DCAA Checklist do not adequately address compliance with due professional care. In addition, we agree with DCAA that the questions should be answered after a complete review of the audit file and after all other questions are answered. Therefore, an additional enhancement to the DCAA Checklist format would be to put questions on due professional care at the end of the DCAA Checklist. At the exit conference for this review held on March 6, 2001, DCAA agreed to use the following revised wording, "Did the auditors exercise due professional care in performing the audit?" On the March 12, 2001, version of the DCAA Checklist, DCAA eliminated question 1.2 and adopted the wording above for question 1.1. DCAA made that change midway through its review of incurred cost audits (the third review). We recognize that DCAA reviewers applying the due professional care standard have a wide variety of knowledge and audit experience; therefore, to assist the reviewers in consistently applying the due

professional care standard, DCAA should provide criteria so that variations in applying auditor judgment when answering this question, because of the individual auditor's experience and expectations, can be minimized.

Reliability of Data from Computer-Based Systems. DCAA adapted the following question from PCIE Checklist F and used it to evaluate compliance with GAS 6.62 on reliability of data from computer-based systems.

5.3 If the data from computer-based systems was significant to drawing audit conclusions, did the auditor obtain evidence about the reliability of the data by either (a) determining that the validity of the data was established in other DCAA audits or by other auditors, or (b) directly testing the data. (The level of direct testing may be reduced by testing the effectiveness of general and application controls in the computer-based systems.)

Applicable Auditing Standards. GAS 6.62 requires that evidence supporting the reliability of data be obtained. The auditor can either perform the audit work to verify the reliability of the data or the auditor can rely on work performed in other audit assignments. GAS 6.62 specifically addresses the level of documentation needed when the reliability of data from computer-based systems is and is not a significant element of the finding.

Auditors should obtain sufficient, competent, and relevant evidence that computer-processed data are valid and reliable when those data are significant to the auditors' findings. This work is necessary regardless of whether the data are provided to auditors or auditors independently extract them. . . . When computer-processed data are used by the auditors, or included in the report, for background or informational purposes, and are not significant to the auditors' findings, citing the sources of the data and stating that they were not verified will satisfy the reporting standards for accuracy and completeness.

In addition, GAS requires that working papers contain sufficient information so that an experienced auditor having no prior connection to the audit can determine from the working papers the evidence that supports the auditor's significant conclusions and judgments. We consider how the auditor complied with GAS 6.62 to be significant. Therefore, if the auditor relied on data not contained in the audit file for the assignment under review, the working paper reference must be specific enough for a reviewer to find the information.

How DCAA Answered the Question. According to the DCAA briefing charts, "December 2000 ESC Briefing on DoDIG Evaluation of FY 1999 QA [quality assurance] Review Effort," DCAA answered "yes" to question 5.3, "if evidence was found in FAO permanent files that EDP [electronic data processing] controls were tested (even if not documented in WPs [working papers])."

DCAA Review Results. DCAA concluded that the auditors adequately documented evidence of the reliability of data from computer-based systems on 65 (51.6 percent) of the 126 assignments. In addition, DCAA determined that for 17 (13.5 percent) of the audits reviewed that standard was not applicable.

For the 21 audits we test checked, DCAA answered “no” to question 5.3 in 7 (33.3 percent) cases; “yes” in 12 (57.2 percent) cases; and “not applicable” in 2 (9.5 percent) cases.

External Review Results. We answered “no” to question 5.3 for 16 (76.2 percent) of the 21 audits we retested. In addition, we determined that “not applicable” only applied to one (4.8 percent) audit. We answered “no” more frequently than DCAA because if another audit or permanent file was not properly referenced in the reviewed audit files, we did not assume that the auditor knew that this review had been performed. In addition, if the auditor did not document why, or it was not obvious why, the computer-process data was not significant to the auditor’s findings, we answered “no.”

Conclusions on External Review of Reliability of Computer-Processed Data. By applying its criteria, DCAA did not assess whether the auditor performing the reviewed audit had obtained the required evidence about computer-processed data. Instead, DCAA assessed whether the FAO had performed certain information system reviews. Therefore, DCAA did not adequately apply the criteria in GAS 6.62 to determine whether the auditor obtained sufficient, competent, and relevant evidence that computer-processed data are valid and reliable. DCAA generally evaluates contractor internal control systems, including general and application controls for information systems, as separate audits when the internal control system is significant to the contractor’s operations. The audit work evaluating the reliability of computer-processed data would be documented in a separate audit file or permanent file maintained on that contractor. In that case, relying on the other audit to satisfy the requirements of GAS 6.62 requires proper referencing of the other work in the audit assignment. During performance of quality assurance reviews, audit files must provide all of the needed information so the audit files can stand on their own.

Improvement Suggested. To improve the assessment of compliance with GAS 6.62, DCAA needs to revise question 5.3 to make it a multipart question. The revision should ask whether the quality assurance reviewer determined whether:

- the auditor properly determined if computer-processed data was significant to his audit conclusions, and
- the auditor appropriately documented that determination (significant or not significant).

If the auditor determined that computer-processed data was significant to the audit conclusions, then the quality assurance reviewer must determine whether:

- any auditor in the FAO conducted the appropriate audit work to determine the reliability and validity of computer-processed data, and

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- the auditor on the forward pricing assignment being reviewed properly documented the work performed by other auditors in the working papers.

If the auditor determined that computer-processed data was significant to the audit conclusions and no auditor in the FAO conducted the appropriate audit work to determine the reliability and validity of computer-processed data, then the quality assurance reviewer must determine whether the auditor on the forward pricing assignment being reviewed:

- adequately performed audit work during the forward pricing review to verify computer-processed data, and
- appropriately documented that work, if performed.

Using the multipart question should allow DCAA to quickly document the assessment of compliance with GAS 6.62. Once a complete assessment is performed, determining what corrective action, if any, is needed and how to implement the action will be much easier for DCAA.

Understanding Internal Controls. DCAA adapted the following two questions from PCIE Checklist E and used them to evaluate compliance with GAS 4.21 and 4.37 relating to understanding internal controls.

6.1 Did the auditors obtain an understanding of the internal controls sufficient to plan the audit by performing procedures to understand the design of controls relevant to the audit and whether they have been placed in operations?

6.2 Did the auditors appropriately document their understanding of the internal control components obtained to plan the audit?

Auditing Standards and Audit Guidance. Understanding internal controls, according to GAS 4.21, means obtaining a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed. In addition, GAS 4.37 requires that working papers provide written evidence supporting the auditor's significant conclusions and judgments. CAM 5-106 states that the first step in reviewing and evaluating a contractor's internal controls is to obtain an understanding of the accounting and management systems being reviewed. CAM 5-106 also emphasizes the requirement that the auditor's understanding be documented.

Once the auditor has gained an adequate understanding of the contractor's accounting and management systems, that understanding should be documented in the audit working papers and related permanent files. This documentation will typically take the form of system flowcharts, narrative descriptions, and copies of relevant documents and reports. The method(s) used and extent of documentation required are a matter of professional judgment. However, the documentation should provide sufficient information to communicate the auditor's understanding in a clear and summarized manner.

Criteria Used by DCAA. When answering question 6.1 for audits of major contractors,¹³ DCAA concluded the auditor had obtained an understanding of internal controls when the FAO had completed current Internal Control Audit Planning Summary (ICAPS) forms. For audits of nonmajor contractors, DCAA answered “yes” to question 6.1 when the FAO had an up to date completed Survey of Contractor’s Organization, Accounting System, and System of Internal Controls (SHORTICQ). DCAA used those forms to obtain an understanding of a contractor’s internal controls and to assess control risk. For question 6.1 to be answered “yes,” the auditor did not have to include or reference the appropriate form(s) in the audit file. The form(s) had only to be available somewhere in the FAO files. For question 6.2 to be answered “yes,” the auditor had to include or reference the appropriate form(s) in the audit assignment file.

Results of DCAA Review. DCAA determined that the auditors for 108 (85.7 percent) of the 126 assignments obtained an understanding of the contractor’s internal controls for question 6.1. However, for question 6.2, DCAA determined that the auditor appropriately documented that understanding for only 74 (58.7 percent) of the 126 assignments. For the 21 audits that we test checked, DCAA answered question 6.1 “yes” in 14 (66.6 percent) cases and answered question 6.2 “yes” in 9 (42.9 percent) cases, a difference of 5 cases.

Results of External Review. We answered “no” to question 6.1 and question 6.2 for 14 (66.6 percent) of the 21 audits we retested. We answered “no” for both questions if the auditor did not include or reference the appropriate internal control forms in the audit file or provide some other information indicating a knowledge of the contractor’s internal controls. The only way to determine whether the auditor performing the audit had obtained an understanding as required was through documentation that existed in the audit file. Therefore, independent of any retesting, we concluded that DCAA improperly assessed the auditor’s compliance for 34 (27.0 percent) of the 126 assignments where DCAA answered question 6.1 “yes” and question 6.2 “no.” Of the 21 assignments that we retested, we identified 3 audits where DCAA improperly applied its own criteria.

For the first audit, the DCAA reviewer answered both questions “no” and noted in the comment column, “No documentation in the workpaper file. Estimating system and ICAP[S] reviews have been performed.” Based on the comment and the DCAA criteria, question 6.1 should have been answered “yes” and question 6.2 should have been answered “no.”

For the second audit, the DCAA reviewer incorrectly answered question 6.1 “yes” based on the standard appendix to the audit report on the contractor’s organization and systems. The reviewer answered question 6.2 “no” commenting, “Assessment of control risk not documented in the audit file, see 3.1.e above.” The information presented in the audit report was not included in the audit file.

¹³A major contractor is a contractor where DCAA has \$80 million or more of contractor costs to audit in one fiscal year.

For the third audit, the DCAA reviewer answered both questions “no;” however, information in the audit assignment file clearly indicated that the auditor had obtained information about the contractor’s internal controls. The auditor noted in the risk assessment that estimating and accounting system reviews had been performed with no deficiencies identified but the SHORTICQ was incomplete and outdated. For this audit, the auditor gathered the existing information on the most applicable internal control systems and properly documented the overall status of the internal control assessment. The FAO was deficient in properly completing the required SHORTICQ.

Conclusion on External Review of Internal Controls. DCAA did not adequately apply the criteria in GAS and CAM when assessing whether the auditor performing the reviewed audit had obtained an understanding of internal controls. Instead, DCAA assessed whether any auditors at the FAO had obtained such an understanding. DCAA uses internal control system reviews¹⁴ of a major contractor as the basis for all other audit work at a major contractor. DCAA uses the information on the SHORTICQ for a nonmajor contractor as the basis for all other audit work at a nonmajor contractor. Therefore, it is important that quality assurance reviewers assess the understanding of internal controls for both the FAO (whether internal control system reviews have been performed or SHORTICQs completed) and the auditor actually performing the audit being reviewed (knowledge of the results of completed system reviews or SHORTICQs and the effect on the current assignment).

In an effort to improve the assessment of understanding internal controls, DCAA combined the two questions into one new question on the March 12, 2001, revision to the DCAA Checklist. The new question asks:

6.1 For other than internal control audits, did the auditors: obtain and document an understanding of the applicable significant internal controls by performing procedures to understand the design of controls relevant to the audit and whether they have been placed in operation?

The revised question does not resolve our concerns. To fully evaluate compliance with GAS and CAM, FAO and individual auditor compliance must be assessed. The revised question requires one overall assessment of FAO and the auditor knowledge. In addition, whether either FAO or auditor compliance is properly documented in the appropriate audit file is another factor that should be evaluated separately. Therefore, revised question 6.1 could make the assessment of compliance with GAS and CAM more difficult than before.

Suggested Improvement. To improve its assessment of compliance with GAS 4.21, DCAA should revise the questions on internal controls to more specifically assess the information available at the FAO versus the knowledge level of the auditor performing the reviewed assignment. Specifically, the revised questions should assess:

¹⁴Internal control system reviews are performed as separate audit assignments and can be accomplished by different auditors or audit teams.

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- what information the FAO had on internal controls,
 - whether the FAO information was sufficiently documented,
 - what information the auditor performing the reviewed assignment obtained on the internal controls, and
 - whether the auditor sufficiently documented that information in the audit file.

Revising the questions to distinguish between the information available at the FAO versus the knowledge obtained by the auditor will enhance the DCAA quality assurance review process by clarifying the nature of the identified deficiency. That, in turn, will allow the headquarters Quality Assurance Division to determine the root cause for the deficiency and recommend the most appropriate corrective action. In addition, the reviewer could more easily document compliance with the standard and appropriately credit the FAO for performing the required internal control reviews.

Noncompliances, Illegal Acts, and Other Irregularities. Current DCAA audit guidance for forward pricing assignments does not require the auditor to fully assess audit risk due to fraud or other illegal acts. Specifically, the DCAA standard audit programs for forward pricing assignments do not include all the audit steps needed to properly implement GAS 6.26 and GAS 6.28 or Statement on Auditing Standards (SAS) 82, “Consideration of Fraud in a Financial Statement Audit,” effective December 15, 1997. While SAS 82 specifically applies to financial statement audits, DCAA MRD 98-PAS-044(R), “Audit Guidance on SAS No. 82 ‘Considering Fraud in a Financial Statement Audit’,” March 26, 1998, states that many of the objectives of SAS 82 are applicable to the DCAA financial-related audits and performance audits. Forward pricing reviews are considered financial-related audits. The MRD summarizes the requirements of SAS 82 and discusses the impact of the standard on DCAA audits. SAS 82 requires auditors to assess the risk of material misstatement that are the result of fraud, and specifically, to plan and perform audits that will obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. CAM 4-702.3 requires that:

The auditor should specifically assess the risk of material misstatement due to fraud and should consider that assessment in designing the audit procedures to be performed. Effective audit risk assessments and audits of internal controls are useful procedures for assessing risk of fraud against the government. Proper execution of audit programs together with adequate tests of contractor internal control systems should provide reasonable assurance that significant fraudulent and other unlawful practices are detected.

In addition, GAS 6.26 states that for all performance audits, auditors should be alert to situations or transactions that could be indicative of illegal acts or abuse. GAS 6.28 also requires that:

Auditors should design the audit to provide reasonable assurance about compliance with laws and regulations that are significant to audit objectives. This requires determining if laws and regulations are significant to the audit objectives and, if they are, assessing the risk that significant illegal acts could occur. Based on the risk assessment, the auditors design and perform procedures to provide reasonable assurance of detecting significant illegal acts.

