

August 6, 2002



Audit Oversight

Defense Contract Audit Agency
Quality Assurance Review of Internal
Control System Audits
(D-2002-6-007)

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of the Department of Defense

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Acronyms

| | |
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| 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 |
| ODC | Other Direct Cost |
| PCIE | President's Council on Integrity and Efficiency |
| PWT | Participative Work Team |
| RQA | Regional Quality Assurance Division |
| SAP | Standard Audit Program |



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

August 6, 2002

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Report on Defense Contract Audit Agency Quality Assurance Review of
Internal Control System Audits (Report No. D-2002-6-007)

We are providing this 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 Recommendation B.5. and provide additional comments to Recommendation B.2. in response to the final report. We request that management provide the comments by September 5, 2002.

We request that management provide comments that conform to the requirements of DoD Directive 7650.3. If possible, please provide management comments in electronic format (Adobe Acrobat file only). Send electronic transmission to the e-mail addresses cited in the last paragraph of this memorandum. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the evaluation staff. For additional information on this report, please contact 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 D for the report distribution. The team members are listed inside the back cover.

A handwritten signature in black ink, reading "Patricia A. Brannin".

Patricia A. Brannin
Deputy Assistant Inspector General
for Audit Policy and Oversight

Office of the Inspector General of the Department of Defense

Report No. D-2002-6-007

(Project No. D2001OA-0113)

August 6, 2002

Defense Contract Audit Agency Quality Assurance Review of Internal Control System Audits

Executive Summary

Who Should Read This Report and Why? The Under Secretary of Defense (Comptroller) and the Defense Contract Audit Agency (DCAA) Executive Steering Committee should read this report. The report discusses the status of the DCAA quality assurance program and the quality assurance review of internal control systems audits.

Background. This is the second in a series of reports on the DCAA headquarters-led quality assurance program. 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, audit quality review, and management improvement efforts. The "Government Auditing Standards," issued by the Comptroller General of the United States, requires that each audit organization have an appropriate quality control system. For FY 2001, DCAA completed 42,657 reviews, valued at \$218.4 billion, with net savings of \$3.2 billion. DCAA incurred \$383.2 million in total operating costs to provide the audit services. DCAA selected internal control system audits, one of four categories of audits, as the second category to be covered by the DCAA headquarters-led quality assurance reviews.

Results. Since the program was announced in October 1998, DCAA continues to refine its quality assurance program to include the fundamental elements of a mature program. However, DCAA can further improve the program by institutionalizing the followup process for all quality assurance reviews and by issuing clarifying guidance for documenting reliance on data from computer-based systems (finding A).

The DCAA quality assurance review of internal control system audits identified significant noncompliances related to standard audit programs, internal control testing and risk assessment, supervision, and quality and accuracy of audit reports for which DCAA had either implemented or initiated corrective action. However, additional issues relating to the accuracy of audit reports and the associated internal control risk assessments exist that need to be resolved through correction of inaccurate reports and the related risk assessments and addition of a checklist question. To improve the quality of audits, DCAA should actively oversee the scheduling and completion of internal control system audits, correct any inaccurate outstanding reports, revise any inaccurate Internal Control Audit Planning Summaries, and verify whether fieldwork dates are included in applicable audit reports (finding B).

Management Comments and Oversight Response. DCAA generally concurred with the recommendations with the exception of including a checklist question to verify whether the dates of fieldwork are included in applicable audit reports. However, regarding the correction of inaccurate audit reports, DCAA did not address the situation

where auditors issued full scope opinions but did not audit the entire systems. A discussion of management comments is in the Findings section of the report, and the complete text is in the Management Comments section. We request that DCAA reconsider its position on one recommendation and provide additional comments on the other recommendation in response to the final report.

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Background

This is the second in a series of reports on the Defense Contract Audit Agency (DCAA) headquarters-led 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 and undergo an independent external quality control review at least once every 3 years. The objective of an external quality control review is to determine whether the organization’s internal quality control system is properly implemented and operating effectively to provide reasonable assurance that established policies, procedures, and auditing standards are being followed.

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 1997,¹ 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 5105.36, “Defense Contract Audit Agency,” June 9, 1965,² establishes DCAA as a separate organization under the direction, authority, and control of the Under Secretary of Defense (Comptroller). 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. During FY 2001, DCAA completed 42,657 reviews, valued at \$218.4 billion,³ with net savings of \$3.2 billion. DCAA incurred \$383.2 million in total operating costs to provide the audit services. DCAA audit guidance is contained in the DCAA Manual 7640.1, “DCAA Contract Audit Manual” (CAM).⁴ 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

¹Although it does not affect this review, the PCIE Guide was revised as of January 4, 2002.

²DoD Directive 5105.36 was last updated on February 28, 2002.

³This 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).

⁴DCAA Manual 7640.1 is updated every 6 months. As of August 2002, the version is July 2002.

programs and internal control matrices. Between CAM updates, DCAA headquarters notifies managers of new and revised audit guidance by issuing Memorandums for Regional Directors (MRDs) that are usually incorporated in the next CAM update. DCAA has a quality control system that is implemented at all levels of the organization. Appendix B describes the structure of the DCAA quality control system.

Internal Control System Audits. DCAA selected internal control system audits as the second in the series of quality assurance reviews because of the significance of the audit results in relation to incurred cost audits, the third audit type that DCAA reviewed. DCAA identified 10 accounting and management systems⁵ that must be audited every 2 to 4 years if the system has a significant impact on Government contract costs being charged by major contractors.⁶ In addition, DCAA may perform internal control system audits at nonmajor contractors⁷ when the cognizant auditor determines that the audit effort to review a contractor's internal control system is expected to be offset by a reduced effort on other related audits. DCAA performs internal control system audits to gather sufficient evidence to express an opinion on the adequacy of a contractor's relevant accounting or management system and the related internal controls for compliance with applicable laws, regulations, and contract terms. Externally, DCAA provides results of an internal control system audit to contracting officials with an audit report. Internally, DCAA summarizes the results of an internal control system audit on an Internal Control Audit Planning Summary (ICAPS), a form that summarizes the auditor's review of a contractor's internal controls, opinion of adequacy, and assessment of control risk. DCAA integrates the information obtained during an internal control system audit into the planning and reporting of other related audits.

Objectives

The objective for this oversight review was to review the status of the DCAA quality assurance program and to assess how DCAA performed the quality assurance review of internal control system audits. Subsequent oversight reviews will assess how DCAA performs quality assurance reviews of incurred cost audits and all other audits. We will make an overall determination as to whether the DCAA quality control system as a whole provided reasonable assurance that established policies, procedures, and applicable auditing standards were being followed after completing our external quality control review. See Appendix A for a discussion of the scope, methodology, and prior coverage.

⁵The systems are billing, budget and planning, compensation, environment and overall accounting controls, estimating, general electronic data processing controls, indirect and other direct costs, labor, material management and accounting, and purchasing.

⁶A major contractor is a contractor where DCAA has contractor costs of \$80 million or more to audit in one fiscal year.

⁷A nonmajor contractor is a contractor where DCAA has contractor costs of less than \$80 million 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.

A. Status of Defense Contract Audit Agency Quality Assurance Program

Since the program was announced in October 1998, DCAA continues to refine its quality assurance program to include the fundamental elements of a mature program. DCAA has either completed or is in the process of taking corrective action to improve the quality assurance program. However, DCAA can further improve the ability of the program to provide a thorough evaluation of whether its audits are performed in compliance with auditing standards and DCAA policies and procedures by institutionalizing the followup process for all quality assurance reviews and by issuing clarifying guidance for documenting reliance on data from computer-based systems.

DCAA 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. Inspector General of the Department of Defense (IG DoD) Report No. D-2002-6-001, "Defense Contract Audit Agency Quality Assurance Program," December 6, 2001, discusses DCAA implementation of the characteristics outlined in the PCIE Guide. Appendix B includes general requirements for quality control systems and quality assurance reviews, describes the DCAA quality assurance program, and summarizes our review results and the actions that DCAA has implemented or initiated to improve its quality assurance program. However, DCAA still needs to improve followup procedures to ensure that the quality assurance program will operate effectively.

Followup Procedures. The PCIE Guide recommends that procedures for resolution and followup of recommended corrective action be established. A good followup system should provide information on what improvements were made as a result of the work and whether the improvements achieved the desired result. Determining actions that were taken on recommendations requires active 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 headquarters-led quality assurance reviews. If the Executive Steering Committee (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. If the ESC adopts a corrective action and assigns it to the regions for implementation or followup, DCAA relies on the regional directors to independently ensure that corrective action is taken. The headquarters Quality Assurance Division performs no additional followup action until the next quality assurance review of the same type audit unless otherwise specifically directed by DCAA management.

In the management comments to a draft of IG DoD Report No. D-2002-6-001, DCAA agreed to institutionalize a followup process. Specifically, DCAA developed a new strategic plan objective of increasing the number of field audit offices (FAO)⁸ found to be at a “high level” of compliance with auditing policies and procedures to 70 percent during the FY 2002 review of forward pricing assignments. The milestone plan for that objective required the regions to implement their corrective action plans by May 2001 and to brief the ESC by December 2001 on the status of progress for previously established regional action plans. As of February 7, 2002, DCAA had only institutionalized the process for followup actions that resulted from review of forward pricing assignments but had not established the same process for other quality assurance reviews. However, at the June 2002 ESC meeting, the ESC rescinded the objective and, although the ESC is considering a replacement objective, one has yet to be proposed or adopted. DCAA should implement a standard followup process for all of the various headquarters-led internal quality assurance reviews.

Corrective Action Needed for Full Compliance With GAS

During the DCAA quality assurance review of forward pricing assignments, DCAA identified an issue related to properly documenting reliance on data from computer-based systems at nonmajor contractors, but has not yet implemented corrective action. GAS 6.62 requires that

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.

DCAA found that auditors reviewing price proposals from nonmajor contractors did not obtain adequate evidence about reliability of the data from computer-based systems or did not document that they had obtained any evidence. In addition, DCAA policies and procedures did not specifically require the auditors 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, between December 2000 and March 2002, DCAA revised the milestone six times.

⁸An 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 the assignment of a permanent staff of auditors and support elements. A branch office is not located in a contractor’s facility and its auditors perform work at several contractor facilities.

DCAA issued MRD 02-PQA-050, "Audit Guidance for Nonmajor Contractor Audits with Maximum Control Risk Assessments and Audit Evidence Highly Dependent on Contractor Computerized Information Systems," on June 25, 2002, after a draft of this report was issued. Continuing noncompliance with GAS was a deficiency that should have been corrected in a much more timely manner.

