

December 20, 2002



# Oversight

Defense Contract Audit Agency  
Quality Assurance Review of  
Incurred Cost Audits  
(D-2003-6-003)

Office of the Inspector General  
of the Department of Defense

*Quality*

*Integrity*

*Accountability*

### **Additional Information and Copies**

The Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Assistant Inspector General for Inspections and Policy of the Department of Defense, prepared this report. If you have questions or would like to obtain additional copies of the draft report, contact Mr. Wayne C. Berry at (703) 604-8789 (DSN 664-8789) or Ms. Diane H. Stetler at (703) 604-8737 (DSN 664-8737).

### **Suggestions for Future Audits**

To suggest ideas for or to request future audits, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

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Inspector General of the Department of Defense  
400 Army Navy Drive (Room 801)  
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### **Acronyms**

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
MFR	Memorandum for Record
MRD	Memorandum for Regional Directors
PCIE	President's Council on Integrity and Efficiency
RQA	Regional Quality Assurance Division



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
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December 20, 2002

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Report on Defense Contract Audit Agency Quality Assurance Review of  
Incurred Cost Audits (Report No. D-2003-6-003)

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

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

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

A handwritten signature in cursive script, reading "Patricia A. Brannin", is positioned above the typed name.

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-2003-6-003  
(Project No. D2002OA-0105)

December 20, 2002

### Defense Contract Audit Agency Quality Assurance Review of Incurred Cost Audits

#### Executive Summary

**Who Should Read This Report and Why?** The Under Secretary of Defense (Comptroller)/Chief Financial Officer 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 incurred cost audits.

**Background.** This is the third in a series of reports on the DCAA headquarters-led quality assurance program. DCAA selected incurred cost, one of four categories of audits, as the third category to be covered by the DCAA headquarters-led quality assurance reviews. For FY 2001, DCAA completed 42,657 assignments, 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.

**Results.** When planning the quality assurance review of incurred cost audits, DCAA developed and implemented a reasonable methodology for selecting both the field audit offices and the annual incurred cost audit summary assignments for review. However, DCAA did not adequately plan or document the scope of review for individual incurred cost audit summary assignments. Specifically, DCAA did not establish specific criteria for selecting subactivity assignments for review or adequately document the subactivity assignments actually reviewed. In addition, DCAA prepared the final report before completing the summary working papers. As a result, the final report presented to the Executive Steering Committee did not fully disclose the scope of the review or adequately summarize the final results. Based on a draft of this report, DCAA determined that the final report on a headquarters-led quality assurance review would be a briefing provided to the Inspector General of the Department of Defense.

DCAA should fully document the scope of review of all quality assurance reviews and complete all work before providing the final report to the Inspector General of the Department of Defense.

**Management Comments.** DCAA concurred with both of the recommendations.



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## Background

This is the third 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), January 2002, 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,<sup>1</sup> establishes DCAA as a separate organization under the direction, authority, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. The primary mission of DCAA is to perform contract audits for DoD. In addition, DCAA is responsible for providing accounting and financial advisory services regarding contracts and subcontracts to DoD Components that perform procurement and contract administration duties. Also, DCAA provides contract audit services for non-DoD Federal organizations on a reimbursable basis. For FY 2001, DCAA completed 42,657 assignments, valued at \$218.4 billion,<sup>2</sup> 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).<sup>3</sup> Specifically, CAM section 2-101 states that GAS is applicable to DCAA. DCAA ensures compliance with the applicable auditing standards throughout audit planning and performance activities by supplementing audit guidance in the CAM with standard audit programs and internal control matrixes. Between CAM updates, DCAA

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<sup>1</sup>DoD Directive 5105.36 was last updated on February 28, 2002.

<sup>2</sup>This amount represents dollars that DCAA examined or reviewed for forward pricing assignments, incurred cost audits, and special audits (for example, terminations, claims, and Government facility rentals).

<sup>3</sup>DCAA Manual 7640.1 is updated every 6 months. As of October 2002, the current version is July 2002.

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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.

**Incurred Cost Audits.** DCAA initiated the quality assurance review of FY 2000 incurred cost audits, its third headquarters-led quality assurance review, in November 2000. In FY 2000, DCAA issued 31,580 reports, of which 3,538 (11.2 percent) were incurred cost audit reports. In addition, DCAA auditors expended a total of 791,000 hours performing incurred cost audits. DCAA performs incurred cost audits to determine whether a contractor's claimed costs are reasonable, allocable, and allowable in accordance with applicable laws, regulations, and contracts. DCAA performs incurred cost audits at major contractors<sup>4</sup> as well as at nonmajor contractors.<sup>5</sup> DCAA establishes one overall assignment called an annual incurred cost audit summary assignment for each applicable contractor fiscal year. The assignment is used to record the total annual dollar volume for the applicable contractor fiscal year, dollars examined during each Government fiscal year, questioned costs, and audit status. An annual incurred cost audit summary assignment remains open until the overall incurred cost audit report for that contractor fiscal year is issued. To complete an annual incurred cost audit summary assignment, DCAA has authorized the field audit offices (FAOs)<sup>6</sup> to either perform all of the needed audit work under the summary assignment or to establish as many subactivity assignments as necessary to audit the contractor's final incurred cost submission.