Extent of DCAA Review. When performing the reviews of forward pricing assignments, DCAA only identified a deficiency if documentation was present in the working papers, indicating that a potential fraud or illegal act may have occurred and the auditor did not identify it as such. In addition, DCAA did not identify a deficiency if noncompliances were considered, even though illegal acts were not. Without proper documentation, DCAA has no assurance that its auditors are adequately assessing the risk of fraud or other illegal acts. DCAA has stated that the risk of fraud is generally inherently less in pre-award audits because fraud requires that the Government be harmed and the Government cannot be harmed until contract award.

To improve compliance with GAS, DCAA should add audit steps:

- to the preliminary risk assessment that require the auditor to consider the risk of fraud or other illegal acts;
- to address situations where the potential for fraud exists and to evaluate its impact on the audit objectives and scope; and
- to document whether anything came to the auditor's attention during the audit that would indicate that fraud or illegal acts occurred and that the auditor took appropriate action.

Including those audit steps in the standard audit programs should provide DCAA with reasonable assurance that DCAA auditors are adequately assessing the risk of fraud and will properly implement GAS and the intent of SAS 82. In addition, the documentation required by the additional audit steps will allow quality assurance reviewers to properly assess whether GAS 6.26 and 6.28 were complied with. In comments on a discussion draft of the report, DCAA stated,

DCAA believes its position to date has been reasonable. . . . The IG's position also has merit. . . . DCAA will therefore, reconsider its position and review each of its forward pricing audit programs to determine where it might best add appropriate steps to more directly cover SAS 82 concerns.

Cross-Referencing Reports. The relationship between the working papers and the audit report is addressed in GAS 6.46 and GAS 7.55. DCAA used the following question from the Audit Report Checklist to determine whether the audit reports were properly cross-referenced to the working paper files.

1. Is the draft report cross referenced to the working papers?

The DCAA quality assurance review addressed GAS 6.46 in question 5.1.a of the DCAA Checklist.

5.1 Do the working papers document that the auditors obtained:

a. Sufficient, competent, and relevant evidence to support findings, judgments, and conclusions in the report?

Cross-referencing of a draft report to the working papers allows an external reviewer to easily track the significant information in the report back to the pertinent working papers.

Pertinent Audit Guidance. GAS 7.55 states that a report should include only information, findings, and conclusions supported by competent and relevant evidence in the working papers. CAM 10-104.11 states, “The draft report should always be cross referenced to the working papers. This ensures that the audit conclusions are supported and are easily found.” CAM 4-403(i)(3) provides guidance on the extent to which the draft report needs to be cross-referenced to the working papers. “As a minimum, reference the following: The summary results and notes in the draft audit report to the summary and lead working papers.” However, the guidance is not sufficient to ensure that all information, findings, and significant conclusions in forward pricing assignment reports were supported by competent and relevant evidence in the working papers. Sections of DCAA audit reports, such as scope and qualifications, contain standard language that does not need to be cross-referenced. Those sections can also contain information that is unique to the assignment; however, the existing CAM guidance does not require that the unique information in the subject, executive summary (significant issues), scope, qualifications, or contractor organizations and systems information be cross-referenced. Proper cross-referencing of the draft report to working papers also helps ensure compliance with GAS 6.46, which requires that, “Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors’ findings and conclusions.” Therefore, the criteria that DCAA used to determine the adequacy of the cross-referencing needs to be revised to include all significant report elements.

Results of DCAA Review on Cross-Referencing Reports. DCAA determined that for 19 (15.1 percent) of 126 audits reviewed, the draft report was not properly cross-referenced to the working papers in accordance with CAM guidance. Additionally, DCAA answered “no” to question 5.1.a for 13 (10.3 percent) out of the 126 audits.

Oversight Review Results on Cross-Referencing Reports. Using the criteria in GAS 6.46 and GAS 7.55, we determined that 16 (76.2 percent) of the 21 audit reports were not sufficiently cross-referenced to the working papers. Depending on the content of a report, the information that CAM does not require to be cross-referenced may be crucial to understanding the results of the audit. For example, at one FAO we visited, the report for an assist audit of forward pricing bid rates contained information in the “Contractor’s Organization and System” section about two contractors that had merged, one of whom became business units within the other. Although the section cited

previous audits on six internal control systems, the report did not contain sufficient information to determine whether the results of the six system reviews applied to the pre-merger or post-merger contractors or to the business unit under audit. In addition, a note in the report stated that all references to the old contractor had been replaced with references to the new contractor. Also, none of the information presented was cross-referenced to the working papers; therefore, the reviewer had no way to assess whether the information presented in the report was accurate and up to date. In another case, DCAA and we noted that the report had not been cross-referenced to the working papers and that the working paper documentation was not adequate for this audit. In addition, we answered question 5.1.a “no.” The supervisor had changed the report findings and instructed the auditor to adjust the working papers accordingly. The auditor did not revise the working papers sufficiently so that we could track the draft report findings back to the working papers. Therefore, we could not determine the adequacy of the work performed. Complete cross-referencing of the report to supporting working papers and other files help ensure the factual accuracy of the report’s content.

Needed Improvements. Revising the checklist question on cross-referencing would improve DCAA assessments of whether reviewed audits comply with GAS 6.46 and GAS 7.55. The checklist question and CAM guidance should include all of the requirements of GAS 7.55. The CAM revisions should also help emphasize to the audit staff the importance of proper report cross-referencing and ensure audit report quality.

Use of Rating System

Ratings. DCAA established an overall FAO rating to show FAOs that an FAO could “pass” an internal quality assurance review. For the internal quality assurance review of forward pricing assignments, DCAA did not develop a performance goal or performance indicators. Instead, DCAA used a subjective rating system to describe the overall performance of its FAOs. DCAA used the following two ratings.

- High – As good as we can reasonably expect and no followup necessary
- Satisfactory – Corrective action plans obtained and the regions are required to conduct followup to ensure that plans have been effectively implemented

DCAA did not develop criteria for objectively measuring FAO performance to assign either of the two ratings. Instead, DCAA, using the results of the DCAA Checklist reviews, subjectively decided which ones they felt were operating at a high level versus a satisfactory level. DCAA decided to rate 8 of the FAOs as high and 10 of the FAOs as satisfactory.

Performance goals should be objective, quantifiable, and measurable. In addition, the measurement criteria should be established prior to conducting the review to ensure proper implementation of the rating process. Merely comparing the performance of one FAO against another does not provide any information on whether either FAO is meeting agency performance goals and can result in inconsistent ratings. For example, DCAA rated one of the FAOs we visited as operating at a high level of compliance even though DCAA found that one of the seven assignments reviewed did not meet the due professional care standard. DCAA determined that “as good as we can reasonably expect” or a high level of compliance equates to one out of seven FAO audits failing to comply with the due professional care standard. Because of the overall importance of complying with this standard, at the very least a high rating should indicate that all reviewed assignments met that particular standard. On the other hand, another FAO was rated as satisfactory, even though DCAA found that all of the seven assignments reviewed met the due professional care standard. In the trip report for that FAO, DCAA addressed issues related to using the incorrect standard audit program and insufficient supervisory auditor involvement. Without establishing criteria, reviewers cannot use the rating system to accurately describe whether an FAO is meeting agency performance goals or how significant the noncompliances are in relation to the overall quality assurance program.

Strategic Goal. In an effort to formalize the internal quality assurance review process, DCAA developed a new goal for its strategic plan that requires, “By FY 2002, increase the number of FAOs found to be at a ‘high level’ of compliance in DCAA’s PCIE reviews to 70% in the forward pricing audit area.” The metric DCAA plans to use for that measure is the percentage of FAOs at a high level of compliance as determined in the FY 2002 PCIE-based quality assurance reviews.

The Government Performance and Results Act of 1993 recommends that performance goals be objective, quantifiable, and measurable and that performance indicators be used for measuring or assessing the relevant outputs, service levels, and outcomes of each activity. Strategic plan goals are covered by the Government Performance and Results Act. Therefore, if a similarly subjective process is used to determine if the goal is met, then the process will not meet the requirements of the Government Performance and Results Act. In addition, DCAA is still assigning an overall FAO rating based on only one type of assignment.

Summary

The goal of an organization’s internal quality control system is to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed. To ensure an accurate evaluation of the quality of the work performed, reviewers, both internal and external, should independently evaluate compliance with each auditing standard when reviewing

working paper files. The key to adequately evaluating compliance with auditing standards is the use of questions and criteria that reflect the requirements of GAS and the audit organization's own policies and procedures and audit environment. Questions tailored to assess the audit environment under review would allow internal and external reviewers to more efficiently document conclusions.

DCAA has designed and is implementing an internal quality assurance review process intended to meet the goal of an external quality control review. DCAA stated that one of its key goals is to design and perform PCIE-based reviews in such a way that we could place maximum reliance on the reviews and reduce our oversight review effort. For DCAA to meet its goal of implementing an internal quality assurance program so that an external reviewer can place maximum reliance on its work, DCAA should design and perform internal quality assurance reviews that will provide more documentation of the work performed.

Management Comments on the Finding and Evaluation Response

Summaries of management comments on the finding and our evaluation response are in Appendix B.

Recommendations, Management Comments, and Evaluation Response

C. We recommend that the Director, Defense Contract Audit Agency:

1. Sufficiently document all auditor conclusions when performing internal quality assurance reviews.

Management Comments. DCAA nonconcurred, stating that they believe that providing sufficient, meaningful documentation supporting the “yes” and “not applicable” answers to the DCAA Checklist questions would have a significant impact on the number of audits that could be reviewed. DCAA is already committing approximately 7 staff-years to the annual performance of its internal quality assurance reviews and does not believe that it is prudent or appropriate to commit any additional resources to the internal review process at this time. Consequently, DCAA believes that any imposed requirement to systematically provide sufficient and meaningful documentation supporting “yes” and “not applicable” responses would result in a significant reduction in the number of audits reviewed. In addition, DCAA believes that its policy of only systematically documenting the noncompliances is in line with what other internal (and at least some external) reviewers do.

Evaluation Response. We disagree with the DCAA position. DCAA has 35 auditors assigned to the headquarters Quality Assurance Division, the RQAs, and the Field Detachment Quality Assurance Division to evaluate the work of 4,172 staff conducting 41,722 reviews. During the internal quality assurance review of forward pricing assignments, DCAA reviewed 126 assignments. DCAA has adopted the criteria set forth by the PCIE in the PCIE Guide. That criteria requires that, “Working papers should be prepared to document the work performed and the conclusions reached during the course of the review.” In addition, the PCIE Guide states that an organization’s internal quality assurance review should gather, “competent evidential matter . . . to determine that the audit organization is in compliance with applicable auditing standards, policies and procedures.” A “yes” answer indicates compliance with the applicable standard; however, without sufficient documentation—either a note explaining how the reviewer reached that conclusion or a reference to working papers from the assignment file—it is not possible for others to evaluate the sufficiency of the DCAA reviewer’s work without independent retesting.

In addition, we disagree with the contention that DCAA would have to reduce the scope of its review if the DCAA reviewers were required to meaningfully and sufficiently document their work. Of the 21 assignments that we retested, the reviewers for 6 documented their “yes” and “not applicable” answers. As the DCAA quality assurance program matures and personnel become more familiar with the DCAA Checklist and the criteria for “yes,” “no,” and “not applicable” answers, the time needed to completely document the review should decrease. DCAA would benefit from fully documenting the “yes” and “not applicable” answers because that information would increase the value of the DCAA quality assurance organization by helping DCAA to better identify best practices or process improvements that could be adopted throughout the agency. Identification of such practices is a mandate of the DCAA headquarters Quality Assurance Divisions and the RQAs. Also, DCAA stated that one of its goals was for the Inspector General, DoD, to be able to place maximum reliance on DCAA work. For us to do that, we need an audit trail from significant findings and conclusions discussed in trip reports back to the working papers that support them.

Finally, some internal reviewers may believe that documenting only “no” answers is sufficient to satisfy an external reviewer. However, an audit organization’s internal quality assurance program performs a different function than an external review of an audit organization. Part of the value of an internal review is the ability of an external reviewer to rely on the results. For the external reviewer, an internal quality assurance reviewer conclusion that auditing standards are met is as significant as a conclusion that standards are not met. DoD Service audit organizations, when conducting external reviews, documented all of the conclusions as to whether an audit met GAS. We request that DCAA reconsider its position and provide comments to the final report.

2. Revise the Defense Contract Audit Agency Checklist to:

a. Revise question 5.3 on reliability of computer-processed data to cover the field audit office's knowledge and documentation of the reliability and validity of computer-processed data; the auditor's knowledge and documentation of computer-processed data; and the auditor's determination and documentation of any decision that computer-processed data is not significant to the audit findings and conclusions as required by Government Auditing Standard 6.62.

b. Revise the questions in section 6 relating to internal controls to cover the field audit office's knowledge and documentation of internal controls as well as the auditor's knowledge and documentation.

Management Comments. DCAA concurred in part, stating that the DCAA headquarters Quality Assurance Division tried to keep the DCAA Checklist questions as close to what was in the PCIE Guide as possible. However, the headquarters Quality Assurance Division has changed and will continue to change the DCAA Checklist questions and adopt new ones when appropriate. With respect to the 5.3 and section 6 questions, DCAA agreed that the questions could be reworded to address some of the Inspector General, DoD, concerns and increase the value and consistency of the answers. At a minimum, for future PCIE-based quality assurance reviews, DCAA will ensure that its reviewers sufficiently explain and/or document why they believe an auditor has demonstrated an adequate understanding of the internal controls, but not appropriately documented that understanding. DCAA will also further examine the Inspector General, DoD, proposed changes relating to checklist questions 6.1 and 6.2 to ensure that the significant data that needs to be captured by these questions is in fact captured.

Evaluation Response. The DCAA comments meet the intent of the recommendations.

3. Revise the standard audit programs for forward pricing assignments to include audit steps addressing assessment of risk due to fraud and other illegal acts.

Management Comments. DCAA concurred, stating that they will review each of the forward pricing audit programs to determine where it might best add appropriate audit steps or new wording to existing steps to more directly cover SAS 82 concerns. DCAA provided draft changes to the audit programs on November 1, 2001.

4. Modify DCAA Manual 7640.1, "DCAA Contract Audit Manual," and the "Audit Report Quality Review Sheet for Audit Reports of All Types" to require that auditors cross-reference all sections of an audit report containing nonstandard language, including the subject, executive summary (significant issues), scope, qualifications, and appendices to working papers, permanent files, or other audit assignments as appropriate.