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 the external reviewer can rely on the reports produced. Once the quality assurance program is further refined, issues discussed above are addressed, and planned corrective actions are implemented; DCAA should have reasonable assurance that its quality assurance program is operating effectively and that its internal quality control system is appropriately comprehensive and suitably designed to provide reasonable assurance that DCAA is complying with all of the applicable standards, policies, and procedures.

Recommendations, Management Comments, and Oversight Response

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

1. Institutionalize the followup process for all of the quality assurance reviews.

Management Comments. DCAA concurred in principle, stating that they would continue to brief the results of the internal quality assurance reviews to the ESC and to the IG DoD; the ESC would adopt appropriate corrective actions; and the DCAA Assistant Director for Policy and Plans, the regional directors, and the Field Detachment Director will implement and follow up on corrective actions. All of the requirements have been incorporated into the draft DCAA instruction on the policies and procedures for the DCAA quality assurance program. DCAA plans to issue the instruction by September 30, 2002.

In addition, DCAA will continue to use its strategic planning process to bring about desired changes and needed improvements in its audit performance. Desired changes and improvements include changes and improvements identified by the DCAA quality assurance program and internal quality assurance reviews.

Oversight Response. The DCAA comments meet the intent of the recommendation. We believe that the DCAA instruction, once issued, will resolve this recommendation.

2. Issue clarifying guidance for documenting reliance on data from computer-based systems and qualify the affected reports for audits at nonmajor contractors until the guidance is implemented.

Management Comments. DCAA concurred, stating that they issued MRD 02-PQA-050, "Audit Guidance for Nonmajor Contractor Audits with Maximum Control Risk Assessments and Audit Evidence Highly Dependent on Contractor Computerized Information Systems," on June 25, 2002.

B. Quality Assurance Review of Internal Control System Audits

The DCAA developed and implemented a reasonable methodology for selecting FAOs and audit assignments to be reviewed during the quality assurance review of internal control system audits, the second category of audits reviewed as part of the overall review of the DCAA quality assurance program. The DCAA quality assurance review of internal control system audits identified significant noncompliances for which DCAA had either implemented or initiated corrective action. Specifically, DCAA identified issues related to standard audit programs (SAP), internal control testing and risk assessment, supervision, and quality and accuracy of audit reports. The issues that DCAA identified are important to ensure that quality audits are performed in accordance with GAS and that quality audit reports are issued. However, additional issues relating to the accuracy of audit reports and the associated internal control risk assessments exist that need to be resolved through correction of inaccurate reports and the related risk assessments and modification of various checklist questions. Timely implementation of corrective actions will ensure that the DCAA quality assurance program is effective.

Review of Internal Control System Audits

DCAA initiated its second headquarters-led quality assurance review in November 1999. In FY 1999, DCAA completed 44,064 reviews, of which 2,473 (5.6 percent) were internal control system audits. DCAA auditors expended a total of 264,401 hours to complete the 2,473 internal control system audits. DCAA developed a two-tier selection methodology for selecting which FAOs and audits to review. First, DCAA selected FAOs to visit based on the number of hours incurred on internal control system audits at major and nonmajor contractors. Once FAOs were selected, DCAA selected the audits 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 reasonable methodology to be used to judgmentally select the 3 FAOs for review in each region, but excluded the 18 FAOs previously reviewed under the quality assurance review of forward pricing assignments. For each region and Field Detachment,⁹ DCAA selected one FAO resident office¹⁰ with the highest number of hours expended on internal control system audits, one FAO with the highest number of hours

⁹Field Detachment is responsible for the overall planning, management, and execution of worldwide DCAA contract audits of compartmented programs.

¹⁰An FAO resident office is established at a contractor location when the amount of audit work justifies assignment of a permanent staff of auditors and support staff.

expended on internal control system audits at major contractors (two FAOs if no resident office existed), and one FAO with the highest number of hours expended on internal control system audits at nonmajor contractors.

Selection of Internal Control System Audits. DCAA selected and reviewed a total of 84 internal control system audits, 14 from each region. The 84 audits represented approximately 3.4 percent of the universe of 2,473 internal control system audits that all of the FAOs completed in FY 1999. DCAA developed a reasonable methodology that they used to judgmentally select the audits for review at each of the 18 FAOs. Specifically, DCAA selected;

- four audit assignments from the FAO resident office with the highest number of hours expended on internal control system audits,
- four audit assignments from the FAO with the highest number of hours expended on internal control system audits at major contractors, and
- six audit assignments from the FAO with the highest number of hours expended on audits at nonmajor contractors.

For the FAOs where DCAA selected four audits for review, DCAA selected the most recently completed audits based on the date of the report. If more than one report had the same date, then DCAA selected the audit with the most hours expended. For the FAOs where DCAA selected six audits for review, DCAA selected the audits based on the type of system being reviewed and the highest number of expended hours. If the FAO did not have a sufficient number of audits with reports issued in FY 1999, then DCAA selected audits with reports issued in FY 1998 using the same criteria. Audits described as followups were not selected at any of the FAOs. In addition, DCAA developed a methodology for substituting audits at FAOs in case any of the originally selected audits proved to be inappropriate for review.

Results of DCAA Review

DCAA identified significant, systemic noncompliances throughout DCAA during the quality assurance review of internal control system audits. DCAA presented that information, along with proposed corrective actions, to the ESC in September 2000. DCAA identified systemic, significant noncompliances in the following four areas:

- adequacy and proper use of SAPs;
- internal controls testing and risk assessments;
- supervision; and
- quality and accuracy of audit reports.

DCAA has initiated corrective actions to resolve the significant noncompliances and has completed all but two dealing with adequacy of SAPs. The corrective actions included evaluating current SAPs and developing new ones if needed; revising the CAM; developing an optional working paper checklist; directing regional and Field Detachment management to continue placing management emphasis on the areas that resulted in the significant noncompliances; and requiring the regional and Field Detachment directors to develop corrective action plans for resolving the systemic and significant noncompliances within the respective regions.

Standard Audit Programs

Adequacy of SAPs. DCAA identified issues related to the adequacy of mandatory SAPs for internal control system audits of indirect and other direct cost (ODC) systems and accounting system surveys at nonmajor contractors. DCAA has initiated, but not completed, corrective action.

Indirect and ODC System. DCAA found that auditors using the SAP, “Indirect/ODC System and Related Internal Controls,” did not adequately audit the portion of the system related to ODC because of deficiencies in the SAP. As a result, auditors inappropriately provided overall opinions on the adequacy of the indirect/ODC system at various contractors.

Accounting System Survey. DCAA found that auditors used the limited audit steps in the “Preaward Surveys and Accounting System Surveys at Nonmajor Contractors (NMAPSYS)” SAP to support opinions on the entire system of internal controls for accounting systems or billing systems. However, the overall purpose of the accounting system survey SAP is to gather information for completing a preaward survey of a prospective contractor before contract award—not to conduct an internal control system audit of an accounting system or a billing system.

The ESC tasked the DCAA Policy and Plans Directorate to evaluate the two SAPs and revise, as appropriate, so that adequate coverage of the internal control systems is ensured. In addition, the DCAA Policy and Plans Directorate was to evaluate the need for new post-award SAPs and shell reports for billing and accounting system surveys at nonmajor contractors. DCAA planned to complete both corrective actions by February 16, 2001. However, at the December 2000 ESC meeting, DCAA revised the milestone date to March 16, 2001. At the March 2001 ESC meeting, DCAA revised the milestone date to June 2001. At the September 2001 ESC meeting, DCAA again revised the milestone date to December 2001. At the December 2001 ESC meeting, DCAA revised the milestone date to April 2002. At the March 2002 ESC meeting, DCAA further revised the milestone date to July 2002. Finally, by way of an e-mail of July 25, 2002, DCAA revised the milestone to October 2002.

Timely implementation is needed to ensure that the auditors performing internal control system audits correct identified noncompliances before the next quality assurance review. The need for timely implementation is especially true for

corrective actions that affect SAPs because DCAA auditors rely heavily on SAPs as a quality control to ensure proper audit coverage and compliance with GAS.

Use of Up-To-Date SAPs. DCAA identified significant noncompliances related to auditors not using the most up-to-date SAPs and took corrective action. DCAA found that auditors did not use the most up-to-date SAPs, eliminated key steps required for a full-scope internal control system audit, or did not update audit programs for changes in audit policy that occurred during the audit. DCAA headquarters revised the CAM to include the following statement.

Auditors should ensure they begin the audit with the most current version of the APPS [Automated Planning and Performance System] . . . A summary of changes made to the standard audit programs is issued with the quarterly APPS update. When changes to the approved audit program are necessary, the auditor should discuss the need to modify the audit program with the supervisor, document the results of the discussion in the interim supervisory guidance section of the working papers or on the audit program itself, as appropriate, and modify the audit program based on the interim discussions.

The ESC required regional and Field Detachment management to analyze their respective regional results and develop corrective action plans to improve processes related to using the most recent SAP. As part of the corrective actions, the regions and Field Detachment distributed a listing of guidance reminders to each FAO. In addition, the Regional Quality Assurance Divisions (RQA) and the Field Detachment Quality Assurance Division either provided training packages or presented training to each FAO.

Completion of SAP Steps. DCAA identified significant noncompliances related to adequately completing steps in the SAPs. Specifically, DCAA found that auditors were not:

- performing sufficient tests of controls;
- determining the sufficiency and reliability of contractor internal auditors before placing reliance on their work;¹¹
- performing necessary audit work to support report conclusions; and
- documenting completion of audit steps on assessing the risk of fraud and illegal acts.

DCAA determined that continued regional and Field Detachment management emphasis to ensure that auditors perform necessary audit work and that reports accurately reflect the work performed would correct the identified noncompliances. The regions and Field Detachment, as part of their corrective actions, distributed guidance reminders to each FAO and either provided

¹¹Placing reliance on the work of internal auditors was previously addressed in IG DoD Report No. APO 94-018, "Report on the Oversight Review of the Defense Contract Audit Agency Reliance on the Work of Others," September 22, 1994.

training packages or presented training that included coverage of the significant noncompliances relating to adequately completing of SAP steps to each FAO. In addition, the guidance reminders that the Central and Western Regions distributed to the FAOs included a reference to IG DoD Handbook 7600.3, "Handbook on Fraud Indicators for Contract Auditors," March 31, 1993. The guidance reminders that the other four regions distributed to the FAOs did not include any reference to the handbook.