**Results of DCAA Quality Assurance Review of Incurred Cost Audits and Inspector General of the Department of Defense Retesting.** The DCAA quality assurance review of incurred cost audits identified significant noncompliances with GAS for which DCAA has either implemented or initiated corrective action. Specifically, DCAA identified issues related to due professional care, planning, supervision, evidence, compliance with laws and regulations, and reporting. We conducted independent testing at two FAOs and concluded that the same type of systemic noncompliances did exist and that the DCAA results were valid. In addition, our independent review did not identify any systemic issues not previously identified by DCAA. Resolving 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. See Appendix C for a discussion of the significant noncompliances and the corrective actions that DCAA implemented or initiated.

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<sup>4</sup>A major contractor is a contractor where DCAA has contractor costs of \$80 million or more to audit in one fiscal year.

<sup>5</sup>A nonmajor contractor is a contractor where DCAA has contractor costs of less than \$80 million to audit in one fiscal year.

<sup>6</sup>An 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 multiple contractors.

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

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## Scope of Quality Assurance Review of Incurred Cost Audits

When planning the quality assurance review of incurred cost audits, DCAA developed and implemented a reasonable methodology for selecting both the FAOs and the annual incurred cost audit summary assignments for review. However, DCAA did not adequately plan or document the scope of review for individual incurred cost audit summary assignments. Specifically, DCAA did not establish specific criteria for selecting subactivity assignments for review or adequately document the subactivity assignments actually reviewed. In addition, DCAA prepared the final report<sup>7</sup> before completing the summary working papers.<sup>8</sup> As a result, the final report did not fully disclose the scope of the review or adequately summarize the final results.

### Selection of FAOs and Annual Incurred Cost Audit Summary Assignments

For the internal quality assurance review of incurred cost audits, DCAA developed a two-tier methodology for selecting which FAOs and audits to review. First, DCAA selected FAOs to visit based on the number of hours expended on incurred cost audit work at major and nonmajor contractors. Once FAOs were selected, DCAA selected the annual incurred cost audit summary assignments to be reviewed.

**Selection of FAOs.** DCAA selected 28 FAOs to review—12 FAOs auditing major contractors, 12 FAOs auditing nonmajor contractors, and 4 FAOs auditing corporate or home offices.<sup>9</sup> DCAA developed a reasonable methodology to judgmentally select the FAOs for review. However, DCAA eliminated two FAOs auditing corporate or home offices from the review due to time constraints. As a result, DCAA reviewed a total of 26 FAOs. The 26 FAOs represented 32.9 percent of the universe of 79 FAOs in existence as of June 2002.

**Selection of Annual Incurred Cost Audit Summary Assignments.** DCAA initially selected 100 annual incurred cost audit summary assignments for review—4 assignments performed at corporate or home offices, 36 assignments performed at major contractors, and 60 assignments performed at nonmajor contractors. DCAA developed a reasonable methodology that they used to judgmentally select the assignments for review at each FAO. If the FAO did not have a sufficient number of audits with reports issued in FY 2000, then DCAA

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<sup>7</sup>DCAA prepares the final report in the form of Microsoft PowerPoint slides and makes an oral presentation to the Executive Steering Committee.

<sup>8</sup>The summary working papers are the Memorandums for Record that DCAA prepares for each FAO.

<sup>9</sup>A corporate or home office is the general corporate or divisional headquarters responsible for the management of business carried out at various plants, branches, divisions, or subsidiaries of the organization.

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selected audits with reports issued in FY 2001 using the same criteria. Audits described as Office of Management and Budget Circular No. A-133 audits<sup>10</sup> were excluded from selection because we separately perform quality control reviews on these audits. 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. DCAA actually reviewed 97 annual incurred cost audit summary assignments—3 audits performed at corporate or home offices, 34 audits performed at major contractors, and 60 audits performed at nonmajor contractors.

DCAA developed and implemented a reasonable methodology for selecting FAOs and annual incurred cost audit summary assignments to be reviewed. However, DCAA did not develop and document an objective methodology for selecting subactivity assignments to be reviewed.

## **Planning for and Documenting Review of Subactivity Assignments**

When planning the quality assurance review of incurred cost audits, DCAA did not adequately plan the scope of review for individual incurred cost audit summary assignments. In addition, DCAA did not consistently document which subactivity assignments they had reviewed.

**Selecting Subsidiary Assignments for Review.** DCAA did not establish specific criteria for selecting subactivity assignments for review. When planning and performing an incurred cost audit, DCAA supervisory auditors establish as many or as few subactivity assignments as needed to audit a contractor's final incurred cost submission. For example, an FAO established 2 subactivity assignments for an annual incurred cost audit summary assignment examining \$631 million of incurred costs while another FAO established 27 subactivity assignments for an annual incurred cost audit summary assignment examining \$450 million of incurred costs. When subactivity assignments are used, auditors may perform a significant amount of audit work under the subactivity assignments. For example, the FAO that established the 27 subactivity assignments expended 3,094 hours to complete the 27 subactivity assignments and only 242 hours to complete the annual incurred cost summary assignment. Therefore, the work performed under the subactivity assignments is critical to the overall results of an incurred cost audit.