Management Comments. DCAA concurred, stating that they would review existing policy and appropriately modify the CAM and the Audit Report Review Sheet by December 31, 2001.

5. Establish criteria against which the field audit office can be rated.

Management Comments. DCAA concurred that they need to establish more specific, written criteria for gauging the overall performance of its FAOs.

Appendix A. Evaluation Process

Scope

An audit organization's internal quality assurance program is an integral part of its overall management control program. We based our review of the DCAA quality assurance program on the GAS standards relating to quality controls, the PCIE "Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General," DCAA strategic plan goals and objectives, and DCAA policies and procedures in force from June 1992 through March 2001. We reviewed the DCAA internal quality assurance program and FY 1999 internal quality assurance review of forward pricing assignments. For the FY 1999 review, we reviewed the FAO and assignment selection process, completed DCAA Checklists and supporting documentation, and all 18 trip reports that DCAA prepared. In addition, we visited 3 FAOs (Silicon Valley Branch Office in California, Lockheed Martin Orlando Resident Office in Florida, and Mid-South Branch Office in Colorado) to retest DCAA work and conclusions. Also, we discussed the internal quality assurance review process with DCAA officials to determine how much reliance we could place on the process when conducting our external quality control review. Further, we reviewed briefing charts presented to the ESC and meeting minutes and action items resulting from ESC meetings and decisions.

Inspector General, DoD, Oversight Responsibilities. Under Section 8(c)(6), Title 5, U.S.C., Appendix 3, the Inspector General Act of 1978, as amended, the Inspector General, DoD, is responsible for monitoring and evaluating adherence of DoD auditors to internal audit, contract audit, and internal review principles, policies, and procedures. The office within the Inspector General, DoD, responsible for conducting independent oversight reviews of DCAA is the Office of the Assistant Inspector General for Auditing, Deputy Assistant Inspector General for Audit Policy and Oversight. As part of that responsibility, Audit Policy and Oversight evaluates the internal quality assurance reviews performed by the DCAA headquarters Quality Assurance Division and the RQAs. Audit Policy and Oversight uses the PCIE Guide as a tool when conducting oversight reviews of the internal quality assurance reviews.

Methodology

To evaluate the adequacy of the DCAA internal quality assurance program, we reviewed DCAA policies and procedures and interviewed DCAA headquarters quality assurance staff to determine the procedures that have been established to conduct internal quality assurance reviews. To evaluate the results of the FY 1999 internal quality assurance review of forward pricing assignments, we retested DCAA working papers to determine the significant deficiencies that

were found, and we visited 3 (16.7 percent) of the 18 FAOs visited by DCAA and retested 21 (16.7 percent) of the 126 assignments reviewed by DCAA using the same DCAA Checklist that DCAA used when they conducted the initial review. We then compared our results to the DCAA results, identified differences, and determined why the differences occurred.

Use of Computer-Processed Data. We did not use computer-processed data to perform the evaluation.

Evaluation Dates and Standards. We conducted this evaluation from August 2000 through March 2001 in accordance with standards issued by the Inspector General, DoD. The project was suspended from May 9, 2001, to September 14, 2001.

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

Prior Coverage

Inspector General, DoD

Report No. D-2000-6-010, "External Quality Control Review of the Defense Contract Audit Agency," September 27, 2000

Appendix B. Management Comments on the Findings and Evaluation Response

Finding A

Management Comments on Independent Review of Field Detachment.

DCAA stated that the Inspector General, DoD, statement that DCAA did not adequately consider the significance and unique risks associated with the Field Detachment audit work in setting up its quality assurance program are inaccurate in that they ignore one key fact. That one key fact is, although the Field Detachment has less than half the staff and workload of the average DCAA region, the Field Detachment Quality Assurance Division has the same number of staff as each RQA to cover the work. In other words, the Field Detachment Quality Assurance Division has twice the staff to offset and deal with the unique Field Detachment risk factors.

Evaluation Response on Independent Review of Field Detachment. We disagree with the DCAA position. While having double the staff might offset some of the unique Field Detachment risk factors for regionally directed reviews, having double the staff does not lessen the impact of the lack of independence. If the staff is not independent, then the size of the staff does not matter. The reviewers are not independent when conducting the DCAA headquarters-led quality assurance reviews.

Management Comments on Required Clearances of Inspector General, DoD, Personnel. DCAA contends that the Inspector General, DoD, statement that its non-cleared reviewers can systematically review unclassified Field Detachment audit assignments is not valid. DCAA disagrees that the Inspector General, DoD, reviewers could be systematically accommodated to routinely gain unrestricted access to DCAA audit working papers even when the working papers and audit assignments themselves are not classified. Such action would significantly and unacceptably increase the risk of security violations and indicates a misunderstanding of procedures for operating in a classified environment. Typically, a mixture of classified and unclassified information is present within the same program. An individual must have the appropriate “investigation” and be granted the proper “clearance” to be given “access” to the program. Jobs exist that require investigation/clearance eligibility based solely on the “nature” of the work, and not because the job requires handling of classified information. The nature of the audits conducted by the Field Detachment requires that they be performed in a sensitive compartment information facility (SCIF). Access to the SCIF is limited to individuals having the proper clearances.

Evaluation Response on Required Clearances of Inspector General, DoD, Personnel. We did not say or intend that uncleared personnel should be systematically accommodated to routinely gain unrestricted access to the DCAA audit working papers. The Inspector General, DoD, reviewers that visited the

Field Detachment FAO to review the seven forward pricing assignments had the appropriate security clearances to gain access to the SCIF and to review the requested audit assignment files. The reviewers did not request to review files for which they were not cleared.

Management Comments on Classification Level of Documentation. DCAA stated that, although reviewers work with classified documents, the reviewers avoid including classified information in their working papers, to the maximum extent practicable. Thus, while frequently the working papers are not classified, they typically contain highly sensitive information, such as contractor names, contract numbers, contract amounts, customer names, or organizations. Individually, such data is not classified; however, when certain information is combined with certain other information, the combined information may become classified, and if not specifically classified, that information certainly becomes more sensitive. For example, combining a contractor's name with a customer can result in a classified document. Accordingly, every precaution possible is taken to avoid even the slightest exposure to a compromise. For that reason, all of the assignment folders, classified and unclassified, are maintained in the SCIF and only individuals with the proper clearances and special access program briefings are allowed access to the working papers on a need-to-know basis. Any plans or recommendations that the Inspector General, DoD, may have for reviewing the Field Detachment audit work should be made to fully comply with the secured environment process and should not be dependant upon any "workarounds"—so that they can be carried out without the possibility of jeopardizing security.

Evaluation Response on Classification Level of Documentation. We did not request that DCAA provide any workarounds to circumvent security requirements associated with classified data during our review of forward pricing assignments. We only requested access to unclassified data and classified data for which the auditors conducting the evaluation had the appropriate clearances. DoD Regulation 5200.1-R, "Information Security Program," January 14, 1997, identifies the situation described by DCAA as classification by compilation. The regulation requires that:

If portions, standing alone, are unclassified, but the document is classified by compilation, mark the portions "(U)" and the document and pages with the classification of the compilation. You must also add an explanation of the classification. . . . When a document consisting of individually unclassified items of information is classified by compilation . . . the overall classification shall be marked conspicuously at the top and bottom of each page and the outside of the front and back covers (if there are covers). An explanation of the basis for classification by compilation shall be placed on the face of the document or included in the text.

The regulation states that classified files, folders, and similar groups of documents must have clear classification markings on the outside of the folder or holder; although, the cover sheets need not be attached when the item is in secure storage. However, that does not alleviate the requirement to specifically identify and appropriately mark documents that are classified. In addition, the regulation requires that working papers, defined as "documents and material

accumulated or created in the preparation of finished documents and material,” containing classified information be marked with the highest classification of any information contained therein. Also, DCAA has expressed concern that, while data may not be classified, it may be sensitive. According to DoD Regulation 5200.1-R, sensitive information is defined by the Computer Security Act of 1987, which applies to unclassified information that deserves protection. The working papers and documents that are sensitive should be appropriately marked.

Finding C

Management Comments on Criteria. DCAA disagreed that they used ill-defined criteria for evaluating audit work. DCAA stated that the reviewers relied on the CAM and other official and well-established sources of DCAA audit guidance (for example, MRDs and DCAA regulations and instructions). The guidance is GAS-based, sufficiently detailed, regularly maintained, and the same guidance used to actually perform the audits. In addition, DCAA has provided the Inspector General, DoD, with all of the DCAA published guidance since about 1988. Detailed references to the appropriate CAM guidance have been incorporated into most of the DCAA Checklist questions. In short, the guidance used was generally more comprehensive than that used by most other internal/external reviewers.

Evaluation Response on Criteria. We disagree with the DCAA position. While DCAA identified its criteria as the CAM, MRDs, and DCAA regulations and instructions, DCAA did not vet that criteria to identify and prioritize the most important elements to be tested during the internal quality assurance reviews. For example, when we reviewed the criteria that DCAA cited, CAM 5-101, for questions 6.1 and 6.2 on understanding internal controls, we found that the manual referenced CAM 5-102 through CAM 5-1200 for descriptions of requirements and audit guidance. That material encompasses 145 pages. In addition, the DCAA Checklist did not include any references to any MRDs or any DCAA regulation or instruction. The guidance to be covered by DCAA during its quality assurance reviews was generally more comprehensive than that covered by most other internal/external reviewers simply because DCAA has issued more official guidance than other Government audit organizations. Therefore, to plan and conduct efficient and effective quality assurance reviews using such voluminous guidance, DCAA needs to identify and use well-defined and specific criteria.

Management Comments on Cross-Referencing Trip Reports. DCAA disagrees that its trip reports were not adequately cross-referenced to the appropriate documents supporting the findings, including the key working papers of the reviewed audit. DCAA contends that the trip reports were all cross-referenced in detail to both the individual audits reviewed and to the individual DCAA Checklist questions. For each significant issue of noncompliance addressed, the trip report identified all of the corresponding “no” answers on each DCAA Checklist and referenced each “no” answer to the

specific audit reviewed and DCAA Checklist. The DCAA Checklists, in turn, refer the reader to the particular deficiency in the audit, audit work package, and or audit report for which each “no” response was recorded.

Evaluation Response on Cross-Referencing Trip Reports. We agree that each trip report identified the forward pricing assignment being discussed and the DCAA Checklist question identifying the noncompliance. However, DCAA did not adequately cross-reference significant findings and conclusions in the trip report to the reviewer’s working papers. For example, the trip report for one assignment at one FAO contained the following explanation as to why the reviewer answered “no” to DCAA Checklist questions 1.1 and 1.2.

The [contractor] IPT [integrated process team] proposed evaluation (A.4 above) was reported as if it were an audit, however, it is evident that an agreed-upon procedure evaluation was actually performed. The customer initially requested an audit and the acknowledgement letter clearly stated that a full audit would be performed. However, during the IPT process, it was agreed that the auditor would review only the proposed rates. The auditor completed the assignment using the standard audit program for an application of agreed-upon procedure review. During our review, the FAO acknowledged that a full audit was not performed and agreed that they should have issued an *“Application of Agreed-Upon Procedures Report”*. As a result, the review was noncompliant with the reporting standards under GAGAS and Agency policy. For this reason, we marked checklist items 1.1 and 1.2 under Due Professional Care, “No”.

However, the comment that the DCAA reviewer wrote for DCAA Checklist questions 1.1 and 1.2 was, “An agreed-upon procedures review was performed. Audit report on evaluation proposal issued.” The DCAA reviewer’s working papers did not include information about agreements made during the integrated process team process or any memorandums of discussion with FAO personnel except for the exit conference notes, which did not specifically address this issue for this assignment. DCAA stated that one of its goals was for the Inspector General, DoD, to be able to place maximum reliance on DCAA work. For us to do that, we need an audit trail from the significant findings and conclusions discussed in trip reports back to the review documentation that supports them.

Management Comments on Criteria for Rating System. DCAA stated that they had established a process to rate the level at which FAOs were complying with GAS and DCAA audit policy. DCAA agreed that the process was more subjective than objective and that, in rating the FAOs covered by the internal quality assurance review of forward pricing assignments, the reviewers used only two of the available ratings.

Evaluation Response on Criteria for Rating System. DCAA stated that the reviewers judgmentally considered and weighted five factors when assigning ratings to FAOs. DCAA listed the five factors considered in its response. However, in its March 31, 1999, Microsoft PowerPoint slides that DCAA considered to be its informal policies and procedures, DCAA made no mention of any sort of a rating system they might be considering for use during the internal quality assurance reviews. In addition, the results of the review that the DCAA headquarters Quality Assurance Division presented to the ESC in

December 1999 did not include any sort of criteria that might have been considered when assigning ratings to FAOs. The first time that any specific, written criteria for rating FAOs was provided to the Inspector General, DoD, was in the DCAA March 23, 2001, response to a discussion draft of this report.

Management Comments on Rating System. DCAA expressed concern about our assessment of the rating for the FAO and the forward pricing assignment that we described in the report. Specifically, DCAA stated that the forward pricing assignment referred to was, “actually a fine example of why good reviewer judgement is critical to the PCIE-based review process and analysis of its results.” DCAA explained that the assignment in question was a low-risk cost realism review—not a forward pricing assignment. However, the report ultimately provided the customer with all the information that he wanted and the customer later communicated his appreciation to the auditor. DCAA stated that, “Given the difficulty with question 1.1 [due professional care], the circumstances of the audit in question, the good quality of the FAO audit files, and the QA [quality assurance] results from the FAO’s six other audits, the QA team applied the criteria above and judged the FAO to be operating at a overall at a *high level of compliance*.”

Evaluation Response on Rating System. We disagree with the DCAA position. In our example, the report sent to the customer stated that the purpose was to determine whether the proposal was acceptable as a basis for negotiating a fair and reasonable price. The results section contained the following conflicting statements regarding the review of cost or pricing data:

The offeror has submitted adequate cost or pricing data. The proposal was prepared in accordance with applicable provisions of FAR [Federal Acquisition Regulation] and DoD FAR Supplement (DFARS). Therefore, we consider the proposal to be acceptable as a basis for negotiation of a fair and reasonable price. . . . In accordance with FAR 15.804-3, the contractor was not required to submit certified cost or pricing data because adequate price competition was anticipated.”

For that assignment, the DCAA auditor reviewed only labor and indirect rates—the contractor did not provide cost or pricing data. In addition, we found no written documentation from the customer supporting the DCAA statement that the customer “communicated his appreciation” in either the audit assignment file or the DCAA reviewer file.