In addition to the guidance reminders and training packages, some regions provided information on how to properly document the risk assessment for fraud and illegal acts. Specifically, the Eastern Region issued RQA-1 Quality Alert No. 2001-01, "Working Paper Documentation of the Auditor's Assessment of Fraud Risk Indicators," March 30, 2001, which provides guidance on when to consider fraud risk indicators and where to document that consideration in the working papers. The quality alert included a listing of fraud risk indicators for incurred cost audits obtained from IG DoD Handbook 7600.3. The Central and Western Regions also distributed the fraud indicators. The Mid-Atlantic and Northeastern Regions and Field Detachment did not distribute any guidance. Although each region took action, inconsistent approaches of implementing corrective action for significant, systemic noncompliances can be inefficient and may not ensure that identified deficiencies are uniformly corrected throughout DCAA.

Internal Control Testing and Risk Assessment

DCAA identified and took corrective action on significant, systemic noncompliances related to testing internal controls and assessing control risk. Specifically, DCAA identified issues related to testing internal controls, cycling internal control system audits, implementing the Internal Control Reporting System, assessing control risk at nonmajor contractors, and documenting assessment of control risk. DCAA headquarters revised the CAM and identified opportunities for improvement. In addition, DCAA directed the regions and Field Detachment to continue to place management emphasis on the areas. The regions and Field Detachment prepared corrective action plans and conducted training.

Testing Internal Controls. DCAA found that auditors were not performing sufficient tests of controls at major contractors as the SAPs require. The issue was previously addressed in IG DoD Report No. PO-98-6-016, "Defense Contract Audit Agency Audits of Indirect Costs at Major Contractors," August 6, 1998. Specifically, DCAA auditors did not always perform sufficient transaction testing during internal control system audits, thus increasing the possibility that weak internal controls could allow improper amounts charged on Government contracts. To resolve the issues addressed in IG DoD Report No. PO 98-6-016, DCAA revised CAM 5-108 in January 2000 to provide more specific guidance on testing internal controls. To resolve issues found during the internal quality assurance review of internal control system audits, DCAA revised CAM 5-105(b) in July 2001 to require that the auditor test a contractor's key internal controls over selected transactions every 2 to 4 years regardless of

whether the internal controls were tested in the prior comprehensive audit of a contractor's accounting or management system. CAM revisions need to be accompanied by appropriate changes in the applicable SAPs and training to properly emphasize the issues and avoid the possibility of a repeat finding during the next 3-year cycle of quality assurance reviews.

Cycling Internal Control System Audits. DCAA found that FAOs had not performed all of the 10 major internal control system audits within the last 4 years. In MRD 94-PFD-088, "Audit Guidance on Preparation of Initial Internal Control Audit Planning Summary (ICAPS)," May 24, 1994, DCAA established a new process for conducting internal control system reviews at major contractors that required an initial full scope audit of the 10 internal control systems at major contractors to be completed by the end of FY 1998. DCAA incorporated the process into CAM 5-103 and included the requirement that, "Each relevant accounting or management system that has a significant impact on government contract costs be reviewed on a cyclical basis, (e.g., every 2 to 4 years) based on a documented risk assessment." The process is commonly known as cycling of internal control system audits.

During the quality assurance review of internal control system audits, DCAA found that FAOs were not fully complying with the requirement to cycle audits of internal control systems every 2 to 4 years. Specifically, DCAA found that 6 (50 percent) of the 12 FAOs having audit cognizance over major contractors had not properly cycled their internal control system audits. The ESC directed the regions and Field Detachment to develop corrective action plans that would improve the process. FAO noncompliance with DCAA guidance on performing initial full scope reviews of internal control systems was previously reported in IG DoD Report No. PO-98-6-016. DCAA agreed with the report recommendations and took corrective action by issuing MRD 98-PIC-048, "Status of Initial Internal Control Audit Planning Summary (ICAPS) Review," March 31, 1998, which required FAOs to complete all initial full scope audits by the end of FY 1998. Because reemphasizing the requirement to perform the initial full scope review did not completely resolve the issue, the process improvements that the regions and Field Detachment implement should include active oversight to ensure proper cycling of internal control system audits by, for example, requiring the use of the "Three Year Cycle" report generated by the Internal Control Reporting System to plan the cyclical reviews of contractor internal control systems.

Implementing the Internal Control Reporting System. The DCAA headquarters Quality Assurance Division determined that the Internal Control Reporting System¹² could be improved by modifying the system to enable it to retain ICAPS data from previous years, to subdivide the 10 major systems into subsystems for audit purposes, to record approval by the supervisor and FAO manager, and to prevent changing the assessment of control risk based on a

¹²The Internal Control Reporting System is database software that summarizes, by contractor, the adequacy of each of the 10 internal control systems and the control risk. In addition, the Internal Control Reporting System contains automated ICAPS for each internal control system.

flash review.¹³ The DCAA headquarters Quality Assurance Division coordinated the proposed improvements with the DCAA headquarters Operations Directorate by way of an interoffice memorandum on April 2, 2001, as required by ESC Action Item E00-9-13. DCAA headquarters tasked the Eastern Region to modify the Internal Control Reporting System to incorporate the proposed improvements. The Eastern Region anticipates releasing the revised software for use throughout DCAA by October 2002.

Assessing Control Risk at Nonmajor Contractors. DCAA found that auditors were performing full internal control system audits at nonmajor contractors but were not preparing an ICAPS to document the assessment of control risk and the potential impact on the scope of related audit effort. At that time, auditors were only required to complete the “Survey of Contractor’s Organization, Accounting System, and System of Internal Controls” for nonmajor contractors even if the auditor performed a full scope internal control system audit. As a result, DCAA revised the July 2001 version of the CAM to require that the auditor complete an ICAPS when a full internal control system audit is performed at a nonmajor contractor.

Documenting Assessment of Control Risk. DCAA identified a significant, systemic noncompliance related to assessing control risk. Specifically, DCAA found that auditors were assessing as low the control risk for system control objectives not covered by the audit. CAM 3-305.2 requires auditors to assess control risk (low, moderate, or high) for each relevant control objective when preparing or updating an ICAPS. In addition, when the auditor updates the risk assessment for any control objective, the auditor is required to include the applicable report number and date. To resolve the noncompliance, DCAA headquarters Quality Assurance Division only recommended continued regional and Field Detachment management emphasis.

Regional and Field Detachment Corrective Action for Internal Control Testing and Risk Assessment. To resolve the significant noncompliances related to assessing control risk and documenting the assessment, each RQA and Field Detachment developed training packages to resolve the systemic noncompliances and provided training to the auditors. However, the content of the training packages varied among regions.

- The Eastern Region training package contained a discussion of the significant, systemic noncompliances; the steps each auditor could take to prevent the noncompliances during future audits; CAM citations; examples of well-documented working papers; and practical exercises for documenting the assessment of control risk.
- The Central, Northeastern, and Western Regions training packages contained a discussion of the significant, systemic noncompliances and the steps each auditor could take to prevent the noncompliances during future audits and CAM citations.

¹³An auditor issues a flash report when an internal control deficiency is observed during other financial related audits.

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- The Mid-Atlantic Region training package included a discussion of the significant, systemic noncompliances as part of training on evidence and working papers and included CAM citations.
 - The Field Detachment training package consisted of an overall general discussion of the significant, systemic noncompliances.

DCAA needs to ensure that corrective actions the regions and Field Detachment implement consistently address the significant, systemic noncompliances and the steps each auditor should take to prevent the noncompliances during future audits.

Supervision

DCAA identified significant, systemic noncompliances related to supervision of audits and determined that continued regional and Field Detachment management emphasis would correct the noncompliances. DCAA found that audit working paper packages were missing required documentation, audit working paper packages contained either no or little evidence of supervisory involvement during the audit, and the audit encountered problems that the quality control system or supervisor should have prevented. The ESC tasked the regions and Field Detachment to develop and implement corrective actions for the FAOs in their respective regions. The comprehensiveness of the corrective actions varied. Three RQAs provided training packages to all FAOs in their regions to be presented during either participative work team (PWT) meetings or at FAO staff conferences. The training packages outlined supervisory review requirements and included some applicable CAM citations.

The other two RQAs and Field Detachment took somewhat similar but less comprehensive approaches. One RQA issued a memorandum providing specific guidance on supervision of audits and working paper documentation, including CAM citations, and also provided a training package to all FAOs. Field Detachment provided a presentation to all FAOs detailing the systemic noncompliances; however, the presentation provided minimal guidance on steps that supervisors should take to improve documentation of supervisory involvement. The second RQA was developing discussion material and planned to provide the materials to all FAOs during the first quarter of FY 2002; however, the discussion materials were not completed until March 2002, as a result of RQA staffing issues. If the RQAs had coordinated on corrective actions by, for example, jointly developing training packages or designating a lead RQA for developing discussion materials, the information would be consistent and available throughout the agency within the same time period. A coordinated approach may have helped the RQA with staffing issues to distribute the discussion materials to the FAOs in the region by the original milestone date. Actions to correct significant, systemic noncompliances related to auditing standards, such as supervision, should be implemented as quickly as possible. Otherwise, the same noncompliance could continue to surface during future internal quality assurance reviews.

Reporting Requirements

DCAA established an audit report quality review program in 1995 that included the use of the DCAA “Audit Report Quality Review Sheet for Audit Reports of All Types” (Audit Report Checklist). The regions and Field Detachment are required to review a sample of reports and submit the results to DCAA headquarters semiannually. DCAA summarizes the results in an MRD that is provided to the regional and Field Detachment directors. DCAA used the DCAA Checklist and the Audit Report Checklist to evaluate the quality of the 84 reports reviewed during the quality assurance review of internal control system audits. DCAA found that auditors were:

- issuing adequate overall opinions on internal control systems when audit fieldwork disclosed significant deficiencies;
- rendering a full scope opinion when performing a limited scope audit; and,
- not reporting on the impact of control risk and status of system.

In addition, we identified an issue related to reporting fieldwork dates in audit reports that could be addressed by adding a question to the Audit Report Checklist.

Issuing Adequate Overall Opinions When Fieldwork Disclosed Significant Deficiencies. DCAA determined that auditors rated internal control systems as adequate even though the audit fieldwork disclosed significant deficiencies. The auditors believed that existing DCAA guidance allowed issuing an adequate opinion in cases where the contractor agreed to correct the system deficiencies. DCAA headquarters took corrective action by issuing MRD 01-PQA-009, “Audit Guidance on Revisions at CAM 10-408.2a, *Internal Control Audits*, Addressing Audit Opinions When Significant System Deficiencies are Found,” January 31, 2001. The revised guidance, incorporated into the January 2001 version of the CAM, requires that:

The audit opinion rendered on a contractor's system of internal control must now be either *inadequate* or *inadequate in part*, whenever both conditions below exist:

- The auditor finds one or more significant deficiencies in a contractor's system of internal control, *and*
- At least one of the deficiencies has *not* been corrected as of the date of report issuance.

