

September 10, 2004



Audit Oversight

Quality Control Review of the
Defense Finance and Accounting
Service Office of Internal Review
(D-2004-6-009)

Department of Defense
Office of the Inspector General

Quality

Integrity

Accountability

Report Documentation Page

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Acronyms

DFAS	Defense Finance and Accounting Service
GAS	Government Auditing Standards
OIR	Office of Internal Review
PCIE	President's Council on Integrity and Efficiency



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September 10, 2004

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE, OFFICE OF INTERNAL REVIEW

SUBJECT: Quality Control Review of the Defense Finance and Accounting Service
Office of Internal Review (Report No. D-2004-6-009)

We are providing this final report for your review and comment. We have reviewed the Defense Finance and Accounting Service (DFAS) Office of Internal Review (OIR) system of quality control for the year ended March 31, 2003. The Government Auditing Standards (GAS) require that an audit organization performing Government audits have an appropriate internal quality control system and undergo an external quality control review every 3 years by an organization that is not affiliated with the organization reviewed. As the organization that has audit policy and oversight responsibilities for audits in the DoD, we conducted this external quality control review of DFAS OIR.

An audit organization's quality control policies and procedures should be appropriately comprehensive and suitably designed to provide reasonable assurance of meeting the objectives of quality control. We tested the DFAS OIR system of quality control to the extent considered appropriate. The audits we reviewed were for the year ended March 31, 2003.

Our work to determine the adequacy of the internal quality control system design and its compliance with policies, procedures, and standards was limited because DFAS OIR issued the "Internal Review Audit Manual, Policies and Procedures" on February 24, 2003, and our review period ended March 31, 2003. GAS, 1994 revision, paragraph 3.33 states that an organization's internal quality control system should be in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed. We were unable to express an opinion on the DFAS OIR internal quality control system for audit operations. Because the policy and procedures for the system had been in place only for a month, we could not determine whether the system was operating effectively. However, our review disclosed areas where DFAS OIR could improve compliance with GAS.

Results. Overall, we found that DFAS OIR needed to make improvements to the quality control program and guidance related to the areas of Independence, Quality Control, Audit Planning, Evidence and Working Papers, and Audit Reporting. The improvements to the quality control program should ensure that the audits conducted are performed according to GAS. Additionally, DFAS OIR should ensure that the areas identified for improvement are reviewed as part of the periodic internal peer review.

Based on our review, we have the following comments, observations, and recommendations that if implemented should improve the internal quality control system of DFAS OIR.

Comments, Observations, and Recommendations

Independence Requirements for Audit Managers, Experts, and Non audit Services.

The DFAS OIR Audit Manual, Chapter 1210, addresses impairments to independence for the audit staff. However, the policy does not address guidance for audit management, experts, and non audit services, which increases the risk of impairments to independence. The GAS Independence Standard, Amendment No. 3, was issued January 2002 and became effective on January 1, 2003. The Independence standard substantially changed the previous standard to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities.

Two of the six audits that we reviewed were completed after the January 2003 GAS Independence Standard, Amendment No. 3, became effective. On the two audits, the audit managers did not document their independence on the audit project. The GAS Independence Standard places the responsibility to fulfill the requirements of the standard on both the individual auditor and the audit organization. Although, DFAS OIR Audit Manual, Chapter 1210 requires the audit team members to complete a Statement of Independence, the site manager, who plans and reviews the audit work, is not addressed in the policy.

Also, the DFAS OIR policy for independence does not include guidance for documenting impairments to independence when subject matter experts are used. We reviewed an audit project in which persons from a functional area under audit were used as subject matter experts. On the audit project an individual worked as both a subject matter expert and an interviewee to substantiate information on the audit subject area. GAS, 1994 revision, paragraph 3.14 states “Government auditors, including hired consultants and internal experts and specialists, need to consider three general classes of impairments to independence — personal, external, and organizational. If one or more of these independence impairments affects an auditor’s ability to do the work and report findings impartially, in the situations where the auditor cannot decline to perform the audit the impairment should be reported in the scope section of the audit report.” In this case, we found no documentation on how the independence of the internal experts was addressed. GAS, 2003 revision, though not a requirement at the time, states, “if the specialist has an impairment to independence, auditors should not use the work of that specialist” (GAS, paragraph 3.06). The fact that DFAS OIR did not identify the impairment indicates the need to strengthen its policy and ensure that audit team members including internal experts are independent.