In addition to the assignment where DCAA determined that due professional care was not met, DCAA determined that the standard did not apply to two other assignments at the same FAO (an audit of a price proposal and an audit of forward pricing overhead rates for calendar years 1998 through 2002). Therefore, for that FAO, DCAA affirmatively found that only four of the seven assignments met the due professional care standard. Of those four assignments, DCAA determined that the working papers for one did not contain adequate documentation supporting the recommend rate position. That is, the working papers did not contain sufficient, competent, and relevant evidence to support the conclusions in the audit report.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)

Other Defense Organization

Director, Defense Contract Audit Agency

Defense Contract Audit Agency Comments



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

IN REPLY REFER TO

PQA 225.4[D2000OA-0238]

June 5, 2001

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDIT
POLICY AND OVERSIGHT, DEPARTMENT OF DEFENSE,
INSPECTOR GENERAL

SUBJECT: Response to Draft DoDIG Report on Evaluation of DCAA's Quality Assurance
Program (Project No. D2000OA-0238)

Thank you for the opportunity to comment on the subject draft report and the results of the evaluation reported therein. The overall objective of the evaluation, as stated on page 3, "was to review the DCAA newly implemented quality assurance program and to assess how DCAA performed the internal quality assurance review of forward pricing assignments, which was the first agency-wide review conducted by the new headquarters Quality Assurance Division." Our general comments on the draft report are provided in Part I below. In Part II, we have provided comments to address specific findings, statements, and recommendations. These comments follow the order of the draft report.

I. General Comments

The IG report generally concludes that DCAA's new quality assurance (QA) program incorporates many of the elements needed for an effective review of the Agency's quality control system, *but* it does not include all of the elements that a mature program should have and/or needs. Substantial time and resources were spent by the IG in (1) reviewing the program and its first series of PCIE-based reviews of the Agency's forward pricing audit work, and (2) developing suggestions and recommendations for improving the program. DCAA generally agrees with the overall IG assessment, and is appreciative of the effort spent to further the program and the goal that both organizations pursue regarding it – i.e., the more confidence the IG has in the program, the greater the reliance it can place on it, thereby reducing the amount of resources that the IG has to commit to the oversight of DCAA.

After reviewing the final draft and prior draft versions of the report, there are still three significant report findings and related recommendations with which DCAA disagrees. These findings/recommendations are summarized and briefly addressed in I.A below. In our opinion, disagreement on these three areas should not significantly impact the IG's reliance on DCAA's quality assurance work. Therefore, we believe DCAA's QA program is achieving the intended benefits for the IG and DCAA.

PQA 225.4[D2000OA-0238]

SUBJECT: Response to Draft DoDIG Report on Evaluation of DCAA's Quality Assurance Program (Project No. D2000OA-0238)

A. Significant Unsettled Issues

1. Independence of the Field Detachment's Quality Assurance Division

a. IG. DCAA does not have adequate assurance that its quality control system within its Field Detachment organization is operating effectively. The Detachment is responsible for DCAA's classified audit work. The Field Detachment's Quality Assurance Division (FDQA) performs the PCIE-based QA reviews of the Detachment's field audit offices (FAOs) and reports to the Detachment Director. This raises, in the IG's view, a significant independence issue, as the results of the FDQA PCIE-based reviews could be unduly influenced by the Detachment Director. To rectify the situation, the IG believes that DCAA should have another contingent of cleared QA staff perform the PCIE-based reviews at the Detachment field offices.

b. DCAA. The FDQA does report to the Field Detachment's Director and does perform the Detachment's PCIE-based reviews (versus having a contingent not affiliated with the Detachment perform the reviews). DCAA has its QA program set-up this way because the FDQA organization spends most of its time performing other needed Detachment QA work, and the FDQA staff already has all of the security clearances needed to perform the QA work. The incremental increase in reviewer independence that would be gained from having a second contingent of cleared QA staff perform the Detachment's PCIE-based reviews does not justify the additional security risks presented by having two QA contingents appropriately cleared to review the Detachment's audit work. DCAA does not believe that the Department's program security offices would support the IG's position/recommendation, especially, after considering all of the related relevant factors. These factors include: (1) the relative significance of the Field Detachment's audit work, (2) the GAGAS-based requirement for the DoDIG to also maintain a contingent of cleared external reviewers, (3) the fact that the FDQA staff performing the PCIE-based reviews of the Detachment FAOs is independent of the FAO staff, (4) DCAA Headquarters already exercises considerable management influence over the reviews, and (5) the need to maintain appropriate clearances for the QA staff supervisors and management, as well as the QA reviewers. In addition, the corrective actions stemming from the PCIE reviews are primarily Agency-wide in nature, and are approved by DCAA's Executive Steering Committee. There is nothing in the IG's review to suggest that the DCAA-wide deficiencies found or the corrective actions that were undertaken as a result of DCAA's PCIE-based reviews would have been any different if the Field Detachment reviews had been conducted with a modicum of increased independence.

2. Audit Report Signature Authority

a. IG. A significant management control deficiency exists in DCAA's overall quality control system because DCAA authorizes supervisory auditors, acting as field audit office (FAO) managers, to sign audit reports for assignments they supervised.

PQA 225.4[D2000OA-0238]

SUBJECT: Response to Draft DoDIG Report on Evaluation of DCAA's Quality Assurance Program (Project No. D2000OA-0238)

b. DCAA. As a result of performing its first round of PCIE-based reviews, DCAA's quality assurance organization noted a number of opportunities where the Agency could further improve its system of quality control. One of the more significant opportunities involved the revision of the Agency's regulation governing which DCAA audit managers are authorized to sign the Agency's audit reports. The existing regulation was very flexible and permitted the Agency's FAO managers to delegate to their supervisory auditors the authority to sign all audit reports. The revised regulation identified the Agency's most significant audit reports and prohibited the FAO manager (or acting FAO manager) from further re-delegating their authority to sign those reports. The IG recommends that DCAA's policy on the delegation of audit report signature authority should be further revised so that supervisory auditors, acting as FAO managers, cannot sign reports on audit assignments they supervised.

DCAA agrees that having two reviewers of a report is generally better than one reviewer and that the Agency's current policy will not always ensure that there will be two reviewers for the type of reports that DCAA considers significant or sensitive. We do not agree, however, that DCAA's policy should be changed to preclude an acting FAO manager from signing his or her own reports when required by the circumstances. Effectively implementing such a policy change would further complicate an already complex policy without significant benefit, in DCAA's opinion. It is also DCAA's position that only the most qualified supervisory auditors should be designated to act as FAO managers and that less qualified supervisory auditors should not be given the final authority to sign out audit reports simply because they had no involvement with a particular audit.

The aspect of DCAA's signature authorization policy being questioned by the IG has been in effect since before the IG's inception and is generally in consonance with the Agency's overall policy on the signature authority of acting managers. We also believe it is generally in consonance with the Department's related policy, and we are not aware of any on-point GAGAS or PCIE provision that requires the close attention that DCAA continually gives to its audit report signature quality control policy. In addition, we note that nothing in DCAA's policy prohibits an acting FAO manager from showing a report that he/she supervised to any other supervisor in the FAO prior to its signature by the acting manager. Indeed, we are aware of cases where acting managers do just that in order to obtain the benefits of "a consultation." But, just as there is no Agency-wide policy regarding when FAO managers should request regional personnel to review a report, we believe that the need for an intra-office consultation is a decision best left to the acting manager.

Notwithstanding the above comments, should the data from future QA, IG, or other reviews indicate significantly more errors associated with the reports signed out by acting FAO managers, DCAA will revisit its signature authorization policy at that time.

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3. Adequate Documentation for All Responses to the QA Checklist Questions

a. **IG.** DCAA's quality assurance reviewers need to sufficiently document all auditor conclusions when performing internal quality assurance reviews, including their "Yes" and "Not Applicable (N/A)" responses to the QA Checklist Questions.

b. **DCAA.** In performing the PCIE-based reviews, DCAA's quality assurance organization used a checklist adapted from the PCIE's *External Review Guide*. The checklist questions are worded such that a "No" answer represents some manner of noncompliance with the DCAA policy or the GAGAS and a "Yes" answer represents general compliance. To evaluate DCAA's forward pricing audits, the QA reviewers answered a total of 9,198 questions. There were 714 "No" responses; 6,753 "Yes" responses; and 2,445 "N/A" responses.

To date, the QA reviewers have only been systematically documenting the exceptions or noncompliances that they found. The main reason for this is that requiring the *meaningful* documentation of all "Yes" and "N/A" responses would necessitate a significant cut back on the number of audits reviewed. The fewer audits reviewed, the less meaningful the results and the less likely that existing problems/noncompliances would be accurately identified and satisfactorily addressed. Another reason is that the "Yes" answers for many of the key checklist questions cannot be supported by simply reviewing and referencing a single working paper or working paper section, i.e., they require the reviewer to consider the entire audit work (or a good part thereof). Lastly, DCAA believes its policy of only systematically documenting the noncompliances is in line with what other government and private sector internal and external reviewers do. DCAA would be pleased to team with the IG to gather additional data on this final point.

B. Reliance on DCAA's Quality Assurance Program

As DCAA's designated external reviewer, the DoDIG determines (1) the level of reliance to place on DCAA's quality assurance program and (2) the level of testing needed to opine on the adequacy of DCAA's overall quality control system. If the IG believes there are certain areas of risk associated with DCAA's quality assurance program, then:

- the IG needs to consider these areas in setting the scope of its external review, and
- the IG may determine that some additional testing of its audit work is required.

For example, if the IG continues to believe that DCAA's approach to covering its Field Detachment audit work presents increased risk, then the IG will plan its external review testing accordingly to gain the level of assurance it needs (i.e., focus more of its testing on the FD). If, after the retesting, the IG determines that DCAA's QA organization reasonably identified, reported, and corrected the significant noncompliances, the IG can then place an increased level of reliance on the QA work. Over time, we are confident that this will bring the IG to the level of maximum reliance.

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II. Comments on Draft Report Findings, Statements and Recommendations

DCAA's comments below are in the same order and in similar format as the IG's draft report findings and recommendations. The "A, B, & C" comments respectively address the DoDIG's findings and recommendations in sections A, B, & C of the report.

A. Comments to Findings in Report Section A: *Defense Contract Audit Agency Quality Assurance Program*

a.1. **IG on DCAA's Inadequate QA Program Policies and Procedures.** On page 6 of the draft report under the heading, *Formal Quality Assurance Review Procedures*, the IG states:

... DCAA has informal procedures in the form of Microsoft PowerPoint slides dated March 31, 1999. The slides explain the structure and makeup of the Quality Assurance Divisions, general information on how the internal quality assurance reviews will be performed, examples of quality assurance work, and basic information on how the internal quality assurance review of forward pricing assignments would be conducted. DCAA recognizes the need for formal policies and procedures and plans to issue an instruction by September 30, 2001. However, DCAA plans to begin the review of all other assignments during July 2001, the last review for the first 3-year cycle. DCAA needs to develop formal policies and procedures before beginning that review for the external reviewer to evaluate the adequacy of the policies and procedures as part of its overall evaluation of the DCAA quality assurance program.

a.2. **DCAA on the Adequacy of its QA Program Policies and Procedures.** The planning for the last *All Other* round of PCIE-based QA reviews will begin in July 2001. It will be done in accord with the DCAA policy and procedures currently in place (adjusted to reflect the final results/recommendations from the subject IG review), which DCAA acknowledges, should be formalized. The detailed planning, coordination with regional QA staff members joining the review team, and notification and arrangements with the DCAA regions and impacted field offices will continue into August. For learning purposes, efforts will be made to visit and review the selected *All Other* audits at two field offices prior to September 3, 2001. All of the remaining *All Other* field office visits/reviews, perhaps as many as 16, will be initiated after October 8, 2001 and should be completed by 15 February 2002. The five-week break in September is necessary to allow DCAA's field audit offices to complete and close out their planned FY 2001 audit work. It is during this period that the Headquarters QA Division plans to complete its formalization of the QA review policies and procedures. Assigning additional resources to have the formalization completed by July 2001 would adversely impact the current PCIE-based review plans and schedule. We believe that this schedule will allow the IG to review DCAA's policies and procedures well before the completion of the IG's own review of DCAA's first cycle of PCIE-based quality reviews.

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b.1. IG Questioning the Independence of the Field Detachment's PCIE-based

Reviews. The IG alleges on pages 7, 8 and 9 of the report that DCAA has only minimal assurance that its quality control system within its Field Detachment is operating effectively. The conclusion was reached because the Detachment's QA Division (FDQA) reports to the Detachment Director and performs the PCIE-based reviews of the Detachment's field audit offices. To rectify the situation, the IG believes that DCAA should have another contingent of cleared QA staff perform the PCIE-based reviews at the Detachment field offices. Such action is justified in the IG's view because of the significance of the Detachment's audit work, and the risks associated with that work. Moreover, the IG believes that only one or two QA auditors outside the Detachment would have to attain the higher security clearances since (1) only limited PCIE-based review work needs to be done and (2) perhaps half of the Detachment audit assignments contain no classified information at all and could be reviewed by a noncleared auditor.

b.2. DCAA on the Independence of its Field Detachment PCIE-based Reviews.

Under DCAA's policies for performing its PCIE-based reviews, the FDQA staff performed the reviews at the FAOs within their own organization with limited supervision and very limited staff assistance from PQA. The RQA staffs, on the other hand, are prohibited by DCAA QA policy from performing or assisting PQA in performing the PCIE-based reviews within their own regions. The main reason why DCAA's QA policy treats the RQA and FDQA divisions differently is as follows: management reasoned that given the low relative significance and high security aspects of the FD audit work, the additional independence represented by a PQA reviewer over an FDQA reviewer was not significant enough to justify obtaining the additional security clearances – especially, in view of the fact that the FDQA staff is already required to obtain and maintain the appropriate clearances to perform its annual QA work.

The IG states that “DCAA should not assume that external reviewers will always retest Field Detachment Quality Assurance Division work.” Nevertheless, the IG is currently evaluating and performing retesting of the Detachment's quality assurance work and has plans to continue the retesting of that work. To the best of our knowledge, the IG retesting has not yet disclosed any significant findings specifically attributable to the FDQA reviews process or its lesser degree of independence. However, if the IG follow-up retesting efforts surface (and support with data) any significant findings exclusively associated with the FDQA reviews, DCAA management will reassess its earlier decision and revise its QA review processes as needed. Until that time, it is our opinion that DCAA's quality assurance program as it functions within the FD provides reasonable assurance that established policies, procedures, and applicable auditing standards are being followed.