When significant deficiencies are found and the contractor has proposed or is in the process of taking appropriate corrective actions, the actions should be described in the *Results of Audit* report section. The existence, however, of a corrective action plan will not make an inadequate system reliable. Therefore, the auditor should not report a contractor's system as “adequate” based on the contractor's corrective action plan. Before opining that the system is adequate, the auditor must first verify the contractor's implementation of the action plan

correcting the deficiencies. A follow-up review should be performed as soon as possible to ensure the contractor's plan has been implemented.

The CAM revision adequately addressed the identified issue for audit reports issued after January 2001. However, DCAA did not require the auditors to verify that contractors corrected deficiencies for internal control systems that DCAA previously reported as adequate nor did DCAA require auditors to correct any outstanding reports that inaccurately stated that an internal control system was adequate. Therefore, contracting officials and DCAA auditors at other FAOs may mistakenly rely on inaccurate audit reports. Inaccurate reports need to be corrected and reissued. In addition, DCAA did not require the auditors to revise risk assessments on the ICAPS or in the Internal Control Reporting System or even to simply identify the contractor years¹⁴ that could have been potentially affected by the system deficiencies. Corrections to the ICAPS and the Internal Control Reporting System are necessary to ensure that auditors who plan future related audits have accurate information on the adequacy of contractor internal control systems.

Rendering a Full Scope Opinion When Performing a Limited Scope Audit.

DCAA found that auditors issued full scope opinions on entire internal control systems without auditing the entire system. For example, at one FAO that we retested, we identified three assignments where this condition existed.

Two Billing System Reports. DCAA identified two assignments where the FAO issued audit reports that rendered full scope opinions on two contractors' billing systems when the auditors performed only limited scope reviews. The DCAA reviewers determined that the two reports did not accurately describe the limited scope of the work performed and concluded that one of the reports should not have been issued at all.

One Accounting System Report. The FAO issued a report on an accounting system that rendered a full scope opinion when, again, the auditors performed only a limited scope review. However, the DCAA reviewers did not conclude that the report was inaccurate even though the circumstances were similar to the billing system reports.

The DCAA reviewers determined that no adverse effects had occurred by issuing the three reports because DCAA auditors did not rely on the results when planning or performing related DCAA audits. In addition, the recipients of the reports had not requested that the audits be performed, and DCAA believed that the recipients did not rely on the inaccurate information. However, DCAA has no control over how individuals outside the agency use audit reports once they are issued. The DCAA proposed corrective action of renewed regional and Field Detachment management emphasis on the CAM reporting requirements. Although the DCAA corrective action of evaluating the need for new post-award SAPs and shell reports for billing and accounting

¹⁴A contractor year is a contractor fiscal year. The ICAPS should identify each contractor fiscal year that is affected by a deficiency in an internal control system, which may have a significant impact on the pricing, administration, or settlement of Government contracts.

system surveys at nonmajor contractors discussed above should also resolve the problems encountered by this FAO, the DCAA evaluation will not correct an inaccurate report.

An audit report is the sole representation to auditee management and other interested parties of an audit organization's work. Therefore, at the very least, an audit report should be factually accurate, otherwise report recipients will come to discount information in the audit reports and question the reliability of work performed by the audit organization. Without the reader's trust, the usefulness of audit reports and the effectiveness of an audit organization could be negatively impacted. DCAA audit reports must comply with the GAS 7.5 requirement to be complete and accurate. Specifically, GAS 7.56 requires that:

Reported evidence should demonstrate the correctness and reasonableness of the matters reported. Correct portrayal means describing accurately the audit scope and methodology, and presenting findings and conclusions in a manner consistent with the scope of audit work.

Therefore, regardless of why the audit reports were issued or how they were used, DCAA should ensure that the reports accurately represent the scope of the audit and all other pertinent factual information. Once DCAA determines that an audit report was issued with an inaccurate overall opinion on an internal control system, DCAA should issue a corrected report. A corrected report is also important to DCAA because DCAA uses internal control system audit reports as a basis for completing risk assessments for individual audits and for planning future related audits. An incorrect audit report with a less than accurate system opinion could compromise the DCAA planning process.

Reporting on Impact of Control Risk and Status of System. DCAA found that auditors did not report the impact that control risk will have on the extent of audit effort on related audits and did not provide background and status of the internal control system being reviewed. The DCAA proposed corrective action of renewed regional and Field Detachment management emphasis on the CAM reporting requirements.

Reporting Fieldwork Dates in Audit Reports. During our oversight review, we found that DCAA does not always include the dates of fieldwork in its audit reports. CAM 10-407 requires that the scope section of DCAA audit reports include the period of performance of the audit fieldwork. In addition, the standard report shells that DCAA distributed by way of the Automated Planning and Performance System included a standard sentence that prompts auditors to insert the dates of fieldwork. Our review of the 20 internal control system audit reports revealed that only 5 (25 percent) reports included the dates for fieldwork. In one instance, a report issued in September 1999 did not indicate when fieldwork was performed. Our oversight review and the DCAA quality assurance review of the working papers disclosed that the auditors performed fieldwork in 1997 but did not update the fieldwork before issuing the report. Issuing the report without updating the fieldwork and without disclosing the dates of fieldwork did not meet the GAS requirement for accuracy. The accuracy and usefulness of DCAA reports would be improved by including a question on the Audit Report Checklist to verify whether the dates of fieldwork were included in the scope section of a report as required by CAM.

Relying on Meeting Strategic Plan Objective as Viable Corrective Action. DCAA determined that, other than the modification to CAM 10-408.2a and renewed regional and Field Detachment management emphasis, they did not need to propose other corrective action to reduce future occurrences of reporting noncompliances because the DCAA Strategic Plan, April 2001, requires the regions and the FAOs to meet the strategic 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 agency-wide “zero error” rate was 73.4 percent and for calendar year 2000 it was 80.6 percent. However, for the 84 internal control system audit reports reviewed, DCAA found that only 25 (29.7 percent) reports had zero errors. In addition, DCAA concluded that 6 (7.1 percent) of the 84 reports should not have been issued. For example, at one FAO the branch manager conducted a post-issuance review of an audit report using the Audit Report Checklist and found no deficiencies. However, the DCAA quality assurance reviewer evaluated the same report using the Audit Report Checklist, found five deficiencies, and determined that the report should not have been issued. We do not believe that establishment of a strategic plan objective and the current audit report quality review program, as implemented, will correct the noncompliances related to the factual accuracy or completeness of audit reports. In addition, the significant differences in the results reported by the FAOs and the results reported by the DCAA quality assurance reviewer raise questions about the appropriateness of the strategic plan goal as an effective corrective action. DCAA is inappropriately relying on the audit report quality review program and the requirement to meet a strategic plan objective as viable corrective actions to resolve significant, systemic deficiencies in audit reports.

Working Paper Documentation

Working papers are the principle support for the audit report, aid auditors in conducting and supervising audits, and allow others to review the quality of audits. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain what evidence supports the auditor’s significant conclusions and judgments and whether the evidence is sufficient, competent, and relevant. In addition, working papers allow for the review of audit quality by providing the reviewer with written documentation of the evidence supporting significant conclusions and judgments. DCAA identified issues related to working paper documentation during the DCAA quality assurance review of forward pricing assignments that we addressed in IG DoD Report No. D-2002-6-001. DCAA developed a working paper checklist as part of the corrective actions resulting from the quality assurance review.

Implementation of Working Paper Checklist. DCAA developed a checklist for the review of working papers but made its use optional. Representatives from the DCAA headquarters Quality Assurance Division, the RQAs, and the Field Detachment Quality Assurance Division jointly developed the checklist to help achieve the DCAA Strategic Plan objective, “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 working paper checklist, developed and tested over a 4-month period, was issued with the following guidance:

The checklist can be used for the purposes of auditor self-assessment, a peer review, or a supervisory review of the audit working papers. The checklist questions have been assigned priorities to assist a region that may wish to further reduce the number of checklist questions. A “Priority 1” question relates to a significant GAGAS compliance issue, or to a past significant noncompliant practice cited in the FY 1999 or FY 2000 PCIE-based QA reviews. “Priority 2” questions also relate to GAGAS compliance and are covered by DCAA’s adapted PCIE-based checklist, but the PCIE-based reviews to date have not disclosed significant noncompliances related to the questions. “Priority 3” questions are not directly associated with either the adapted PCIE-based checklist questions or the GAGAS.

The DCAA headquarters Quality Assurance Division will maintain the checklist and issue periodic updates through the DCAA headquarters Policy and Plans Directorate. DCAA permitted the regional and Field Detachment directors to determine whether and how the working paper checklist should be used. Each director implemented use of the checklist somewhat differently.

Central Region Implementation. The director recommended that the checklist be used to document regional audit manager and FAO manager post-issuance reviews of audit working papers required by regional audit manager and FAO quality control programs. In addition, the checklist should be distributed to all of the auditors for use as a guide in preparing individual audit working papers and compiling final audit working paper packages. However, managers cannot require the completion of the checklist by auditors or peer reviewers.¹⁵

Eastern Region Implementation. The director recommended that the checklist be adopted by all FAOs in place of checklists being used. Specifically, FAOs will be required to use the checklist for all peer and post reviews for all mandatory assignments¹⁶ completed after October 1, 2001, that are identified in Eastern Regional Instruction 7640.2, “Eastern Region Management Accountability and Control Program,” October 1, 2001. Using the working paper checklist does not preclude the FAOs or PWTs from incorporating additional questions that they believe are necessary to check for prior systemic issues. In addition, auditors are encouraged to use the checklist as a self-assessment tool on their own individual audits. Also, the director provided optional supplemental checklists for defective pricing, nonmajor contractor incurred cost, internal controls, and data accuracy. The supplemental checklists contain specific questions not covered by the general checklist and could be used in their current format or modified by the FAOs as necessary. However, FAOs are not required to report checklist results to DCAA headquarters or the Eastern Region.

¹⁵Auditors in the Central Region are unionized.

¹⁶Mandatory assignments include but are not limited to forward pricing rate agreements, incurred cost audits, internal control system audits, and terminations.

Field Detachment Implementation. The director is implementing the checklist on a test basis for post-issuance review of audit reports. Specifically, the FAO manager will apply the checklist to the working papers for the same five reports selected for review under the audit report quality review program and forward the results to the respective audit manager and the Field Detachment Quality Assurance Division. The Field Detachment Quality Assurance Division will assess the results and establish a permanent implementation policy. In addition, the checklist may be distributed to the audit staff for auditors to use as a self-assessment tool, for PWTs to assess progress, for supervisors to provide feedback to auditors, and for the FAO to train new auditors.