In addition, DFAS OIR independence policy did not address non audit services. DFAS OIR conducts consulting services for DFAS but has not established safeguards to reduce the risk of breaching or violating the overarching principles. The overarching principles as stated in GAS Independence Standard, Amendment No. 3 and GAS 2003 revision are “(1) audit organizations should not provide nonaudit services that involve performing management functions or making management decisions and (2) audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant/material to the subject matter of the audits” (GAS, 2003 revision, paragraph 3.13). GAS Independence Standard, Amendment No. 3, went into effect January 1, 2003. At the time of our review, DFAS OIR drafted guidance on non audit services dated May 2003.

However, the DFAS OIR Audit Manual issued February 2003 should have included policy establishing safeguards to reduce the opportunity of an individual auditor impairing their independence or the organization's independence.

Recommendation. We recommend that the Director, Defense Finance and Accounting Service, Office of Internal Review:

- Revise DFAS OIR policy on Independence to include guidance for audit managers, experts, and non audit services.
- Establish a policy on non audit services consistent with requirements established in GAS.

Management Comments. The Director, Defense Finance and Accounting Service, Office of Internal Review concurred with the recommendation.

Quality Control Guidance. The DFAS OIR Audit Manual, Chapter 1100 requires all final reports to be independently referenced and all site offices to undergo a periodic internal peer review conducted every 2 years and allows the Director or Deputy Director to request a Quality Assurance Review on select assignments. The quality controls used before February 24, 2003, consisted of checklists and independent reference reviews. However, DFAS OIR did not apply the quality controls consistently. DFAS OIR auditors did not perform the required quality controls on four of the six audits we reviewed. On one audit, we found that the audit supervisor identified that quality controls were not performed for the audit project and did not provide an explanation or state what mitigating actions were taken to ensure that a factually accurate audit report was issued. GAS, 1994 revision, paragraph 3.29 states "situations may occur in which government auditors are not able to follow an applicable standard and are not able to withdraw from the audit. In those situations, the auditors should disclose in the scope section of their report, the fact that an applicable standard was not followed, the reasons therefore, and the known effect that not following the standard had on the results of the audit." GAS, 2003 revision, paragraph 3.34 further requires that if auditors state they are performing their work in accordance with GAS, they should justify any departures from GAS. When an exception is identified to the quality control standard, an explanation needs to accompany that deviation from the standard.

Recommendation. We recommend that the Director, Defense Finance and Accounting Service, Office of Internal Review ensure DFAS OIR include as part of the periodic internal peer review the areas identified for improvement.

Management Comments. The Director, Defense Finance and Accounting Service, Office of Internal Review concurred with the recommendation.

Audit Planning Requirements. The DFAS OIR Audit Manual, Chapter 1210 establishes guidance for planning the audit. We found inconsistent application of the GAS audit planning requirements on the audits we reviewed.

Specifically, in the areas of considering other’s work, designing for compliance with legal and regulatory requirements, and assessing management controls, DFAS OIR did not consistently apply the requirements to their audit projects.

Considering Other’s Work. GAS, 1994 revision, requires that when using other’s work, the audit staff should have some basis for reliance on that work. On one audit we reviewed, subject matter experts were used in the audit. The audit staff documented verbal assertions made by the subject matter experts on the assessment of illegal acts and management controls. GAS 6.15 and 6.16 requires that when relying on the work of non auditors, such as subject matter experts, audit staff should perform procedures that provide sufficient basis for that reliance. We did not find audit working papers that documented the basis for the auditors’ reliance on the subject matter experts’ assertions.

Designing for Compliance with Legal and Regulatory Requirements. DFAS OIR did not consistently consider legal and regulatory requirements. On three audit projects we reviewed, the audit staff did not design the audit to provide reasonable assurance about compliance with laws and regulations that are significant to audit objectives as required in GAS, 1994 revision, paragraph 6.28. In addition, on one of the three audit projects, the audit report identified different potential risk areas than the risk areas identified in the audit working papers. Neither the audit report nor the working papers for that audit project provided support for the risk areas identified.