Lastly, the IG statements to the effect that DCAA did not adequately consider or weigh the significance and unique risks associated with the FD audit work in setting up its QA program are inaccurate in that they ignore one key fact in the QA program set-up. That is, although the FD has

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less than half the staff and workload of the average DCAA region, FDQA has the same number of QA staff as the regional QA divisions to cover this work. In other words, in effect, it has twice the QA staff to off-set and deal with the unique FD risk factors.

c.1. IG on the Number of Additional Cleared QA Reviewers Needed to Cover the Field Detachment Audit Work. As summarily stated above, the IG believes that DCAA should have another contingent of cleared QA staff perform the PCIE-based reviews at the Detachment field offices. Such action is justified in the IG's view because of the significance of the Detachment's audit work, and the risks associated with that work. Moreover, as stated on page 8 of its report, the IG believes that only one or two QA reviewers (outside the Detachment) would have to attain the higher security clearances because of the limited time required to perform the PCIE-based QA reviews within the Detachment.

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c.2. DCAA on the Number of Additional Cleared QA Reviewers Needed to Cover the Field Detachment Audit Work. We agree that only two additional DCAA staff auditors would need to obtain and maintain the special higher security clearances to accomplish the fieldwork for the Detachment PCIE-based reviews. However, to appropriately plan, supervise, analyze, and report the results of the reviews within the Field Detachment would require that the special security clearances be obtained/maintained for several additional QA staff personnel. At present, the FDQA review work is managed by a GM-14 manager, GM-15 Deputy Director, and SES Director. All three individuals already have the special security clearances. On the other hand, in addition to the field office review staff, the PCIE-based reviews currently managed by DCAA's Policy & Plans Directorate have the following individuals significantly involved – a GM-14 review project leader, a GM-15 division chief, a GM-15 Deputy Assistant Director, and a SES Assistant Director. None of these individuals at this time have the special security clearances they would need to extend their current management activities over to the Field Detachment.

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d.1. IG Observation/Implication that Half or More of the Field Detachment Audit Assignments May Contain No Classified Audit Information. On page 9 of the report, the IG states:

... In addition, only four of the seven assignments that we reviewed as part of our external quality control review contained classified information; therefore, a noncleared auditor could review the unclassified Field Detachment assignments.

d.2. DCAA Position Regarding the Classified Nature of the Field Detachment's Audit Work. The IG's statement to the effect that its non-cleared evaluators of DCAA's QA program can systematically review unclassified Field Detachment audit assignments is not valid. It is true that special accommodations can be and have been made for the IG evaluators. DCAA disagrees, however, that the IG evaluators could be systematically accommodated so as to routinely gain unrestricted access to DCAA's audit working papers even when the working papers and audit assignments themselves are not classified. Such action would significantly and

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unacceptably increase the risk of security violations and indicates a misunderstanding of procedures for operating in a classified environment. Typically, there is a mixture of classified and unclassified information within the same program. An individual must have the appropriate "investigation" and be granted the proper "clearance" in order to be given "access" to the program. There are jobs that require investigation/clearance eligibility based solely on the "nature" of the work, and not because the job requires handling of classified information. The nature of audits conducted by the Field Detachment requires that they be performed in a sensitive compartment information facility (SCIF). Access to the SCIF is limited to individuals having the proper clearances.

Additionally, although auditors work with classified documents, they avoid including classified information in their working papers, to the maximum extent practicable. Thus, while oftentimes the working papers themselves are not classified, they typically contain highly sensitive information, such as contractor names, contract numbers, contract amounts, customer names or organizations. Individually, such data is not classified; however, when certain information is combined with certain other information, the information may become classified, and if not specifically classified, it certainly becomes much more sensitive. For example, combining a contractor's name with a customer can result in a classified document. Accordingly, every precaution possible is taken to avoid even the slightest exposure to a compromise. For this reason, all assignment folders, classified and non-classified, are maintained in the SCIF; and, only individuals with the proper clearances and program briefings are allowed access to the working papers –on a need to know basis. Everyone operating in the classified environment understands and abides by the process. Any plans or recommendations that the IG may have for the review of the Field Detachment's audit work should be made to fully comply with the secured environment process and should not be dependant upon any "workarounds", so that they can be carried out without the possibility of jeopardizing security.

e.1. IG Statement on the Signing of Field Detachment PCIE-based Review

Trip Reports. On page 9 of the report, as further support for its position that the Field Detachment PCIE-based reviews were not independently conducted, the IG states:

... In addition, the Director, Field Detachment, signed trip reports for the FAOs in Field Detachment while the Assistant Director, Policy and Plans, signed trip reports for the FAOs in the five regions.

e.2. DCAA Clarification on the Signing of Field Detachment PCIE-based Review

Trip Reports. Under DCAA's policies covering the PCIE-based reviews, DCAA's Director, Field Detachment, and Assistant Director, Policy & Plans, do not and have not signed any of the PCIE-based review reports. For purposes of maintaining/furthering QA reviewer independence, all of the resultant trip reports are signed by either the lead reviewer or chiefs of the DCAA Headquarters or Field Detachment QA divisions (PQA and FDQA, respectively). The lead reviewers are generally the staff members of PQA, FDQA, or the regional quality assurance

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divisions (RQAs), but may also be the chiefs of the divisions. Upon receiving the completed and signed FDQA reports, the Director, Field Detachment, signs the memorandums *transmitting* the reports to the appropriate Detachment field audit offices. Likewise, the Assistant Director, Policy & Plans, signs the memorandums *transmitting* the PQA and RQA reports to the non-Detachment regional and field audit offices. The system for transmitting the reports is set-up this way in deference to the increased sensitivity of the Detachment reports, FAO addresses, and mailings (see d.2 above).

f.1. IG Statement on DCAA's Improper Evaluation of Compliance with Certain Standards. On page 12 of the report, under the heading *Compliance with Auditing Standards and Audit Guidance*, the IG states:

... DCAA did not properly evaluate compliance with certain auditing standards, specifically due professional care; internal controls; and irregularities, illegal acts, and other noncompliances. See Finding C for details. ...

f.2. DCAA on the Proper Evaluation of Compliance with the Standards. We consider the statement that "DCAA did not properly evaluate compliance with certain auditing standards" to be overly broad. Of the total questions answered from the FY 1999 reviews (9,198, including the N/A responses), there are certainly some that the IG and DCAA would be expected to answer and, in fact, have answered differently, in certain cases. The differences, for the most part, can be attributed to rational and supportable differences in the application of auditor judgment (IG vs. DCAA – see Subpart II.C). The application of good auditor judgement in performing the QA reviews is a critical requirement, given the widely varying contract audit circumstances encountered and general language of the GAGAS.

g.1. IG on DCAA's General Standards Coverage. On page 12 of the report, again under the heading *Compliance with Auditing Standards and Audit Guidance*, the IG makes the following statements regarding DCAA's General Standards coverage in its QA reviews.

... as of March 2001, DCAA had not yet started its review of compliance with the general standards of staff qualifications and independence for its overall quality assurance program ...

Qualifications and Independence. The GAS general standards of qualifications and independence serve as the foundation for other auditing standards. The importance of complying with the fieldwork and reporting standards rests on the presumption that the audit organization is in compliance with the general standards. The internal quality assurance review process that DCAA initially developed included plans to review compliance with the general standards of qualifications and independence on an agency-wide basis. Those plans did not include testing at the FAO level.

Qualifications. Subsequent to the start of the 3-year cycle, DCAA decided to postpone its review of qualifications—specifically continuing professional education—until FY 2002 because DCAA was in the process of

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revising guidance on continuing professional education requirements. DCAA plans to complete the review by March 2002. However, a complete review of qualifications covers more than continuing professional education requirements. It should include hiring and promotion policies and procedures and the use of external consultant and internal experts. The DCAA headquarters Quality Assurance Division plans to gather and provide relevant documentation on qualifications before the end of the 3-year cycle.

g.2. DCAA Clarification of its General Standards Coverage. It is true that DCAA has not yet conducted its review of compliance with the general standards of staff qualifications and independence. With respect to staff qualifications, excluding CPE, the initial plans for the QA program called for PQA to gather and summarize to the IG the relevant documentation that DCAA believed already existed that would satisfy the applicable standards. Initially, no additional testing at the field audit office (FAO) level was deemed necessary to satisfy the standards. However, during its review to cover auditor staff qualifications (excluding CPE), DCAA will reassess the need for FAO-level testing, and coordinate its plans with the IG, as consistently done since the establishment of DCAA's quality assurance organization. DCAA plans to complete the review by March 2002.

With respect to the CPE element of staff qualifications, PQA had indications of compliance problems and plans in place and a process underway in FY 2000 for systematically testing auditor adherence to DCAA's requirements on obtaining and recording appropriate CPE credit. While aware of the PQA plans, the IG was committed to performing its own testing for CPE compliance through FYE 2000, as part as their first round follow-up review. PQA subsequently cancelled its FY 2000 testing plans, and the IG evaluators later confirmed the existence of certain deficiencies in how DCAA auditors were obtaining and recording their CPE hours. Concurrent with the IG testing, DCAA's Operations Directorate – as part of a new Strategic Plan objective – began work on substantially revising the Agency's policy and procedures on CPE. The latest milestone plan for this effort, as approved by the ESC in March 2001, calls for the Operations Directorate to coordinate the newly developed policies and procedures with the IG and complete the implementation by June 2002. In light of these events, PQA has re-scheduled its testing for CPE compliance to June 2002 (i.e., the two-year period ending September 30, 2002).

h.1. IG Statement on DCAA Field Audit Offices (FAOs) Covered by the PCIE-based Reviews. On page 13 of the report, the IG states:

Review of FAOs. The PCIE Guide recommends that an internal quality assurance program include all audit offices issuing audit reports. All FAOs issue audit reports; however, DCAA never planned to ensure the review of every FAO in a given 3-year cycle. Although DCAA did not plan to prohibit two reviews of any FAO during the same 3-year cycle, DCAA has tried not to review an FAO twice. In addition, DCAA never planned to include the two overseas FAOs in the headquarters-led quality assurance reviews. DCAA

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should revise its planning process to ensure that each FAO is included in at least one headquarters-led quality assurance review during each 3-year cycle. ...

h.2. DCAA on the FAOs Covered by its PCIE-based Reviews. DCAA is a one of a kind government contract audit organization. Nevertheless, it has tried hard to base its new QA program to the extent practicable on the IG's *PCIE External Review Guide* so that the DoDIG -- DCAA's designated external reviewer -- can rely that much more on the Agency's QA program. Consequently, DCAA supports the IG's judgmental use and reference of the PCIE Guide in the evaluation of DCAA's QA program. The Guide's full title is *Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General*. Appendix C of the Guide contains a checklist for reviewing an IG organization's internal QA program. Question 3 of the checklist -- a three-part question -- asks:

3. Does the program provide for all offices that issue audit reports to be reviewed?
 - a. Are the reviews required to be conducted of each office with reasonable frequency?
 - b. Were all offices that issue audits reviewed?

Question 3 is the basic supporting reference for both: (1) the IG's statement that the PCIE Guide recommends that a QA program include all audit offices issuing audit reports, and (2) its resulting recommendation that DCAA should revise its planning process to ensure that each FAO is included in at least one PCIE-based review during each 3-year cycle.

The PCIE Guide, as we read it, does not specifically require that the QA program of an IG organization (or any other audit organization for that matter) cover all audit offices that issue audit reports, irrespective of all other factors. It simply asks the question based, in our opinion, on the sound general premise that the more wide-spread the QA program coverage, the greater the reliance that can be placed on it. We suspect that the IG organizations, compared to DCAA and some of the larger CPA firms, have relatively few field offices issuing audit reports, and for this reason, it is probably entirely appropriate to expect the QA programs of the IG organizations to cover every field offices. There are many factors, however, that need to be considered in planning the QA program coverage for any given 3-year cycle. These factors include the mission and nature of the audit organization, the number of field offices that issue audit reports, the nature and significance of the audit work, and the resources available for QA reviews.

DCAA considers and weighs all of the factors in planning its QA program coverage. FAO coverage is one of the more important factors, and it is very likely that every DCAA FAO, including DCAA's overseas offices and those in the Field Detachment, will be covered during the first cycle of PCIE-based reviews. DCAA, however, does not believe it is sound policy to decide at the beginning of the 3-year cycle that its QA program will cover every FAO at least once during the cycle, irrespective of all the other factors.

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A. Response to Recommendations in Report Section A: *Defense Contract Audit Agency Quality Assurance Program*. On page 16 of the draft report, the IG recommends that the Director, DCAA, as part of the quality assurance program, take the action stated below.

1. IG Recommendation. Develop written policies and procedures for conducting internal quality assurance reviews before starting the next review.

DCAA. Concur in principle. DCAA does have general policies and procedures for conducting its PCIE-based QA reviews recorded on a series of Microsoft PowerPoint slide presentations prepared in part for the DoDIG. The IG, as we understand the recommendation, would now like DCAA to record its PCIE-based review policies and procedures in greater detail in a more formal document. The IG would also like DCAA to have its formalized policies and procedures developed before starting its next review. For the reasons noted in paragraph II.A.a.2, we plan to have the formalization completed by September 30, 2001, prior to starting the next main series of field audit office reviews. Specifically, we will develop a new DCAA Instruction to adequately record the Agency's PCIE-based review policies and procedures.

2. IG Recommendation. Monitor the work assigned to the headquarters Quality Assurance Division to ensure that the internal quality assurance program reviews are accomplished during each 3-year cycle.

DCAA. Concur

3. IG Recommendation. Institutionalize procedures established at the March 2001 Executive Steering Committee meeting for tracking corrective actions for internal quality assurance reviews to include timely implementation.

DCAA. Concur

4. IG Recommendation. Conduct independent internal quality assurance reviews of all field audit offices, including the two overseas field audit offices and Field Detachment, within the 3-year cycle.

DCAA. Concur in part. DCAA will continue to have its internal quality assurance (QA) organization perform reviews of DCAA audits using guidelines and a checklist prudently based on those presented in the *PCIE External Review Guide*. DCAA will include all of its field audit offices (FAOs) in the universe of FAOs to be potentially selected for its PCIE-based QA reviews.