Mid-Atlantic Region Implementation. The director recommended that the checklist be used for an auditor self-assessment, a peer review, or a supervisory (post) review of the audit working papers. In addition, FAOs should discontinue use of the Mid-Atlantic Region-specific checklists. Implementation of the new checklist should be consistent with the PWTs, as defined, and each PWT should define how and under what circumstances completion of the checklist for auditor self-assessment is required. However, all of the questions on the checklist are to be completed. The RQA will accumulate supervisory post review data for the next two semi-annual reporting periods to determine whether any questions can be eliminated.

Northeastern Region Implementation. The director is requiring that managers and supervisors who perform working paper reviews use the checklist as a tool to ensure compliance with GAS and DCAA policy. FAOs are required to develop control procedures for checklist use and to complete the checklist for the same completed assignments tested in the audit report quality review program. In addition, the FAO is required to maintain the checklist results and forward the results to the RQA. Also, the FAO is required to perform an analysis of the identified noncompliances, develop appropriate corrective actions, and discuss identified noncompliances at PWT meetings. The director recommended that working paper noncompliances be documented, corrected, and discussed with the assigned auditor as well as at PWT meetings. In FY 2002, the RQA plans to conduct field visits to assess the implementation and effectiveness of the checklist. In addition to mandatory use for review of working papers after a report is issued, auditors can use the checklist voluntarily as a self-assessment tool and FAO managers, at their discretion, may require supervisors to complete the checklist as part of the normal GAS documentation of supervisory review prior to report issuance. However, the director did not approve the checklist for use as part of the peer review process until the impact of its implementation can be coordinated with the bargaining unit.¹⁷

Western Region Implementation. The director recommended that the checklist be used to document regional audit manager and FAO manager post audit report issuance reviews of working papers that regional audit managers and FAO quality control programs require. In addition, the checklist should be distributed to each auditor as a guide for preparing working papers and compiling final audit working paper packages. However, the director stated that

¹⁷Auditors in the Northeastern Region are unionized.

those managers should not require auditors, supervisors, or peer reviewers to complete checklists on every audit. Further, the director specifically stated that regional management did not intend to accumulate or track any statistics from the use of the checklist.

Survey on Use of Working Paper Checklist. On November 1, 2001, DCAA issued MRD 01-PQA-082, "Working Paper Quality Processes Survey," requesting that each FAO complete a survey designed to identify and assess the working paper quality processes in place at the FAO and to identify best practices. DCAA summarized the results and presented them at the December 2001 ESC meeting. For peer reviews of reports, DCAA found that each regional audit manager, FAO manager, or supervisor could determine whether and how to use the working paper checklist or alternative checklist. Of the 78 FAOs existing in November 2001, 27 (34.6 percent) FAOs did not have written FAO-wide policies requiring peer reviews and 16 (20.5 percent) other FAOs were not performing peer reviews. For post-issuance reviews of reports, DCAA found that each region developed different guidance for using either the working paper checklist or an alternative checklist. Of the 78 FAOs, 6 (7.7 percent) FAOs did not require the post-issuance review of reports and 6 (7.7 percent) other FAOs required use of a checklist. However, those requirements were not in writing.

Effectiveness of the Working Paper Checklist as a Corrective Action. The working paper checklist should be a useful tool for the FAO manager, regional or Field Detachment audit manager, or RQA to identify noncompliances in the working papers after a report has been issued. However, the working paper checklist would be more beneficial if the FAO staff used the working paper checklist before a report is issued to ensure that any noncompliances are resolved and potential impacts on reports are minimized. In addition, obtaining checklist results from the FAOs in a region could provide regional and Field Detachment management with substantial information on systemic issues that need to be addressed consistently throughout the region or Field Detachment rather than solely on an individual FAO basis. However, expending resources to develop a working paper checklist but making its use optional, permitting the deletion of questions, and not requiring its use as part of the supervisory and peer review processes, is not an efficient use of DCAA resources. In addition, relying on use of the working paper checklist as corrective action in future DCAA quality assurance reviews, such as the review of incurred cost audits, will not resolve the noncompliances related to working paper documentation and help achieve the strategic plan objective because it is optional, can be modified at the FAO level, and is not part of the quality control system.

Summary

DCAA did a credible job identifying several significant, systemic noncompliances that required timely corrective action. Timely implementation of corrective actions should ensure that the DCAA quality assurance program is effective. However, timely implementation of corrective action may not have the desired effect if the corrective action does not fully address the root cause of

the identified noncompliance. In the briefing charts DCAA presented to the ESC, DCAA recommended renewed regional and Field Detachment management emphasis and attention as “proposed fixes” for many of the significant, systemic noncompliances. Specifically, each region and Field Detachment was independently responsible for analyzing the results applicable to their respective region and developing corrective action plans. Essentially, DCAA relied on the regions and Field Detachment to propose and implement region-specific corrective actions that address DCAA-wide significant, systemic noncompliances. Such a decentralized approach to implementing corrective action may not resolve significant, systemic noncompliances because of the inconsistencies among the regions and Field Detachment in interpreting the nature and extent of the noncompliances and in determining what the best approach is for resolving the noncompliances.

In addition, the synergies that could result in consistent implementation of corrective action throughout DCAA will not happen if the regions and Field Detachment do not collaborate on developing and implementing corrective action. Continued decentralization of development and implementation of corrective actions may result in best practices that one region developed not being disclosed to the rest of DCAA. Proper implementation of corrective actions is needed to reduce the possibility that repeat findings or issues will occur during future internal quality assurance reviews or oversight reviews. Continued attempts to correct repeat findings because of ineffective corrective actions are inefficient use of agency resources. In addition, repeat findings and issues can signal significant weaknesses in an agency’s internal quality control system.

Management Comments on the Finding and Oversight Response

Management Comments. DCAA stated that the IG DoD had somewhat overstated the findings of the FY 2000 quality assurance review by including the statement, “DCAA found that 6 (50 percent) of the 12 FAOs having audit cognizance over major contractors had not properly cycled their internal control system audits,” in the draft report. Specifically, the DCAA reviewers found that only 19 of the 220 required internal control system audits for which the 12 FAOs were responsible for performing every 2 to 4 years were not current. Also, DCAA determined that some of the 19 audits were not clear noncompliances with existing policy on cycling internal control system audits because they raised new policy issues.

Oversight Response. Regarding DCAA concerns that the IG DoD draft report overstated the findings of the FY 2000 quality assurance review on this issue, the draft report merely reiterated information included in briefing charts presented to the ESC. Because DCAA considers the briefing charts to be the final report on the quality assurance review of internal control system audits, we considered the findings as expressed in the briefing charts to be the best representation of the DCAA review results. The briefing charts state, “At the time of our field visit, had the FAO performed all 10 major internal control

system audits within the past four years? Of the 12 *major contractor* FAOs visited, 6 were out of cycle.” DCAA did not include any other information in the briefing charts on the finding. Therefore, we were only able to restate the DCAA finding that was presented to the ESC.

Recommendations, Management Comments, and Oversight Response

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

1. Require the regions and Field Detachment to actively oversee the scheduling and completion of internal control system audits to ensure that field audit offices have properly implemented the Defense Contract Audit Agency Manual 7640.1, “DCAA Contract Audit Manual,” requirement to complete such audits every 2 to 4 years.

Management Comments. DCAA concurred in principle, stating that over the past 5 years, DCAA has stressed the need for timely completion of internal control system audits at major contractors. In March 1998, DCAA re-emphasized the requirement to complete the internal control systems audits at major contractors every 2 to 4 years. In addition, as part of the quality assurance review of internal control system audits, DCAA completed a comprehensive review that followed up on the March 1998 guidance at 12 FAOs. As a result of the review, the ESC systematically tasked the regional directors to perform additional followup work at the FAOs with cited noncompliances. In addition, DCAA plans to conduct more followup work during the second 3-year cycle of quality assurance reviews. DCAA stated that the record outlined above demonstrates that DCAA is already actively overseeing the scheduling and completion of internal control system audits. However, DCAA is agreeable to including a clear reminder of the need to cycle internal control system audits in the MRD that will be issued to address Recommendations B.2. and B.3. The MRD will be issued by September 30, 2002.

Oversight Response. We accept the proposed corrective action as meeting the intent of the recommendation. However, the MRD must remind regional management of the need to actively oversee completion of internal control system audits. DCAA has identified the headquarters-led quality assurance reviews and regional followup reviews as part of the oversight process for properly cycling internal control system audits, the reviews are after-the-fact monitoring. DCAA management needs to be actively involved in the cycling process to ensure that it is properly implemented. Therefore, DCAA management should verify that internal control system audits are being included in the FAO operating plans (current fiscal year), future plans (next fiscal year), and out-year projections (next 3 fiscal years). The FAOs develop the plans and submit them to the regions for approval. The regional audit managers should ensure that the plans include the required internal control system audits and that the FAOs complete the audits within the 2 to 4 year time frame. DCAA

management could use the “Three Year Cycle” report generated by the Internal Control Reporting System to properly plan the cyclical reviews of contractor internal control systems.

2. Correct any outstanding report that inaccurately states that an internal control system was adequate.

Management Comments. DCAA concurred, stating that the recommendation refers to those situations where an auditor may have found one or more system deficiencies, but, rated an internal control system as adequate based on the reported explanation that the contractor was pursuing an adequate plan to correct the reported deficiencies. DCAA issued revised audit guidance in January 2001 covering such situations that require the auditor to rate a system as inadequate until a followup audit shows that contractor corrective action was completed and effective. DCAA maintains that the probability is low that contractors have not yet satisfactorily corrected system deficiencies auditors identified that rated a system as adequate pending correction of a deficiency. Nevertheless, any occurrence of such a situation is unacceptable to DCAA. DCAA plans to issue an MRD by September 30, 2002, directing its FAOs to review their internal control system audits and audit reports covering open contractor fiscal years to ensure that system deficiencies are appropriately reported in accordance with current DCAA policy.

Oversight Response. The DCAA comments meet the intent of the recommendation related to issuing adequate overall opinions on internal control systems when audit fieldwork disclosed significant deficiencies that the contractor provided a corrective action plan. However, the DCAA comments do not address the situations where the auditor issued full scope opinions on entire internal control systems without auditing the entire system. We request that DCAA address this issue in comments to the final report.

3. Direct the field audit offices to revise the Internal Control Audit Planning Summaries prepared based on inaccurate reports to accurately reflect audit risk for each affected year.

Management Comments. DCAA concurred, stating that the probability is low that contractors have not yet satisfactorily corrected the system deficiencies identified during audits that rated a system as adequate pending correction. Consequently, because auditors prepare ICAPS based on the results of internal control system audits, DCAA believed that the probability is low that outstanding ICAPS exist that do not accurately reflect the overall audit assessment of the system or the control risk assessments for the control objectives. In addition, the quality assurance review results showed that in most cases, the ICAPS adequately summarized the audit results, even when the audits rated a system as adequate based on the contractor's pursuit of corrective actions. However, the existence of any ICAP summary that is in effect with inaccurate assessments is unacceptable to DCAA. To resolve this, DCAA plans to issue an MRD by September 30, 2002, instructing the FAOs to review all ICAPS for years still subject to audit to ensure the accuracy of the ICAPS assessments for the overall system and the control objectives.