Assessing Management Controls. On three audit projects, we found that the audit staff did not assess management controls that were significant to the audit objectives. The objective of each of the three audit projects was to review some aspect of a financial system or the data processed through a financial system. GAS, 1994 revision, paragraph 6.44 states “internal auditing is an important part of management control.” The DFAS OIR mission makes it necessary for the audits to assess management controls significant to audit objectives. DFAS OIR assessment of management controls provides DFAS managers reasonable assurance that controls are functioning properly. This will prevent duplication of effort for auditors who may rely on their work as stated in GAS, 1994 revision, paragraph 6.44.

Recommendation. We recommend that the Director, Defense Finance and Accounting Service, Office of Internal Review revise the DFAS OIR Audit Manual, Chapter 1210 to include guidance for considering other’s work.

Management Comments. The Director, Defense Finance and Accounting Service, Office of Internal Review concurred with the recommendation.

Evidence and Working Papers Guidance and Quality. DFAS OIR Audit Manual, Chapter 1270 states that exceptions to placing purpose and source on some working papers is left to the discretion of the audit staff. GAS, 2003 revision, paragraph 7.68 states, “audit documentation should be appropriately detailed to provide a clear understanding of its purpose and source and the conclusions the auditors reached.” The DFAS OIR manual should include examples or guidance for exceptions to working paper elements.

Also, we identified situations that affected the quality of evidence and working papers. We found inconsistent cross-referencing of supporting documentation to the

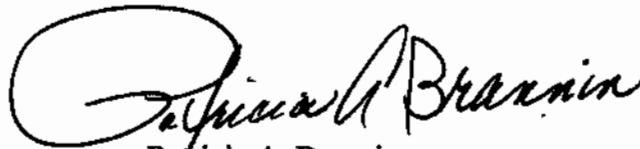
audit findings and the audit report. Two of the six audits we reviewed were completed after the issuance of the DFAS IR Audit Manual. On one of the two audit projects, a statement located in the audit plan supported a cross-reference for a dollar figure in the audit report, but the audit plan was not cross-referenced to supporting documentation. On that same audit project, a percent number used in the audit report was cross-referenced to a spreadsheet in which only part of the figure could be verified. In addition, we reviewed two audit projects with incomplete audit working papers even though DFAS OIR issued the audit reports several months before our review. GAS, 2003 revision, paragraph 7.68c requires that the audit documentation for performance audits contain the work performed to support significant judgments and conclusions, including descriptions of transactions and records examined. In addition, GAS, paragraph 7.68d requires that audit documentation include evidence of supervisory reviews, before the audit report is issued, of the work performed that supports findings, conclusions, and recommendations contained in the audit report. Therefore, we were unable to completely assess the audit quality or determine whether the work performed supported the significant conclusions and judgments as prescribed in GAS, 1994 revision, paragraph 6.64.

Audit Report Statements. On three of the six audit projects we reviewed, the audit report statements did not accurately describe the work performed. On one audit report, it stated that management controls were tested but we found no working papers to support that management controls had been assessed. On another audit report, the report stated that the auditors performed compliance with laws and regulations; however, our review found no working papers to support that steps had been designed to detect noncompliance. On a third audit report, the auditors reported that they did not perform the customary auditing procedures necessary to constitute an examination made according to GAS; however, the auditors did not provide reasons why the standards were not followed. GAS, 1994 revision, paragraph 7.55 states “the report should include only information, findings and conclusions that are supported by competent and relevant evidence in the auditors’ working papers.”

Recommendation. We recommend that the Director, Defense Finance and Accounting Service, Office of Internal Review revise the DFAS OIR Audit Manual, Chapter 1270 on working paper elements to agree with GAS.

Management Comments. The Director, Defense Finance and Accounting Service, Office of Internal Review concurred with the recommendation.