For the reasons noted in paragraph II.A.h.2, DCAA does not believe it would be good policy to firmly commit at the beginning of each PCIE-based 3-year review cycle to covering all of the Agency's FAOs in the review cycle. Further, DCAA does not believe the IG's position on this particular point is soundly based. Nevertheless, under DCAA's current policies and

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procedures for conducting its PCIE-based reviews and given DCAA's revised position relating to its two overseas offices, it is very likely that every DCAA FAO will be covered during the first and subsequent cycles of PCIE-based reviews.

For reasons summarized below and explained in paragraphs II.A.b.2, c.2, d.2, & e.2. DCAA does not believe that it would be prudent to (1) have another contingent of cleared QA staff perform the PCIE-based reviews at its Field Detachment offices or (2) otherwise, change the way it is currently conducting the PCIE-based reviews within its Field Detachment organization. Under the current process, the Field Detachment's QA division (FDQA) performs the PCIE-based reviews of the Detachment's sensitive and often classified audits, even though the FDQA reports to the Detachment's Director. DCAA has its QA program set-up this way because FDQA spends most of its time performing other needed Detachment QA work, and the FDQA staff already have all of the security clearances needed to perform the QA work. The incremental increase in reviewer independence that would be gained from having a second contingent of cleared QA staff perform the Detachment's PCIE-based reviews does not justify the additional security risks presented by having two QA contingents appropriately cleared to review the Detachment's audit work. Indeed, DCAA does not believe that the Department's program security offices would support the IG's position/recommendation, especially, after considering all of the related relevant factors.

B. Comments to Findings in Report Section B: *Internal Quality Assurance Review of Forward Pricing Assignments.* The IG did a very credible job summarizing the results of DCAA's first round of PCIE-based QA reviews performed in FY 1999, and in our comments below, we only take issue with one finding in this report section.

a.1. **IG on DCAA's Policy on Audit Report Signature Authorization.** On pages 21 & 22, under the heading *Corrective Action Completed but Potential for Improvement Exists*, the IG states:

... DCAA found that supervisors were signing audit reports without having a written delegation of signature authority. To correct that deficiency, DCAA issued a revised DCAA Regulation 5600.1, "Delegation of Signature Authority for Audit Reports and Other Audit Related Documents," June 28, 2000. Under the revised regulation, the FAO manager was not authorized to delegate authority to sign reports for various type of audits ...

The revised regulation corrected the identified issue. However, the revised regulation did not recognize that the audit supervisor, as acting FAO manager, can sign his own audit reports on the [significant, sensitive] issues listed above. That management control deficiency occurs because the revised regulation grants acting FAO managers the same signatory authority as FAO managers without that authority being considered a redelegation. Therefore, audits that DCAA determined to be significant or sensitive and subject to review by the FAO manager are not being reviewed by someone independent of the supervisory

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auditor when that supervisory auditor is the acting FAO manager. That step provides a needed quality control over the audit logic and helps ensure the integrity of the audit reports. As a result, the risk of audit reports being issued with errors has increased. For example, at one of the FAOs we retested, the FAO manager did not sign five of the seven reports. Of those five, DCAA determined that two (40 percent) were noncompliant with the reporting standard under GAS and DCAA policy. In addition, DCAA expressed concern regarding a third report but did not conclude whether the reporting standards were met. For the other two FAOs we retested, each of the 14 audit reports was signed by the supervisory auditor. Without the safeguard of an independent review, proper supervision required by GAS may not occur.

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a.2. DCAA Clarification and Comments Regarding its Report Signature

Authorization Policy. It's true that DCAA's QA reviewers did find instances where supervisors were signing audit reports without having the appropriate written delegation of signature authority. The instances were rare, however, and contrary to the IG statement above, this was not the significant or principal finding that led DCAA to revise its Regulation DCAAR 5600.1. The principal finding was that DCAA's regional audit managers and FAO managers were routinely delegating to audit supervisors the authority to sign the Agency's more significant and sensitive audit reports. The practice was not prohibited by the Agency policy on report signature delegation in effect at the time.

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Also, contrary to the IG's statement, the revised regulation does recognize that audit supervisors specifically designated to act for the FAO Manager could sign the same audit reports that the FAO manager could sign, including those that the acting FAO manager may have been responsible for when functioning in his/her capacity as the supervisory auditor. This aspect of DCAA's signature authorization policy was not revised and is in general consonance with the Agency's overall policy on the signature authority of acting managers. We also believe it is in general consonance with the Department's related policy. Moreover, it's the same policy that has been in effect since the IG's inception, and to the best of our knowledge, has never before been labeled as a significant management control deficiency by any external or internal reviewer of DCAA's audit work.

We agree that having two reviewers of a report is generally better than one reviewer, and that our current policy will not always ensure that there will be two reviewers for the type of reports that DCAA considers significant or sensitive. We do not agree, however, that DCAA's policy should be changed to preclude an acting FAO manager from signing his or her own reports when required by the circumstances. Such a change would essentially require the designation of two acting FAO managers, and effectively implementing the change would further complicate an already complex policy without significant benefit in DCAA's opinion. It is also DCAA's position that only the most qualified supervisors should be designated to act as FAO managers, and less qualified supervisors should not be given the final authority to sign out audit reports simply because they had no involvement with a particular audit.

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We also question the accuracy of the IG's finding/statement that the "the risk of audit reports being issued with errors has increased," (presumably, either as a result of supervisors signing their own report since the beginning of FY 1999 or DCAA revising DCAAR 5600.1). The basis for the statement appears to be substantially in error, for the following reasons:

- All of the reports reviewed by the IG were issued under the prior policy (DCAAR 5600.1).
- The related report data cited by the IG does not appear to have an appropriate baseline.
- The related report data appears to include supervisor-signed reports that have not been designated significant or sensitive and that would not, even under the revised policy, require the signature of the FAO manager/Acting FAO manager.
- Under the revised policy/DCAAR 5600.1, DCAA supervisors are signing far fewer audit reports than they signed under the previous policy; therefore, we would expect the risk of audit reports being issued with errors to significantly decrease.
- DCAA is not aware of any comparative data that would support the IG's statement.

Notwithstanding the above comments, should the data from future QA, IG, or other reviews indicate significantly more errors associated with the reports signed out by acting FAO managers, DCAA will appropriately revisit and revise its signature authorization policy at that time. We would do this even though we are not aware of any *on-point* GAGAS or PCIE provisions requiring the close attention that DCAA gives to its audit report signature quality control policy. Question 8.3 from DCAA's PCIE-based review checklist asks whether the audit report was "signed by an authorized individual and was the authorization (e.g., written re-delegation of signature authority) appropriate for the audit under evaluation." The question was adapted from question 11.1 in Appendix E of the *PCIE External Review Guide* entitled, *Checklist for Review of the Individual Financial Statement Audits*. Question 11.1 simply reads: "Does the auditor's report on the financial statements include ... (the) appropriate signature?" There is no corresponding question in the checklist covering performance audits at Appendix F of the PCIE Guide, nor is there any direct GAGAS coverage on what is an "appropriate" report signature. This is left to the audit agency to determine.

B. Response to Recommendations in Report Section B: *Internal Quality Assurance Review of Forward Pricing Assignments*

1. **IG Recommendation.** Revise Defense Contract Agency Regulation 5600.1, "Delegation of Signature Authority for Audit Reports and Other Audit Related Documents," June 28, 2000 so that supervisory auditors, acting as field audit office managers, cannot sign reports on audit assignments they supervised.

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DCAA. Nonconcur. As explained in detail above, DCAA does not agree that its policy should be changed to preclude an acting FAO manager from signing his or her own reports when required by the circumstances. Effectively implementing such a policy change would further complicate an already complex policy without significant benefit in DCAA's opinion. It is also DCAA's position that only the most qualified supervisors should be designated to act as FAO managers and that less qualified supervisors should not be given the final authority to sign out audit reports simply because they had no involvement with a particular audit. However, should the data from future reviews indicate significantly more errors associated with the reports signed out by acting FAO managers, DCAA will appropriately revisit its signature authorization policy at that time.

2. IG Recommendation. Issue clarifying guidance for documenting reliance on data from computer-based systems.

DCAA. Concur. By September 30, 2001, DCAA will issue new guidance on when and how DCAA's auditors of *nonmajor* contractors should obtain and appropriately document adequate evidence on the reliability of the contractor's computer based data.

C. Comments to Findings in Report Section C: *Implementation of the Internal Quality Assurance Review of Forward Pricing Assignments*

a.1. **IG Introductory Comments.** On page 25, the opening paragraph to Section C states:

DCAA primarily used the DCAA Checklist, FAO exit conference notes, and trip reports to document its internal quality assurance review of the individual forward pricing assignments. However, the documents generated by the quality assurance staff did not completely explain the work performed. **In addition, DCAA did not fully evaluate whether the reviewed audits met certain auditing standards.** DCAA maintained limited documentation because management determined that only exceptions needed supporting documentation or explanations. **The use of poorly worded checklist questions, ill-defined criteria for evaluating audit work, and incomplete guidance for assessing noncompliances, illegal acts, and other irregularities impacted the complete evaluation of certain auditing standards.** DCAA needs to take corrective action on the internal quality assurance reviews so an external reviewer can place maximum reliance on the DCAA work when conducting the GAS-mandated external quality control review. If DCAA adequately documents the internal quality assurance reviews, the external reviewers may use the results as direct evidence to support its overall opinion of the internal quality assurance program. [Shading added by DCAA]

a.2. **DCAA on the IG Introductory Comments.** The IG's introductory comments are restated in greater detail in the subsections of Report Section C. DCAA disagrees to some extent

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with the remarks that are shaded. The reasons for our disagreement are provided in the paragraph below and in comments to the relevant detailed subsections (e.g., paragraphs II.C.g.2 and h.2).

With respect to DCAA's "use of poorly worded checklist questions", the cited questions are the same questions adapted from the PCIE Guide that DCAA formally coordinated with the IG in advance of performing its FY 1999 PCIE-based QA reviews. At that time, the IG raised no objections to the wording of the questions. With respect to the IG's broadly worded statement that DCAA's QA reviewers used "ill-defined criteria for evaluating audit work," we disagree. The reviewers relied on DCAA's Contract Audit Manual, as well as other official and well-established sources of DCAA audit guidance (e.g., MRDs, DCAA Regulations and Instructions, etc.). The guidance is GAGAS-based, sufficiently detailed, regularly maintained, and is the same guidance used to actually perform the audits. The IG has received all DCAA published guidance since around 1988. Detailed references to the appropriate CAM guidance have been incorporated into most of the adapted PCIE checklist questions. In short, we believe that the guidance used was generally more comprehensive than that used by most other internal/external reviewers.

b.1. IG Statement on Amount of QA File Documentation. On page 25 of the report, the IG states:

... As supporting documentation, the quality assurance reviewers obtained a copy of the audit report issued for each reviewed assignment and copies of working papers that the reviewer decided were needed. The working papers copied varied from none to the whole audit file depending on how the reviewer completed the DCAA Checklist. ...

b.2. DCAA Clarification on the Amount of QA File Documentation. DCAA agrees that the number and type of audit working papers that its QA reviewers decided they needed to copy for their QA review files varied widely. The number of working papers copied ranged from *just a few* to *most* of the audit file.

c.1. IG on the Documentation of DCAA's "Yes" and "N/A" Checklist Responses. On pages 25, 26, & 27 of the draft report, the IG provides its rationale as to why DCAA's QA reviewers should systematically document all their "Yes" and "N/A" responses, as well as their "No" responses to their PCIE-adapted checklists. For the FY 1999 PCIE-based QA reviews, the QA reviewers documented some of their "Yes" and "N/A" responses, but not the majority of these responses. The "No" responses indicate some form of noncompliance with DCAA policy and/or the GAGAS. The "Yes" responses indicate general compliance, and the "N/A" responses indicate that the question was not applicable to that particular DCAA forward pricing audit (although it could be applicable to other such audits). The key reasons presented by the IG for their position on requiring DCAA's systematic documentation of the "Yes" and "N/A" answers are listed below:

- The gathering of sufficient evidence as called for by the PCIE Guide includes the documentation of "Yes" answers. (p. 26)

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- The documentation of the "Yes" answers would not be as extensive as the documentation of the "No" answers. (p. 26)

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- Adding the requirements for the additional documentation should not lead to a reduction in the audits covered by the PCIE-based reviews. (p.27)

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- The "Yes" and "N/A" documentation would permit the IG to place maximum reliance on the PCIE-based QA review work. Without it, the IG cannot fully rely on the QA work. (IG Report, pp. 25 & 27)

c.2. DCAA on the Documentation of its "Yes" and "N/A" Checklist Responses.

DCAA agrees that there are a number of process improvements that DCAA could adopt to better document the performance and results of its PCIE-based QA reviews. Some of the improvements have been identified by the IG, and some of the IG-suggested improvements, as well as some suggested by DCAA itself, have already been implemented by DCAA's QA organization. However, DCAA does not believe that systematically and sufficiently documenting all of its "Yes" and "N/A" QA checklist responses justifies the cost of the effort to DCAA. DCAA also does not believe that such a requirement was ever contemplated in the set-up of DCAA's QA organization. Additional explanation of DCAA's position, organized so as to address the key points raised by the IG on this issue, is provided below.

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(i) *Compliance with the Requirements of the PCIE-Guide.* The IG report implies that quality assurance organizations like DCAA's that have adapted many of the guidelines and checklist questions from the PCIE External Review Guide are then required by that Guide to systematically and sufficiently document their "Yes" and "N/A" checklist responses. DCAA does not agree. The Guide does not cover how an internal QA organization might best use its checklists and document its checklist responses, nor do we see where the Guide provides specific guidance on the checklist documentation requirements for an external review. DCAA is willing to team with the IG, however, to gather additional information on what other internal review organizations are doing in this area.

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(ii) *Sufficiency of the "Yes" Answer Documentation.* We question the IG's conclusion that if DCAA agreed to systematically and sufficiently document all of its "Yes" and "N/A" responses, the documentation would be less extensive than what we all believe is appropriate and necessary for the "No" responses. DCAA has a different, almost opposite view. To be meaningful and to address the most common audit issues raised by a given checklist question, the documentation would have to be complete; otherwise, it will only serve to raise additional questions. Less than meaningful/complete documentation would be *form over substance*, and would be of no real value to the IG or DCAA. Moreover, due to the general nature of many of the checklist questions, documenting specific noncompliances is a much easier task than sufficiently explaining/documenting why or how aspects of the audit work were determined to be in compliance with the standards. The questions cannot be simply dealt with by reviewing and

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referencing one working paper, one working paper section, or even multiple working paper sections (i.e., they encompass most all of the audit work). Four examples of these checklist questions, as DCAA has adapted them from the PCIE Guide, are provided below.