4. Determine which types of audit reports need to include fieldwork dates to provide a time frame for when the report findings are applicable and modify the standard report formats and the Defense Contract Audit Agency Manual 7640.1, "DCAA Contract Audit Manual," to reflect the revised requirement.

Management Comments. DCAA concurred, stating that they will identify which DCAA audit report types should include fieldwork dates and modify the standard audit report formats by December 2002 to prompt the auditor to include the fieldwork dates.

5. Include a question on the checklist "Audit Report Quality Review Sheet for Audit Reports of All Types" to verify whether the dates of fieldwork are included in the scope section of audit reports, when applicable.

Management Comments. DCAA nonconcurrent, stating that, although DCAA agreed that the usefulness and value of the impacted audit reports would be improved by including the fieldwork date, the fieldwork date represented only one of literally hundreds of specific reporting requirements potentially impacting the 46 standard audit report formats that DCAA maintains. In addition, the costs associated with implementing the Audit Report Checklist as a peer and post-audit quality review tool prohibit having the checklist cover all but the most important reporting requirements. Forty-seven requirements are currently covered by the Audit Report Checklist. DCAA determined that fieldwork dates on selected report types do not rise to the level of significance that warrants adding an additional requirement to the Audit Report Checklist, especially because DCAA is looking at opportunities to further streamline the Audit Report Checklist and related processes. However, DCAA will communicate fieldwork dating changes to selected report formats to all of the FAOs in an MRD that will be issued in December 2002 with the quarterly update to the Audit Planning and Performance System. In addition, during the second 3-year cycle of quality assurance reviews, DCAA will follow up on FAO compliance with the fieldwork dating requirement. Under current plans, the next quality assurance review of internal control system audits will be completed by FY 2004.

Oversight Response. We disagree with the DCAA position as it relates to internal control system audit reports. As stated in the draft report, CAM 10-407 already requires that the scope section of DCAA internal control system audit reports include the period of performance of the audit fieldwork and has included that requirement since 1996. In addition, the standard report formats for internal control system audits have a prompt for the auditors to include the fieldwork date. Therefore, issuing additional guidance when the auditors are not adhering to long-standing policy may not be effective. Because the requirement to include fieldwork dates in audit reports has existed for 6 years, DCAA should develop some method that requires compliance with the requirement before an audit report is issued. Including a question in the Audit Report Checklist to verify whether the dates of fieldwork are included in the scope section of audit reports would be one method. Although we recognize that the method is not the only possible method, FAOs using the checklist as part of the peer review process can ensure greater compliance with two of the

five GAS reporting standards—timeliness and report presentation, specifically accuracy. We request that DCAA reconsider its position and provide comments to the final report.

6. Standardize use of the working paper checklist throughout the agency and integrate the working paper checklist into the peer review quality control procedures.

Management Comments. DCAA concurred in principle, stating that they developed the Working Paper Checklist, believed in the value of the checklist, and wanted the checklist to be effectively implemented and efficiently used. In addition, DCAA believed that the Working Paper Checklist has already been widely integrated into peer review processes. However, DCAA pointed out that the auditors have less than 12 months experience with the Working Paper Checklist and additional data needs to be gathered on how the checklist is being implemented. As part of the next 3-year cycle of quality assurance reviews, DCAA plans to gather data on the use and effectiveness of the Working Paper Checklist. DCAA stated that mandating a more costly, extensive, and less flexible use of the Working Paper Checklist prior to the collection of more meaningful data would not be prudent. However, should the data collected over the next 9 months show that DCAA expectations are not being met or the Working Paper Checklist is not working as planned, then DCAA would agree that some additional action is warranted.

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

Appendix A. Scope and Methodology

Scope

An audit organization's internal quality assurance program is an integral part of its overall management program. We based our review of the DCAA quality assurance program on the GAS standards relating to quality controls; the General Accounting Office GAO/OP-4.1.6, "An Audit Quality Control System: Essential Elements," August 1993; the PCIE "Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General," April 1997; DCAA strategic plan goals and objectives; and DCAA policies and procedures in force from June 1992 through March 2002. We reviewed the status of the DCAA quality assurance program including improvements and enhancements that DCAA made as a result of IG DoD Report No. D-2002-6-001. In addition, we reviewed the FY 2000 DCAA quality assurance review of internal control system audits. Specifically, we reviewed the FAO and assignment selection process; the DCAA documentation files for all of the 18 FAOs visited; the 18 trip reports; and corrective actions that DCAA headquarters, the regions, and Field Detachment had completed or proposed. In addition, we visited four FAOs (the North West and Peninsula Branch Offices in California, the Denver Branch Office in Colorado, and the Great Lakes Branch Office Buffalo Suboffice in New York) to retest DCAA work and conclusions. Also, we discussed the quality assurance review process and the results of our review with DCAA officials to help us determine how much reliance we could place on the process when conducting our oversight review. Further, we reviewed briefing charts that the DCAA headquarters Quality Assurance Division presented to the ESC and meeting minutes and action items that resulted from ESC meetings and decisions relating to the DCAA quality assurance program and the internal quality assurance review of internal control system audits.

IG DoD Oversight Responsibilities. Under section 8(c)(6), title 5, United States Code, Appendix 3, the Inspector General Act of 1978, as amended, the IG 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 IG 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 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 quality assurance reviews.

Methodology

To evaluate the status of the DCAA 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 quality assurance reviews as well as the improvements and enhancements DCAA implemented as a result of IG DoD Report No. D-2002-6-001. To evaluate the results of the FY 2000 quality assurance review of internal control system audits, we reviewed the ESC briefing charts and meeting minutes, the trip reports, the completed DCAA Checklists, and supporting documentation to determine what significant deficiencies DCAA found and corrective actions DCAA proposed and/or completed. We retested the DCAA results by visiting 4 (22.2 percent) of the 18 FAOs that DCAA visited and analyzing 20 (23.8 percent) of the 84 assignments DCAA reviewed using the same DCAA Checklist that DCAA used when they conducted the quality assurance review. We then compared our results to the DCAA results, identified differences, and determined why the differences occurred.

During our oversight review of forward pricing assignments addressed in IG DoD Report No. D-2002-6-001, we determined that DCAA maintained limited documentation to support answers on the DCAA Checklist because DCAA management determined that only exceptions needed supporting documentation or explanation. In addition, DCAA needed to improve the wording of checklist questions; better define the criteria for evaluating audit work; and provide more thorough guidance for assessing noncompliances, illegal acts, and other irregularities to completely evaluate certain auditing standards. However, we did not issue the draft report summarizing our oversight review until April 20, 2001. By that time, DCAA had already completed the quality assurance review of internal control system audits, briefed the ESC, issued the 18 trip reports, and initiated corrective action. Therefore, DCAA could not have incorporated any of our suggested revisions to the DCAA Checklist during the review of internal control system audits. As a result, we are not addressing issues related to specific DCAA Checklist questions or the criteria that DCAA used to evaluate the audit work. We plan to evaluate implementation of the DCAA Checklist and identification of the relevant guidance during our oversight review of the DCAA quality assurance review of incurred cost audits, which began in April 2002.

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

Oversight Review Dates and Standards. We conducted this oversight review from May 2001 through April 2002 in accordance with standards issued by the IG DoD.

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

Prior Coverage

Inspector General of the Department of Defense (IG DoD)

IG DoD Report No. D-2002-6-005, "Defense Contract Audit Agency Regional Quality Assurance Review of the Incurred Cost Sampling Initiative," April 16, 2002

IG DoD Report No. D-2002-6-001, "Defense Contract Audit Agency Quality Assurance Program," December 6, 2001

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

Appendix B. Structure of Defense Contract Audit Agency Quality Assurance Program and Quality Control System

Policies on Quality Control Systems and Quality Assurance Reviews

GAS. 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 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 a 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.

General Accounting Office Guide. The General Accounting Office GAO/OP-4.1.6, “An Audit Quality Control System: Essential Elements” (General Accounting Office Guide), August 1993, provides guidance that Federal organizations can use to design or improve their internal quality control systems. The General Accounting Office Guide states that a quality control system should define principles, policies, and procedures that will achieve the consistent quality of work that an organization expects. In addition, an appropriate quality control system identifies those factors that could jeopardize the quality of an audit and establishes processes or procedures that promptly identify and correct problems before they occur.

DCAA Internal Quality Control System

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,¹⁸ audit quality review, and management improvement efforts. Organizationally, DCAA is divided into a headquarters, 5 regions, Field Detachment, and 81 FAOs. DCAA considers all 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, standard audit report formats, 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-wide 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 between 10 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 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 identifying trends throughout DCAA. FAOs may institute other quality control procedures, such as participatory work teams and pre-issuance review of audit reports.

¹⁸External audit followup includes following up on findings and recommendations in General Accounting Office and IG DoD reports.

DCAA Quality Assurance Program

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. The headquarters, regional, and 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 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 or disapproving DCAA-wide 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 strategic plan, advanced degrees and certifications, procurement plans, and the DCAA quality assurance program. If necessary, the ESC establishes action items for tasks to be completed or information to be provided. The Executive Officer maintains a listing of action items for the Director, DCAA.

Headquarters Quality Assurance Division. The DCAA headquarters Quality Assurance Division performs formal 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 RQA, including Field Detachment, assists the DCAA headquarters Quality Assurance Division in performing quality assurance reviews and other quality assurance projects throughout the agency. At the direction of respective regional directors, the RQAs also perform regional 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 reviews 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 staff assigned to the review report indirectly to the chief of the headquarters Quality Assurance Division.

DCAA Quality Assurance Reviews. Beginning in FY 1999, DCAA established a 3-year cycle for conducting 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 audits.¹⁹ DCAA decided to conduct separate quality assurance reviews for each of the major audit categories. DCAA completed all of the reviews and briefed the ESC on the final review in June 2002.

DCAA 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, sufficient evidence, thorough scope of review, written results, written responses, and an effective followup process. In IG DoD Report No. D-2002-6-001, we discussed DCAA implementation of the characteristics during the DCAA quality assurance review of forward pricing assignments and determined that the DCAA methodology for preparing written results and written responses met the intent of the PCIE Guide. DCAA used the same methodology during the quality assurance review of internal control system audits; therefore, DCAA continues to meet the intent of the PCIE Guide. Our concerns about the DCAA followup process are addressed in finding A of this report. For the characteristics of formal quality assurance review procedures, staffing, independent review, evidence, and scope of headquarters-led quality assurance reviews; DCAA has either taken corrective action or plans to take corrective action to improve or enhance the characteristic.