The Director, Defense Finance and Accounting Service, Office of Internal Review provided comments to a draft of this report, which are attached. See Appendix A for the scope and methodology of the review and Appendix B for the report distribution. Please call Ms. Wanda Scotland at (703) 602-1033 or Mr. George Hunter at (703) 604-8756 if you have any questions.



Patricia A. Brannin
Assistant Inspector General
Audit Policy and Oversight

Appendix A. Scope and Methodology

The mission of DFAS is to provide responsive, professional finance and accounting services for the people who defend America. The DFAS OIR mission is to provide responsive, professional, and objective information and advice to enhance the DFAS stewardship over Department of Defense resources. DFAS OIR examines programs, systems, and processes and provides information, analyses, assessments, recommendations, and other assistance applicable to DFAS management duties and objectives. DFAS OIR is a partner with management in its efforts to continuously improve the efficiency and effectiveness of DFAS programs and processes. “DFAS OIR has four audit services managers that support DFAS’ three business lines (Accounting, Commercial Pay, and Military/Civilian Pay) and DFAS’ Corporate Resources and Elements. DFAS OIR audit services managers ensure specific functional and policy concerns of the DFAS business lines are addressed.” The DFAS Internal Review Audit Manual Policies and Procedures dated February 24, 2003, provides guidance on the performance of audits within DFAS OIR. The audit manual states, “It is the policy of Internal Review to adhere to the GAS issued by the Comptroller General of the United States in the conduct of its audits and audit-related operations.” The GAS published by the U.S. Comptroller General is the criteria guiding auditors in their work to ensure quality and reliable audit results. The GAS require that the internal quality control system established by the audit organization should provide reasonable assurance that it has adopted, and is following, applicable auditing standards and has established, and is following, adequate audit policies and procedures.

The Assistant Inspector General for Audit Policy and Oversight, Office of the Deputy Inspector General for Inspections and Policy of the Department of Defense conducted the review. The review team could not evaluate all aspects of the DFAS OIR system of quality control because of the brief time between the issue date of the audit manual and the end of the review period. However, we did perform a review on 6 of 47 audit reports issued between April 1, 2002, and March 31, 2003, for compliance with GAS to the extent practicable given the issue date of the audit manual. The review team evaluated working papers for the selected audits, conducted interviews of staff members, and performed tests of documentation.

From April 2003 to April 2004 (from September 2003 to January 2004, the review was suspended), the external review team reviewed the quality control program of the audit function for the DFAS OIR from April 1, 2002, through March 31, 2003. The team used the guidelines and checklists established by the President’s Council on Integrity and Efficiency (PCIE) as amended February 2002 to determine whether the DFAS OIR quality control program conformed with GAS. The review team adjusted the PCIE guidelines and checklists as appropriate to reflect the DFAS OIR. The review team considered several factors in applying the PCIE guidelines, such as the size of the DFAS OIR, the degree of operating autonomy allowed, and the nature of work. In conducting the review, the review team evaluated 6 of 47 audit reports issued in the period reviewed and associated working papers for the reports. We also reviewed training and educational activity documentation for the period of January 1, 2001, through December 31, 2002, for full-time auditors in the DFAS Internal Review Office.

We considered the 1994 revision of GAS, as amended, because the audits selected for review were completed before the June 2003 revision of the GAS was issued. However, we included the GAS Independence Standard, Amendment No. 3, issued January 2002, which became effective January 1, 2003. Also, we provided, where appropriate, suggestions for modifying operating procedures based on the 2003 revision of the GAS, which became effective January 1, 2004.

Limitations of Review. The objective of our review was to determine whether the DFAS OIR was performing audits according to GAS. We did not review the Internal Review functions that are not related to audit such as investigations, advisory and assistance services, and the liaison function. We conducted our review in conformance with standards and guidelines established by the PCIE for reviews of audit operations. Our review would not necessarily disclose all weaknesses but is to provide reasonable assurance that the DFAS OIR system of internal quality control was adequate and that quality control policies and procedures are being followed. Departures from the quality control system may occur because of a misunderstanding of instructions, mistakes of judgment, carelessness, or other human factors. Additionally, the departures from the quality control system may not be detected. Projecting any evaluation of a quality control system into the future is subject to the risk that one or more procedures may become inadequate because conditions may change or the degree of compliance with procedures may deteriorate.