3.2. Did the auditor prepare an adequate audit program? In judging whether the program is suitable for the audit, reviewers should determine whether the nature and scope of work to be performed was sufficient to attain the stated audit objective.

4.2. Was supervisory involvement appropriate and timely to provide for (1) adequate planning, (2) the supervisor to be kept informed of significant problems encountered, and (3) assurance that the work was adequately performed in accordance with the audit program and the working papers support the conclusions reached/reported?

5.1. Do the working papers document that the auditors obtained: a. Sufficient, competent, and relevant evidence to support findings, judgments, and conclusions in the report?

5.2. Do the working papers contain: a. The audit objectives, scope and methodology, including the basis/criteria for any judgmental/statistical sampling used?

(iii) *Impact of Additional Documentation Requirement on DCAA's QA Review Coverage.* According to the IG, adding the requirements for the additional documentation should not lead to a reduction in the number of audits covered by the PCIE-based reviews. This position, in our opinion, is not supported by the facts. For the FY 1999 PCIE-based reviews, DCAA's QA reviewers answered 9,198 questions. There were 714 "No" responses. The other 8,484 responses were either "Yes" (6,039) or "N/A" (2,445) responses. Systematically providing sufficient, meaningful documentation supporting the 8,484 "Yes" and "N/A" responses to DCAA's PCIE-based checklist questions (like those exemplified above) would have a significant impact on the number of audits that the could be formally reviewed.

DCAA is already committing approximately 7 staff years to the annual performance of its PCIE-based reviews – resources that do not include the considerable time spent following-up the review findings and supporting the IG's related review effort. As a result of the IG review effort to date, several areas have been identified in which the IG would like DCAA to commit additional resources to improve its policy and procedures documentation, "No" answer documentation, and overall file documentation. DCAA does not believe it's prudent or appropriate to commit any additional resources to the PCIE-based review process at this time. Consequently, any imposed requirement to systematically provide the IG with sufficient and meaningful documentation supporting the thousands of "Yes" and "N/A" checklist responses would result in a significant reduction in the number of audits annually covered by the PCIE-reviews. This, in turn, would substantially decrease the benefit of the PCIE-based reviews to DCAA. The reviews would be less likely to identify and correct auditor noncompliances, DCAA's management would receive less information on the state of its audits, and the IG's re-testing required by the standards and PCIE would be more likely to result in findings of significant noncompliance that DCAA's QA reviewers failed to identify.

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(iv) *Without the "Yes" Answer Documentation the IG Won't be Able to Place Full Reliance on DCAA's PCIE-based QA Review Work.* DCAA understands the value that systematically and meaningfully documenting all of the "Yes" and "N/A" checklist responses would have for the IG. The "Yes" and "N/A" answer documentation, however, would not commensurately benefit DCAA, and in fact, as explained above, would decrease the value of DCAA's QA organization to the Agency. Notwithstanding, if the IG continues to believe that DCAA's approach for documenting its QA work presents increased risk, then the IG will plan/expand its external review testing accordingly to gain the level of assurance it needs. If, after the retesting, the IG determines that DCAA's QA organization reasonably identified, reported, and corrected the significant noncompliances, the IG can then place an increased level of reliance on the QA work. Over time, we are confident that this will bring the IG to the level of maximum reliance.

d.1. **IG on the Cross-Referencing of DCAA's PCIE-based Review Reports.** On page 27 of the report, the IG states:

DCAA wrote a trip report in the form of a Memorandum For The Record for each of the 18 reviewed FAOs. The trip report summarized the major findings of the internal quality assurance review at that FAO and included an enclosure that summarized the DCAA Checklist answers by reviewed assignment. The major conditions discussed referenced the applicable reviewed assignment and the DCAA Checklist question, if pertinent. DCAA was not required to, and did not, cross-reference the 18 trip reports to the supporting quality assurance documents. Cross-referencing the trip report to the actual quality assurance documents would establish an audit trail showing that all facts in the trip report are supported by the quality assurance documents. Cross-referencing the report to the actual supporting working papers is a generally accepted practice. In fact, CAM 4-403(i)(3) provides guidance on cross-referencing that includes the requirement to cross-reference the summary results and notes in a DCAA draft report to the DCAA summary and lead working papers.

d.2. **DCAA on the Cross-Referencing of its PCIE-based Review Reports.** DCAA disagrees that its findings from the FY 1999 PCIE-based QA reviews, as presented in the 18 Memorandums for the Record (MFRs) noted by the IG, were not adequately cross-referenced to the appropriate documents supporting the findings, including the key working papers of the reviewed audit. The 18 MFRs were all cross-referenced in detail to both the individual audits that were reviewed and to the individual PCIE-based checklist questions. For each significant issue of noncompliance addressed in the trip reports, the report identified all of the corresponding "No" answers on each individual checklist and referenced each "No" answer to the appropriate audit and PCIE-based checklist. The individual checklists, in turn, refer the reader to the particular deficiency in the audit, audit workpackage, and or audit report for which each "No" response was recorded.

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e.1. **IG on Reliance on DCAA's PCIE-based Review Documentation.** On page 27 of the report, the IG states:

The DCAA working papers that support its internal quality assurance reviews must contain sufficient evidence to support each auditor conclusion in order for an external reviewer to place maximum reliance on the work. Although DCAA is not required to follow the CAM when conducting internal quality assurance reviews, proper cross-referencing would facilitate identifying supporting documentation for significant auditor conclusions. Because of inadequate comments, cross-referencing, and documentation we did not rely on the working papers when conducting our review. We retested the validity of the results of the DCAA internal quality assurance review of forward pricing assignments by judgmentally selecting three FAOs and evaluating the same seven assignments at each FAO that DCAA initially reviewed using the DCAA Checklist. Better documentation will allow the external reviewer to rely to a greater extent on the DCAA results. That reliance, in turn, will reduce the staff time that both agencies will have to expend on the reviews.

e.2. **DCAA on the IG's Reliance on DCAA's PCIE-based Review Documentation.**

Notwithstanding our difference of opinion on the "Yes" and "N/A" answer documentation, DCAA's QA organization has and will continue to improve the documentation of its comments supporting all of its checklist responses. Similarly, the cross-referencing of its work has and will continue to improve, but we are unlikely to meet the IG's full expectations in the area, as we do not agree with their basic findings/expectations for the QA cross-referencing. We recognize that continued disagreement on these issues might cause the IG to expand its external review testing to gain the level of assurance it needs. If, after the retesting, however, the IG determines that DCAA's QA organization reasonably identified, reported, and corrected the significant noncompliances, the IG can then place an increased level of reliance on the QA work. Over time, we are confident that this will bring the IG to the level of maximum reliance.

f.1. **IG Introductory Comments on the Assessment of DCAA's PCIE Review Results.**

On pages 27 and 28, the opening paragraph to the *Assessment* Section of Report Section C states in part:

... In total, the DCAA Checklist had 49 questions. Of the 49 questions, we identified 8 that, as implemented, impacted the complete evaluation of certain auditing standards. That situation occurred because of the use of poorly worded checklist questions; ill-defined criteria for evaluating the evidence of audit work; and incomplete guidance for assessing noncompliances, illegal acts, and other irregularities. The eight questions need revision to ensure that DCAA properly assesses whether an audit met that particular auditing standard. In addition, by tailoring the questions to evaluate compliance with standards based on the way DCAA operates, DCAA should be able to more efficiently document its conclusions. ... [Shading added by DCAA]

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f.2. DCAA on the IG Introductory Comments on Assessment of DCAA's PCIE

Review Results. Again, the IG's introductory comments are restated in greater detail in later subsections of Report Section C. DCAA disagrees to some extent with the remarks that are shaded. The reasons for our disagreement are provided in the paragraph below and in comments to the relevant detailed subsections (e.g., paragraphs II.C.g.2 and h.2).

With respect to DCAA's "use of poorly worded checklist questions", the cited questions are the same questions adapted from the PCIE Guide that DCAA formally coordinated with the IG in advance of performing its FY 1999 PCIE-based QA reviews. At that time, the IG raised no objections to the wording of the questions. With respect to the IG's broadly worded statement that DCAA's QA reviewers used "ill-defined criteria for evaluating the evidence of audit work," we disagree. The reviewers relied on DCAA's Contract Audit Manual, as well as other official and well-established sources of DCAA audit guidance (e.g., MRDs, DCAA Regulations and Instructions, etc.). The guidance is GAGAS-based, sufficiently detailed, regularly maintained, and is the same guidance used to actually perform the audits. The IG has received all DCAA published guidance since around 1988. Detailed references to the appropriate CAM guidance have been incorporated into most of the adapted PCIE checklist questions. In short, we believe that the guidance used was generally more comprehensive than that used that used by most other internal/external reviewers.

g.1. IG on the QA Reviewers' Responses to Checklist Question 5.3 -- Reliability of the Contractor's Computer-Based Data. On pages 29, 30, and 31, the IG covers in considerable detail why it has concluded that DCAA's QA reviewers "did not adequately apply the criteria in GAS 6.62 to determine whether the auditor obtained sufficient, competent, and relevant evidence that computer-processed data are valid and reliable [p. 30]." The noted criteria in GAS 6.62 are covered by question 5.3 from DCAA's checklist. The question, restated below, was adapted almost verbatim from the checklist at Appendix F on the PCIE Guide. Following the question are the IG paragraphs /statements explaining the specific deficiencies in the manner in which DCAA answered question 5.3 and covered GAS 6.62.

5.3 If the data from computer-based systems was significant to drawing audit conclusions, did the auditor obtain evidence about the reliability of the data by either (a) determining that the validity of the data was established in other DCAA audits or by other auditors, or (b) directly testing the data. (The level of direct testing may be reduced by testing the effectiveness of general and application controls in the computer-based systems.)

... DCAA answered "yes" to question 5.3, 'if evidence was found in FAO permanent files that EDP [electronic data processing] controls were tested (even if not documented in WPs [working papers])'.

DCAA Review Results. DCAA concluded that the auditors adequately documented evidence of the reliability of data from computer-based systems on 65 (51.6 percent) of the 126 assignments. In addition, DCAA determined that for 17 (13.5 percent) of the audits reviewed this standard was not applicable.

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For the 21 audits we test checked, DCAA answered "no" to question 5.3 in 7 (33.3 percent) cases; "yes" in 12 (57.2 percent) cases; and "not applicable" in 2 (9.5 percent) cases.

External Review Results. We answered "no" to question 5.3 for 16 (76.2 percent) of the 21 audits we retested. In addition, we determined that "not applicable" only applied to one (4.8 percent) audit. We answered "no" more frequently than DCAA because if another audit or permanent file was not properly referenced in the reviewed audit files, we did not assume that the auditor knew that this review had been performed. In addition, if the auditor did not document why, or it was not obvious why, the computer-process data was not significant to the auditor's findings, we answered "no."

Conclusions on External Review of Reliability of Computer-Processed Data. By applying its criteria, DCAA did not assess whether the auditor performing the reviewed audit had obtained the required evidence about computer-processed data. Instead, DCAA assessed whether the FAO had performed certain information system reviews. Therefore, DCAA did not adequately apply the criteria in GAS 6.62 to determine whether the auditor obtained sufficient, competent, and relevant evidence that computer-processed data are valid and reliable. ...

As a suggestion to correct the cited deficiencies, the IG on pages 29 and 30 of the report, suggests that DCAA break question 5.3 down into 6 separate questions.

g.2. DCAA on the QA Reviewers' Responses to Checklist Question 5.3 -- Reliability of the Contractor's Computer-Based Data. With respect to checklist question 5.3, there is no doubt that the IG performed an in depth analysis and that its efforts are well intentioned and directed at strengthening DCAA's QA program. The question, however, is also an example in our view of the IG straying from the relevant facts and significant issues. We believe this for the reasons that follow.

(i) PCIE-based question 5.3 worked well, in DCAA's opinion, to flag a significant area where DCAA's existing policy would not ensure adequate compliance with the current GAGAS.

(ii) DCAA's QA reviewers did find and report the significant cases where DCAA's auditors were not adequately complying with the GAGAS because of the policy inadequacy noted in (i) above. DCAA's management accepted the findings as being significant and tasked the Agency's Policy & Plans Directorate to develop the needed policy – a complex undertaking with a potentially significant impact on Agency auditor resources.

(iii) DCAA's QA reviewers also found and reported as a significant problem the quality of the risk assessments for the audits they reviewed. Included in these findings were cases where the auditor did not appropriately document his/her consideration of the impact of the relevant IT-

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related internal control audits performed by the FAO. This was the process followed by the QA reviewers. It is also the correct process in DCAA's opinion and much preferred over adding additional, duplicative checklist questions.

(iv) For the reasons like that noted in (iii) above, the basis for the IG evaluators' conclusion as to why they answered "no" more frequently to question 5.3 than DCAA is at least partially incorrect. DCAA's reviewers did not ignore the requirement for documenting the impact of the FAO's IT-related internal controls audit, nor did they simply assume that the auditor knew that the relevant IT-related internal control audits had been performed.

(v) When all the facts and circumstances are aired, the differences between what the IG is saying and what DCAA's QA reviewer's have already cited and reported to the Agency's management are not significant, in DCAA's opinion.

(vi) In the process of maintaining the checklist used for the PCIE-based QA reviews, DCAA's Headquarters QA Division (PQA) has tried to keep the checklist questions and the wording of these questions as close to what is in the PCIE External Review Guide as possible. PQA, however, is not averse to changing the questions or adopting new ones when it makes good sense to do so, and in fact, has made a number of changes already. Dividing a PCIE-based question that has worked well into 6 separate questions to more objectively compile associated facts that may not be necessary or worth the additional cost is not prudent in DCAA's opinion. Further, since the question is suitable "as is" to the PCIE and IG external reviewers, DCAA is not convinced that having its QA reviewers respond to and meet the documentation requirements for six replacement questions is a good idea. Nevertheless, PQA is agreeable to further examining the IG's proposed changes and would be happy to meet with the individual evaluators to gain a better understanding of the data they think should be collected that is not now being adequately collected.

h.1. IG on DCAA's Assessments of the Auditor's Understanding of Contractor Internal Controls. On pages 31 to 34 of the draft report, the IG covers in considerable detail the responses of DCAA's QA reviewers to their PCIE-based checklist questions 6.1 and 6.2. The questions, restated below, relate to GAS 4.21 and 4.37 and the auditor's understanding of contractor internal controls.