Formal Quality Assurance Review Procedures. DCAA completed three internal quality assurance reviews without preparing formal policies and procedures for conducting the reviews. DCAA needs to develop formal policies and procedures so that an external reviewer can evaluate the adequacy of the policies and procedures as part of the overall oversight review of the DCAA quality assurance program. DCAA planned to issue the instruction by September 30, 2001; however, DCAA revised the milestone date to February 28, 2002. In March 2002, DCAA revised the milestone date to May 30, 2002. In July 2002, DCAA again revised the milestone to September 30, 2002.

Staffing. DCAA established the headquarters Quality Assurance Division primarily to develop and execute an agency-wide quality assurance program.

¹⁹Examples include defective pricing audits, progress payment audits, operations audits, and termination audits.

DCAA has subsequently added responsibilities, such as providing assistance in preparing the DCAA FY 2000 financial statements. To ensure that the quality assurance program reviews are accomplished during each 3-year cycle, DCAA agreed to continue to monitor the work assigned to the headquarters Quality Assurance Division.

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 of the performance of quality assurance reviews. However, when DCAA established the process for assigning auditors to the quality assurance reviews, DCAA decided that the Field Detachment Quality Assurance Division would conduct the quality assurance review of Field Detachment audits. DCAA decided not to independently assess Field Detachment because of workload, security considerations, and the fact that DCAA considers the Field Detachment Quality Assurance Division independent because it is separate from Field Detachment audit operations. However, the Field Detachment quality assurance staff is located at Field Detachment FAOs in California, Texas, and Massachusetts. The quality assurance staff is not physically separate from Field Detachment audit operations. In response to IG DoD Report No. D-2002-6-001, DCAA modified the process by requiring the Deputy Director, DCAA to select Field Detachment FAOs for review, review and sign draft and final trip reports, and review working papers if necessary. However, the Field Detachment Quality Assurance Division staff is still performing the fieldwork and writing the trip reports. While involving the Deputy Director, DCAA in the review of Field Detachment FAOs does not result in complete independence, the process is a reasonable compromise that meets the intent of the recommendation in IG DoD Report No. D-2002-6-001, given the nature of Field Detachment work.

Evidence. The PCIE Guide recommends that competent evidential matter be gathered and, where applicable, sufficient testing is 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 internal control system audit assignments to review. DCAA documented the results of the quality assurance review of internal control systems audits by completing a DCAA Checklist for each of the 84 audits reviewed, preparing exit conference notes, and writing a trip report summarizing the results of the review for each of the 18 FAOs visited. DCAA gathered what it considered sufficient evidence to evaluate whether its auditors were complying with applicable auditing policies and procedures. However, because of concerns raised in IG DoD Report No. D-2002-6-001 regarding the lack of sufficient documentation and inadequate cross-referencing of trip reports, we retested 4 (22.2 percent) of the 18 FAOs and 20 (23.8 percent) of the 84 internal control system audits to determine whether the two conditions had improved. As previously stated, DCAA completed the quality assurance review of internal control system audits and briefed the ESC in September 2000 before we issued IG DoD Report No. D-2002-6-001 in December 2001; therefore, DCAA could not have implemented any of the recommendations during the review of internal control system audits. However, DCAA took action to implement the recommendations related to documentation and cross-referencing trip reports once IG DoD Report No. D-2002-6-001 was issued.

Documentation Supporting the DCAA Checklists. The DCAA quality assurance staff improved their documentation of the work performed and the conclusions reached during the review. In response to IG DoD, Report No. D-2002-6-001, DCAA modified the DCAA Checklist²⁰ that is being used during the quality assurance review of all other audits. Specifically, DCAA:

- added question 5.3.b, which requires the DCAA reviewer to determine whether any auditor in the FAO documented the reliability of computer-based data if the auditor performing the audit under review had not;
- modified question 6.1 and renumbered it as 6.1.a, which requires the DCAA reviewer to determine whether the auditor documented his understanding of the contractor's internal controls; and,
- added question 6.1.b, which requires the DCAA reviewer to determine whether any auditor in the FAO documented an understanding of the contractor's internal controls on an ICAPS, and Internal Control Questionnaire, or some other procedure if the auditor performing the audit under review had not.

In addition, DCAA is considering whether to break up question 4.2 on supervision into three questions to more accurately assess supervisory involvement during an audit. Also, our review of DCAA Checklists prepared at two pilot sites indicated that DCAA is providing more detailed documentation for each answer on the DCAA Checklist. Specifically, the DCAA reviewers are providing either an explanation or a working paper reference and sometimes both for each "yes" and "no" answer and, when necessary, the DCAA reviewers are providing explanations for some of the "not applicable" answers.

Cross-Referencing the Quality Assurance Review Reports. The DCAA quality assurance staff improved the cross-referencing of the trip reports to the supporting quality assurance documentation because of the improvement in documenting the answers to the DCAA Checklist questions. DCAA wrote a trip report for each of the 18 reviewed FAOs. The trip reports summarize the major findings of the quality assurance reviews at the FAOs and include an enclosure that summarizes the DCAA Checklist answers by reviewed assignment. Each trip report identifies the internal control system audit being discussed and the DCAA Checklist question identifying the noncompliance. Because of the changes that DCAA made to the DCAA Checklist questions and because the DCAA reviewers are providing explanations and working paper references as support for their answers, we have a clear audit trail from the trip reports to the DCAA Checklist answers to the auditor working papers.

Scope of Headquarters-Led Quality Assurance Reviews. In IG DoD Report No. D-2002-6-001, we raised concerns about the scope of the DCAA headquarters-led quality assurance reviews related to the review of FAOs,

²⁰DCAA considers the DCAA Checklist to be a living document; therefore, changes are made as needed.

assessment of due professional care, review of qualifications and independence, and assessment of the DCAA quality control system. DCAA took corrective action or has initiated corrective action to improve the characteristics.

Review of FAOs. All FAOs issue audit reports; however, DCAA never planned to ensure the review of every FAO in a given 3-year cycle or planned to include the two overseas FAOs²¹ in the headquarters-led quality assurance reviews. DCAA notified us on March 30, 2001, that they would begin to include both overseas FAOs in the universe of offices to be potentially selected for future reviews. DCAA stated that, under the DCAA methodology for conducting the PCIE-based reviews and given the DCAA revised position relating to its two overseas offices, every FAO will likely be covered during the first and subsequent review cycles.

Assessment of Due Professional Care. The question on the DCAA Checklists that DCAA used for the internal quality assurance reviews of forward pricing assignments and internal control system audits did not adequately address compliance with due professional care. DCAA took corrective action by modifying the March 12, 2001, version of the DCAA Checklist used during the internal quality assurance review of incurred cost audits to include the question, “Did the auditors exercise due professional care in performing the audit?” to be used to assess compliance with due professional care.

Qualifications and Independence. The quality assurance review process that DCAA initially developed included plans to review compliance with the general standards of qualifications and independence. The plans did not include testing at the FAO level. 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 completed the review of qualifications and independence and briefed the ESC in June 2002.

DCAA Quality Control System. The DCAA quality assurance reviews of internal control system audits did not fully consider regional and FAO quality control policies and procedures. 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. DCAA took corrective action by adding 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 used to review incurred cost audits, the third of four types of audits that DCAA is including in the quality assurance reviews.

²¹The European Branch Office is in Germany with suboffices in Saudi Arabia and Israel. The Pacific Branch Office is in Japan with suboffices in Hawaii and Korea.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer

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

PQA 225.4[D2001OA-0113]

July 17, 2002

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

SUBJECT: Response to Draft Oversight Report on the DCAA Quality Assurance Review of
Internal Control System Audits (Project No. D2001OA-0113)

Thank you for the opportunity to comment on the subject report. Our responses to the
report recommendations are provided below.

DoDIG Report Section A, Recommendation 1

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

1. Institutionalize the followup process for all of the quality assurance reviews.

DCAA Response

Concur in principle. DCAA has and will continue to require the following:

- that the results of its PCIE-based quality assurance reviews be timely briefed to its Executive Steering Committee (ESC) and to you and your staff;
- that its ESC adopt appropriate corrective actions to address the PCIE-based review findings;
- that DCAA's Assistant Director-Policy & Plans, Regional Directors (RDs), and Field Detachment Director (FDD), be appropriately tasked to carry out and follow up on the corrective actions
- that the tasking to the RDs and FDD will encompass the timely submission of individual corrective action plans to the DCAA Director (D), D's documented approval of the plans, and the completion of the planned corrective actions documented by each RDD and FDD in closing correspondence to D.

SUBJECT: Response to Draft Oversight Report on the DCAA Quality Assurance Review of Internal Control System Audits (Project No. D2001OA-0113)

DCAA's sources of documentation for the preceding requirements include CAM 2-S10, ESC meeting minutes and action items, and official PowerPoint presentations maintained by the Headquarter Quality Assurance Division. All of the requirements have also been incorporated into a newly composed DCAA Instruction (DCAAI 7640.20) on DCAA's Audit Quality Assurance Program. The Instruction is currently in coordination with the members of the ESC and Audit Policy and Oversight.

In addition, DCAA will continue to use its Strategic Planning process to bring about desired changes and needed improvements in its audit performance. This includes those changes and improvements identified by the Agency's audit quality assurance program and PCIE-based reviews. However, with respect to the Strategic Plan objective specifically mentioned on page 5 of the May 2002 draft IG report, DCAA's ESC rescinded the objective on June 25, 2002. The objective called for significantly increasing the number of DCAA field audit offices (FAOs) determined by the PCIE-based review process to be operating at a "high level" of compliance with the Government Auditing Standards and Agency audit policy. A replacement objective is being considered, but has yet to be proposed and adopted by the ESC.

DoDIG Report Section A, Recommendation 2

2. Issue clarifying guidance for documenting reliance on data from computer-based systems and qualify the affected reports for audits at nonmajor contractors until the guidance is implemented.

DCAA Response

Concur. On June 25, 2002, after coordination with Audit Policy and Oversight, DCAA issued Memorandum for Regional Directors (MRD) 02-PQA-050, Subject: *Audit Guidance for Nonmajor Contractor Audits with Maximum Control Risk Assessments and Audit Evidence Highly Dependent on Contractor Computerized Information Systems*. The issuance of this audit guidance MRD, along with DCAA's corresponding release of a revised electronic working paper and standard audit program step to accommodate and further facilitate implementation of the audit guidance, fully satisfies the IG recommendation in our opinion.