Appendix B. Report Distribution

Other Defense Organizations

Director, Defense Finance and Accounting Service

Director, Office of Internal Review, Defense Finance and Accounting Service

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations

Senate Subcommittee on Defense, Committee on Appropriations

Senate Committee on Armed Services

Senate Committee on Governmental Affairs

House Committee on Appropriations

House Subcommittee on Defense, Committee on Appropriations

House Committee on Armed Services

House Committee on Government Reform

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Defense Finance and Accounting Service, Office of Internal Review Comments



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

SUBJECT: Comments to the Office of Inspector General, Department of Defense
Draft Quality Control Review of the Defense Finance and Accounting
Service Office of Internal Review (Project No. D2003-OC-0105)

Thank for the opportunity to review and comment on the results from the subject report. It provides useful and timely recommendations for ensuring the quality of our audit work as our organization develops. The Defense Finance and Accounting Service (DFAS) formally organized the Office of Internal Review during spring 2000 to provide independent internal auditing services to ensure accountability and integrity in DFAS operations. Through diligent recruiting and training efforts, we have transitioned into a full scope audit organization. During that transition, we issued the DFAS Internal Review Audit Manual in February 2003 to document our policies and procedures for implementing Government Auditing Standards (GAS). It is important to note that four of the six audits for the subject review were completed prior to the issuance of the Internal Review Audit Manual. The remaining two audits were issued shortly after the issuance of the Audit Manual. Although we were striving to address the critical guidance within GAS and our Audit Manual, we recognize there were areas needing further attention. Your report will serve to help us assure we are providing a superior quality of work.

The following are our comments to each of the five recommendations in the subject report:

1. Revise DFAS Office of Internal Review (OIR) policy on Independence to include guidance for audit managers, experts, and non-audit services.

Internal Review response: Concur. We will revise our policy on independence to specifically cover audit managers, experts, and non-audit services.

2. Establish a policy on non-audit services consistent with the requirements established in Government Auditing Standards (GAS).

Internal Review response: Concur. We have a non-audit services DFAS Internal Review Audit Manual chapter in draft. We will ensure that it is consistent with GAS prior to its issuance.

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3. Ensure DFAS OIR include as part of the periodic internal peer review the (quality control) areas identified for improvement.

Internal Review response: Concur. We began our internal peer review process during April 2004. We will ensure that the process includes coverage of the areas identified in your report.

4. Revise the DFAS OIR Audit Manual, Chapter 1210, to include guidance for considering other's work.

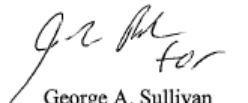
Internal Review response: Concur. We will revise Audit Manual Chapter 1210 to include guidance for considering other's work.

5. Revise the DFAS OIR Audit Manual Chapter 1270 on working paper elements to agree with GAS.

Internal Review response: Generally concur. We will revise our Audit Manual to clarify requirements for working paper elements and provide examples where appropriate. However, Audit Manual, Chapter 1270, currently addresses the issues identified in your review and is consistent with GAS. The issues were the result of audit teams not following the requirements of the Audit Manual noting that the six audits under review were either complete or substantially complete at the time of the issuance of the Audit Manual. We believe that the identified issues will be addressed moving forward by placing stronger emphasis on cross-indexing, independent referencing, audit documentation, and reporting guidance.

The report indicates that Audit Manual Chapter 1270 states that exceptions to placing purpose and source on some working papers is left to the discretion of the audit staff. The Audit Manual Chapter 1270 specifically states, "Generally, working papers document the purpose, source, scope, and conclusion. Purpose and source may be sufficient on some working papers while on others, such as summaries or analytical working papers, all elements may be appropriate." Our general requirement is to include Purpose, Source, Scope, and Conclusion on working papers. Working papers should include at a minimum the Purpose and Source elements.

Thank you again for providing the subject report for comment and review. If you have any questions, please feel free to contact me on (703) 607-5129 or Mr. Jack Rouch, Deputy Director of Internal Review on (703) 607-3963.


George A. Sullivan
Director of Internal Review