6.1 Did the auditors obtain an understanding of the internal controls sufficient to plan the audit by performing procedures to understand the design of controls relevant to the audit and whether they have been placed in operations?

6.2 Did the auditors appropriately document their understanding of the internal control components obtained to plan the audit?

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The IG's findings with respect to questions 6.1 and 6.2 were not unlike those discussed in paragraph g.1 above for question 5.3., and DCAA's overall position regarding the findings is also similar to that stated in paragraph g.2. The paragraphs below from page 32 of the report summarily capture the findings. The paragraphs are then followed by a shortened version of DCAA's position.

Results of DCAA Review. DCAA determined that the auditors for 108 (85.7 percent) of the 126 assignments obtained an understanding of the contractor's internal controls for question 6.1. However, for question 6.2, DCAA determined that the auditor appropriately documented that understanding for only 74 (58.7 percent) of the 126 assignments. For the 21 audits that we test checked, DCAA answered question 6.1, "yes" in 14 (66.6 percent) cases and answered question 6.2 "yes" in 9 (42.9 percent) cases, a difference of 5 cases.

Results of External Review. We answered "no" to question 6.1 and question 6.2 for 14 (66.6 percent) of the 21 audits we retested. We answered "no" for both questions if the auditor did not include or reference the appropriate internal control forms in the audit file or provide some other information indicating a knowledge of the contractor's internal controls. The only way to determine whether the auditor performing the audit had obtained an understanding as required was through the documentation that existed in the audit file. Therefore, independent of any retesting, we concluded that DCAA improperly assessed the auditor's compliance for 34 (27.0 percent) of the 126 assignments where DCAA answered question 6.1 "yes" and question 6.2 "no." Of the 21 assignments that we retested, we identified 3 audits where DCAA improperly applied its own criteria.

h.2. DCAA on its Assessments of the Auditor's Understanding of Contractor Internal Controls. In FY 1999, DCAA's QA reviewers answered questions 6.1 and 6.2 for each of the 126 audits they covered, and we would expect that there would be inconsistencies in their individual responses – some explainable, some not. So, the fact that the IG retested 21 assignments and found three (14%) that apparently did not consistently apply DCAA's criteria for answering the question does not surprise or significantly concern us. We also generally agree with the IG's conclusion that the "only way to determine whether the auditor performing the audit had obtained an understanding as required was through the documentation that existed in the audit file." We do not agree, however, with the IG's stated logic that just because DCAA answered 6.1 "Yes" and 6.2 "No," it automatically follows that DCAA, irrespective of all other factors/variables, improperly assessed the auditor's compliance for 34 of the 126 assignments reviewed (27%). PCIE-based question 6.2 asks whether the auditors **appropriately** documented their understanding of internal control components. There are a number of different circumstances in which the auditors can demonstrate that they have obtained an adequate understanding of relevant contractor internal controls (question 6.1), but have not appropriately documented their understanding in the audit file under review.

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Notwithstanding our area of difference of opinion above, we again recognize that the IG's efforts with respect to question 6.1 and 6.2 are well intentioned and directed at strengthening DCAA's QA program. But, as with question 5.3, we also believe:

(i) Questions 6.1 and 6.2 worked well to flag a significant area where DCAA's existing policy/standard working papers did not ensure adequate compliance with the GAGAS;

(ii) DCAA's QA reviewers did find and report the significant cases where DCAA's auditors were not adequately complying with the GAGAS because of the inadequacies, and DCAA's management accepted the findings as being significant and tasked the Policy & Plans Directorate to improve the standard working papers/policy; and

(iii) When all the facts and circumstances are aired, the differences between what the IG is saying and what DCAA's QA reviewer's have already cited and reported to the Agency's management are not that significant, in DCAA's opinion.

At a minimum, for future PCIE-based QA reviews, DCAA will ensure that its QA reviewers sufficiently explain/document why they believe an auditor has demonstrated an adequate understanding of the internal controls, but not appropriately documented that understanding. PQA will also further examine the IG's proposed changes relating to checklist questions 6.1 and 6.2 to ensure that the significant data that needs to be captured by these questions is in fact captured. Significant changes to the checklist will be coordinated with the IG.

i.1. **IG on DCAA's Use of a Rating System.** On pages 37 and 38 of the draft report, the IG states:

Ratings. DCAA established an overall FAO rating to show FAOs that an FAO could "pass" an internal quality assurance review. For the internal quality assurance review of forward pricing assignments, DCAA did not develop a performance goal or performance indicators. Instead, DCAA used a subjective rating system to describe the overall performance of its FAOs. DCAA used two ratings:

- High – As good as we can reasonably expect and no followup necessary
- Satisfactory – Corrective action plans obtained and the regions are required to conduct followup to ensure that plans have been effectively implemented

DCAA did not develop criteria for objectively measuring FAO performance to assign either of the two ratings. Instead, DCAA, using the results of the DCAA Checklist reviews, subjectively decided which ones they felt were operating at a high level versus a satisfactory level. DCAA decided to rate 8 of the FAOs as high and 10 of the FAOs as satisfactory.

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Performance goals should be objective, quantifiable, and measurable. In addition, the measurement criteria should be established prior to conducting the review to ensure proper implementation of the rating process. Merely comparing the performance of one FAO against another does not provide any information on whether either FAO is meeting agency performance goals and can result in inconsistent ratings. For example, DCAA rated one of the FAOs we visited as operating at a high level of compliance even though DCAA found that one of the seven assignments reviewed did not meet the due professional care standard. DCAA determined that "as good as we can reasonably expect" or a high level of compliance equates to one out of seven FAO audits failing to comply with the due professional care standard. Because of the overall importance of complying with this standard, at the very least a high rating should indicate that all reviewed assignments met that particular standard. ...

i.2. **DCAA on its Use of a Rating System.** It is true that DCAA has established a process by which its QA reviewers use the results from their reviews at individual field audit offices (FAOs) to rate the level at which those offices are complying with GAGAS and Agency audit policy. It is also true that the process is more subjective than objective, and that in rating the FAOs covered by the FY 1999 PCIE-based reviews, the QA reviewers used only two of the available ratings. While no rating was given less than satisfactory, the potential for giving such ratings if certain standards were not met was very much on the minds of every QA reviewer and FAO office manager during every one of the FY 1999 PCIE-based QA reviews.

The IG's statement that DCAA subjectively compared the 18 FAOs against one another to decide the ratings is also incorrect to the extent that it implies the QA reviewers ignored the GAGAS and the high standards set by DCAA's own policy and management. The QA reviewers found that all of the 18 offices reviewed sufficiently satisfied the standards to be judged operating at a satisfactory level of compliance. Ten of the 18 offices were then determined to operating at a high level of compliance. In their assignment of a given rating, the reviewers judgmentally considered and weighed the following factors:

- the number of noncompliances and number of assignments with noncompliances;
- the significance of the noncompliances and number of assignments with highly significant noncompliances;
- the nature and substance of the noncompliances (e.g., significant deficiencies in the audit coverage or in how the audit was technically performed) were generally given more weight than the noncompliances stemming from deficiencies related to audit form (e.g., noncompliant cross-referencing or report format);
- the impact of the noncompliances on DCAA, the government customer, and/or government in general; and lastly
- how DCAA management, IG APO, and the auditing community in general would judge the overall significance of the QA review findings.

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In questioning DCAA's criteria for rating its FAOs, the IG cites one example where an FAO was rated as operating at a *high level of compliance* even though DCAA found that one of the seven assignments reviewed did not meet the *due professional care* standard. The audit example cited is actually a fine example of why good reviewer judgement is critical to the PCIE-based review process and analysis of its results. The audit was cited for not meeting question 1.1 from Appendix F of the PCIE *External Review Guide* (see "p" above). The question, restated below, is the same question that both the IG and DCAA agree is difficult to interpret as written.

Did the auditors follow proper procedures when determining that an applicable government auditing standard was not to be followed?

The QA reviewers answered this question "No" for a relatively low-risk *cost realism* review at the Lockheed-Martin-Orlando Residency. The customer requested an audit and later confirmed that he wanted an audit, when in fact, he was actually conducting a *cost realism* exercise. The auditor did his best to accommodate the customer with a *cost realism* audit report. The QA reviewers determined that (1) the unusual report was in noncompliance with DCAA policy and that the unusual circumstances seemed to fit question 1.1 and require a "No" response. However, aside from its "form" problems, the report provided the customer with all the information he wanted, and the customer later communicated his appreciation to the auditor. Given the difficulty with question 1.1, the circumstances of the audit in question, the good quality of the FAO audit files, and the QA results from the FAO's six other audits, the QA team applied the criteria above and judged the FAO to be operating at an overall at a *high level of compliance*. It was a close call, but the correct call in the end.

In summary, the rating process described above has value to DCAA. We recognize, however, that the IG has no similar need to provide DCAA's FAOs with specific individual feedback. We also recognize that the IG needs to develop and have confidence in its own processes for summarily analyzing the data from DCAA's QA reviews. Based on this understanding, we are in agreement with the IG that DCAA QA reviewers need to establish more specific, written criteria for gauging the overall performance of its field audit offices.

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C. Response to Recommendations in Report Section C: *Implementation of the Internal Quality Assurance Review of Forward Pricing Assignments*

1. IG Recommendation. Sufficiently document all auditor conclusions when performing internal quality assurance reviews.

DCAA. Nonconcur. DCAA agrees that its QA review staff should systematically document all of their determinations of auditor noncompliance and that the documentation in this regard should be meaningful and sufficiently complete/comprehensive. However, for reasons summarized below and explained in detail at II.C.c.2, DCAA does not believe it would be prudent to commit its limited QA resources to providing similar documentation in support of all of the determinations of compliance or non-applicability with a given auditing standard or element of DCAA policy.

In performing the PCIE-based reviews, DCAA's quality assurance (QA) organization used a checklist adapted from the *PCIE External Review Guide*. The checklist questions are worded such that a "No" response represents some manner of noncompliance with the DCAA policy or the GAGAS, a "Yes" response represents general compliance, and a "N/A" response means that the question was not applicable to the particular audit being reviewed. To evaluate DCAA's forward pricing audits in FY 1999, the QA reviewer's answered a total of 9,198 questions. There were 714 "No" responses; 6,753 "Yes" responses; and 2,445 "N/A" responses.

To date, the QA reviewers have only been *systematically* documenting their "No" responses, representing the exceptions or noncompliances that they found. The main reason for this is that requiring the *meaningful* documentation of all "Yes" and "N/A" responses would necessitate a significant cut back on the number of audits reviewed. The fewer audits reviewed, the less meaningful the results and the less likely that existing problems/noncompliances would be accurately identified and satisfactorily addressed. Another reason is that the "Yes" answers for many of the key checklist questions cannot be supported by simply reviewing and referencing a single working paper or working paper section, i.e., they require the reviewer to consider the entire audit work (or a good part thereof). Lastly, DCAA believes its policy of only systematically documenting the noncompliances is in line with what other internal (and at least some external) reviewers do. DCAA would be pleased to team with the IG to gather additional data on this final point.

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2. IG Recommendation. Revise the Defense Contract Audit Agency Checklist to:

a. Revise question 5.3 on reliability of computer-processed data to cover the field audit office's knowledge and documentation of the reliability and validity of computer-processed data; the auditor's knowledge and documentation of computer-processed data; and the auditor's determination and documentation of any decision that computer-processed data is not significant to the audit findings and conclusions as required by Government Auditing Standard 6.62.

b. Revise the questions in section 6 relating to internal controls to cover the field audit office's knowledge and documentation of internal controls as well as the auditor's knowledge and documentation.

DCAA. DCAA concurs in part with recommendation A.2, for the reasons summarized below and explained in detail at II.C.c.2. In the process of maintaining the checklist used for the PCIE-based QA reviews, the QA Division at DCAA Headquarters (PQA) has tried to keep the checklist questions and the wording of these questions as close to what is in the *PCIE External Review Guide* as possible. However, PQA has changed and will continue to change its checklist questions and adopt new ones when it makes good sense to do so. With respect to the 5.3 and section 6 questions, DCAA agrees that the questions can be reworded to address some of the IG concerns and increase the value and consistency of the responses. Additionally, prior to using its checklist for the next round of PCIE-based reviews, PQA will (1) further examine the IG's proposed changes, (2) meet with the individual IG evaluators to gain a better understanding of the data they believe should be collected that is not now being adequately collected, and (3) revise the 5.3 and section 6 questions accordingly. However, based on our reading of the applicable report sections and understanding of the related issues, DCAA does not agree at this time that either 5.3 or section 6 questions should be substantially reworded or substantially broken down into multiple questions.

3. IG Recommendation. Revise the standard audit programs for forward pricing assignments to include audit steps addressing assessment of risk due to fraud and other illegal acts.

DCAA. Concur. DCAA will review each of its forward pricing audit programs to determine where it might best add appropriate audit steps or new wording to existing steps to more directly cover SAS 82 concerns, and by September 28, 2001, DCAA will add the appropriate steps/new wording.

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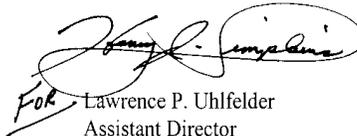
4. **IG Recommendation.** Modify DCAA Manual 7640.1, "DCAA Contract Audit Manual," and the "Audit Report Quality Review Sheet for Audit Reports of All Types" to require that auditors cross-reference all sections of an audit report containing nonstandard language, including the subject, executive summary (significant issues), scope, qualifications, and appendices to working papers, permanent files, or other audit assignments as appropriate.

DCAA. Concur. DCAA will review its existing policy, and by December 31, 2001 appropriately modify its applicable contract audit manual (CAM) sections. The modification will require DCAA's auditors to adequately reference in the draft audit report the working paper support for all the statements in the audit report that should be supported. DCAA agrees that the change should require the systematic referencing of much of the information that is typically presented in the report subject, scope (including the qualifications), and appendices. DCAA further agrees that the executive summary information should also be referenced to the applicable detailed sections of the report, and that references to supporting information in the field audit office's permanent file would also be appropriate. DCAA's *Audit Report Quality Review Sheet* will be appropriately updated to reflect the revised policy/CAM.

5. **IG Recommendation.** Establish criteria against which the field audit office can be rated.

DCAA. Concur. DCAA will further refine the criteria that it currently uses to assess the overall state of field audit office compliance with the auditing standards and Agency policy and put the criteria in writing. A copy of the written criteria will be provided the IG by October 12, 2001.

Questions regarding this memorandum should be directed to Mr. Henry Simpkins, Chief, Quality Assurance Division, at (703) 767-2250.


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