DoDIG Report Section B, Recommendation 1

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

1. Require the regions and Field Detachment to actively oversee the scheduling and completion of internal control system audits to ensure that field audit offices have properly implemented the Defense Contract Audit Agency Manual 7640.1, "DCAA Contract Audit Manual," requirement to complete such audits every 2 to 4 years.

SUBJECT: Response to Draft Oversight Report on the DCAA Quality Assurance Review of Internal Control System Audits (Project No. D2001OA-0113)

DCAA Response

Concur in principle. As noted in the draft IG report section *Cycling Internal Control System Audits* (page 13), DCAA and the IG have both been attentive over the last 5 years to the timely completion of internal control system audits at the major contractor segments for which DCAA is cognizant (approximately 216 in FY 2000). In March 1998, DCAA re-emphasized to its field audit offices (FAOs) the Agency's requirements to have the systems audits completed at major contractors every 2 to 4 years. In FY 2000, DCAA completed a comprehensive PCIE-based review that followed up the policy requirement at 22 major contractor segments audited by 12 FAOs, and as a result of that review, systematically tasked its Regional Directors to follow-up the requirement at those locations with cited noncompliances. Additional follow-up is planned for the next cycle of PCIE-based reviews.

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We believe the record outlined above demonstrates that DCAA already is actively overseeing the scheduling and completion of its internal control system audits in light of the findings of the FY 2000 PCIE-based reviews. We further believe that in the aforementioned section of its draft report, the IG has somewhat overstated the findings of the FY 2000 PCIE-based review. On page 13 of the draft, the IG states that "...DCAA found that 6 (50 percent) of the 12 FAOs having audit cognizance over major contractors had not properly cycled their internal control system audits." More specifically, DCAA's quality assurance reviewers found that out of the 220 internal control system audits (22 segments x 10 system audits each) that the 12 FAOs were responsible for performing every 2 to 4 years, only 19 of these audits (less than 9 percent) were not current (i.e., completed within the 4 year cycle). Further, some of these 19 audits were not clear noncompliances with DCAA's existing policy on cycling internal control (i.e., they raised new policy issues).

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Notwithstanding the above, DCAA Headquarters Policy & Plans is agreeable to including a clear reminder of the need to timely complete the internal control system audits in the MRD that will be issued to address IG Recommendations B.2 and B.3. The MRD will be issued by September 30, 2002.

DoDIG Report Section B, Recommendation 2

2. *Correct any outstanding report that inaccurately states that an internal control system was adequate.*

DCAA Response

Concur. Recommendation B.2 with its wording "inaccurately states that an internal control system was adequate," refers to those situations (prior to DCAA's guidance change in January 2001) where (1) an FAO's internal control system audit may have found one or more system inadequacies, but (2) the FAO opined that the system was adequate based on the reported explanation that the contractor was pursuing an adequate plan to correct the reported

SUBJECT: Response to Draft Oversight Report on the DCAA Quality Assurance Review of Internal Control System Audits (Project No. D2001OA-0113)

inadequacies. DCAA's revised audit guidance covering such situations now requires the FAO to opine that the system is inadequate up until the time that a follow-up audit shows that the corrective action was completed and effective.

The probability is low that contractors have not yet satisfactorily corrected the system inadequacies identified by those FAOs that opined a system was adequate pending correction of an inadequacy. Nevertheless, any current occurrence of this situation is also unacceptable to DCAA. For this reason, DCAA will issue an MRD directing its FAOs to review their system audits and audit reports covering open contractor fiscal years to ensure that system inadequacies are appropriately reported in consonance with current DCAA audit guidance. The MRD will be issued by September 30, 2002.

DoDIG Report Section B, Recommendation 3

3. Direct the field audit offices to revise the Internal Control Audit Planning Summaries prepared based on inaccurate reports to accurately reflect audit risk for each affected year.

DCAA Response

Concur. As explained above, we believe the probability is low that contractors have not yet satisfactorily corrected the system inadequacies identified by FAOs during audits which opined that the system was adequate pending correction of the inadequacies. Consequently, since Internal Control Audit Planning Summaries (ICAPS) are prepared based on the results of the internal control system audits, we also believe that the probability is low that there are ICAPS outstanding which do not accurately reflect the overall audit assessment of the system or the control risk assessments for the system control objectives. Further, the FY 2000 PCIE-based review results showed that in most cases, the ICAPS for the system audits adequately captured/summarized the system audit results, even in those cases where the audits opined that the system was adequate based on the contractor's pursuit of corrective actions. But once again, the existence of any ICAP summary currently in effect with inaccurate assessments is unacceptable to DCAA. Therefore, DCAA in the aforementioned MRD will also instruct its FAOs to review all of their ICAPS for the years still subject to audit to ensure the accuracy of the ICAPS assessments, for both the system overall and its control objectives.

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DoDIG Report Section B, Recommendation 4

4. Determine which types of audit reports need to include fieldwork dates to provide a time frame for when the report findings are applicable and modify the standard report formats and the Defense Contract Audit Agency Manual 7640.1, "DCAA Contract Audit Manual," to reflect the revised requirement.

DCAA Response

Concur. In time for the release of the December 2002 update of the Agency's standard audit report formats, we will (1) identify which DCAA audit report types should include fieldwork dates, and (2) modify the formats to prompt the auditor's inclusion of the fieldwork dates.

DoDIG Report Section B, Recommendation 5

5. Include a question on the checklist "Audit Report Quality Review Sheet for Audit Reports of All Types" to verify whether the dates of fieldwork are included in the scope section of audit reports, when applicable.

DCAA Response

Nonconcur. As evidenced by our willingness to revise selected DCAA standard report formats to prompt the inclusion of the fieldwork date (see Comments above), DCAA supports the IG's principal position that the usefulness and value of the impacted audit reports would be improved with the fieldwork date. The fieldwork date in selected report types, however, represents only one of literally hundreds of specific reporting requirements potentially impacting the 46 report format types that the Agency currently maintains. Needless to say, the costs associated with implementing the checklist as a peer and post audit quality review tool prohibit having the checklist cover all but the Agency's most important reporting requirements (i.e., 47 requirements are currently covered by the checklist). In our opinion, the fieldwork dating on selected report types does not rise to the level of significance that we believe warrants adding a 48th requirement to the checklist, especially given the fact that we are currently looking at opportunities to further streamline the report quality checklist and its related processes.

Notwithstanding the above, DCAA will introduce/communicate its December 2002 fieldwork dating change to selected report formats to all of its FAOs. This will be done via the MRD that is concurrently issued with the quarterly update to DCAA's standard audit report formats, audit programs, and electronic working papers. In addition, during its next round of PCIE-based reviews of DCAA's internal control audits, DCAA's quality assurance (QA) organization will follow up FAO compliance with the new fieldwork dating requirement. Under current plans, this particular round of QA reviews will be completed by around mid-FY 2004,

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DoDIG Report Section B, Recommendation 6

6. Standardize use of the working paper checklist throughout the agency and integrate the working paper checklist into the peer review quality control procedures.

DCAA Response

Concur in principle. As noted on page 20 of the draft report, DCAA has developed a comprehensive standardized checklist to further assure that the general quality of its working papers and working paper documentation complies with Agency audit policy and the Government Auditing Standards (GAS). The checklist is being used by all regions and FAOs. It was distributed to each FAO via MRD 01-PQA-062, issued August 6, 2001. In November 2001, DCAA performed a timely follow-up survey to ensure that Agency expectations regarding its use were being met. The expectations were that the Agency's regional directors and Field Detachment Director would individually direct/guide their FAOs' use of the checklist in a manner that would best (1) provide the assurance sought regarding working paper compliance while (2) maximizing effective use of auditor resources. DCAA's plans also call for continued monitoring of the checklist, mainly by the Agency's QA organization.

As evident by the statement below, the IG is highly critical of DCAA's implementation approach:

expending resources to develop a working paper checklist but making its use optional, permitting the deletion of questions, and not requiring its use as part of the supervisory and peer review processes, is not an efficient use of DCAA resources.

We view the same set of facts in a somewhat different manner. That is, we believe that inefficient use of DCAA resources would arise from mandating across-the-board, repetitive use of the working paper checklist tool. Completing the full checklist in a quality manner generally adds two or more hours to each audit. However, as the IG knows, the results of DCAA's comprehensive PCIE-based reviews show significantly different levels of audit team compliance with the GAS and Agency audit policy. Therefore, for those FAOs with audit teams already determined to be operating at satisfactory levels of compliance, requiring each team to complete the full checklist for every audit would not, in our opinion, constitute cost effective implementation of the checklist tool. On the other hand, we believe that DCAA's field and regional audit managers, who routinely report to their regional directors, are in the best position to pinpoint the need for the checklist and appropriately tailor its use.

We also believe that as DCAA's audit teams and field managers have gained experience with the checklist, its integration into the peer review process during FY 2002 has been made even more effective. We believe this for two basic reasons. First, the information from DCAA's November 2001 follow-up survey was based on limited data representing the first-time

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experiences of the regions/FAOs. Subsequent information/observations by the QA organization are indicating broad peer review use of the checklist; although in many cases, existing union agreements prohibit verification of the detailed use of the working paper checklist. Second, DCAA management is closely monitoring the implementation of an objective under Strategic Plan Goal No. 1, which states that by September 30, 2002, 70% of the Agency's audit teams will be at the advanced level of maturity as measured by the ESC-approved PWT Assessment Guide. To achieve the *Advanced Level* status requires an audit team to be at an advanced state for most of the established team attributes, one of which is "performing peer reviews."

In summary, we are *concurring in principle* to recommendation 6 because (1) we have developed the standard working paper checklist tool; (2) like the IG, we believe in the value of the tool and want it to be effectively implemented and efficiently used; and (3) we believe that the tool's use has already been widely integrated into peer review processes adopted by DCAA's audit teams. To gain increased assurance that the checklist tool is being implemented and used as effectively and efficiently as possible requires the gathering of additional data, in our opinion. At present, DCAA auditors have less than 12 months experience with the checklist. By the first half of FY 2003, DCAA's QA organization will have completed its next round of PCIE-based QA reviews. A key part of these reviews will be the collection of data on the use and effectiveness of the working paper checklist. Mandating a more costly, extensive and less flexible use of the checklist tool prior to the collection of more meaningful data would not be prudent in our opinion. On the other hand, should the data that we will be gathering over the next nine months show that Agency expectations are not being met and/or the checklist is not working as planned, then we would agree that some additional action is warranted.

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



Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Team Members

The Audit Policy and Oversight Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

Wayne C. Berry
Diane H. Stetler
Catherine M. Schneiter
Edward M. Van Why
Lois J. Wozniak
Sharon Carvalho
Krista Gordon
Ashley Harris