When planning for the quality assurance review of incurred cost audits, DCAA provided the following guidance for selecting subactivity assignments for review on the Supplemental Checklist.<sup>11</sup>

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<sup>10</sup>Office of Management and Budget Circular No. A-133, "Audits of States, Local Governments, and Non-Profit Organizations," June 24, 1997, are audits of State and local governments and nonprofit organizations, including educational institutions and hospitals.

<sup>11</sup>DCAA developed the Supplemental Checklist to gather information on quality control and audit planning; use of automated working papers; and the testing of certain types of costs, such as pensions.

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In answering the PCIE-based checklist [DCAA Checklist] questions, the QA [quality assurance] reviewers assume the responsibility for covering any subsidiary workpackages, as well as the summary assignment. The extent to which the subsidiary audit work (if any) needs to be specifically evaluated is a matter of reviewer judgment.

Essentially, DCAA left it up to the discretion of the reviewers as to how many subactivity assignments they needed to review and in what detail because DCAA determined that subactivity assignments were working papers packages that were part of the annual incurred cost audit summary assignments and not individual stand-alone audit assignments. However, DCAA did not require the reviewers to document which subactivity assignments they selected for review or the basis for making the selections.

**Documenting Subsidiary Assignments Reviewed.** DCAA did not adequately document the subactivity assignments reviewed. In general, supervisory auditors established subactivity assignments for annual incurred cost audit summary assignments of major contractors or corporate or home offices. DCAA reviewed 37 annual incurred cost audit summary assignments at 14 FAOs auditing major contractors or corporate or home offices. The FAOs established 521 subactivity assignments for 34 of the 37 assignments. The FAOs did not establish subactivity assignments for the other three assignments. Of the 104,155 hours that DCAA expended to complete the 34 incurred cost audits, DCAA expended 94,819 hours (91 percent) performing work on the 521 subactivity assignments and only 9,336 hours (9 percent) performing work on the 34 annual incurred cost audit summary assignments. DCAA did not identify which of the 521 subactivity assignments they reviewed in the quality assurance working paper files, including the Memorandum for Record (MFR). When asked which subactivity assignments were reviewed, DCAA headquarters Quality Assurance Division personnel stated that the reviewers:

assumed responsibility for covering all of the applicable, significant working papers that supported the auditor's reported findings and conclusions. . . . we followed the guidelines generally set-up for the incurred cost round of PCIE-based reviews and considered all of the subsidiary assignment working papers in our review of individual incurred cost audits.

However, based on that response and the review documentation, we were unable to independently determine whether the DCAA reviewers considered all subactivity assignments when answering questions on the DCAA Checklist. Therefore, to try to determine which subactivity assignments were reviewed, we requested information from reviewers for 12 annual incurred cost audit summary assignments with 204 subactivity assignments. According to the reviewers, they reviewed 93 (45.6 percent) of the 204 subactivity assignments.

DCAA considered the subactivity assignments to be part of the annual incurred cost audit summary assignments, not separate audits that must be performed in compliance with GAS. DCAA stated that the DCAA reviewers now document the basis for "no" answers on the DCAA Checklist as well as the basis for most of the "yes" answers. DCAA maintains that the answers on the DCAA Checklist provide sufficient documentation as to which working papers were covered and

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that additional information is neither required by the PCIE Guide nor necessary. However, the PCIE Guide requires internal quality assurance reviewers to gather competent evidence and to conduct sufficient testing to determine whether the organization is complying with applicable auditing standards, policies, and procedures. Therefore, the issue is not whether DCAA adequately documented the answers on the DCAA Checklist; rather, the issue is whether DCAA gathered competent evidence and conducted sufficient testing to support the findings and conclusions.

**Necessity for Identifying Subactivity Assignments Included in Quality Assurance Review.** The review of subactivity assignments highlighted a scope issue that could exist when reviewing other DCAA audits with a voluminous number of working papers. For instance, one FAO elected to perform all incurred cost audit work for 1 fiscal year under one annual incurred cost audit summary instead of establishing multiple subactivity assignments. The overall assignment contained 34 working paper sections. Unless a reviewer identifies which working paper sections were reviewed, an external reviewer would not be able to properly retest the assignment or to place maximum reliance on the work. Therefore, for audits with a large number of subactivity assignments or voluminous working papers, it is imperative that DCAA specifically identify which subactivity assignments or working paper sections they based their conclusions on or which subactivity assignments or working paper sections they specifically excluded from review. Otherwise, an external reviewer assumes that the internal quality assurance reviewer examined all audit documentation. An external reviewer can consider the extent of working paper review when retesting the work. If significant differences are identified during retesting, then the issue becomes whether conclusions drawn by testing only a portion of the audit documentation are accurate. However, if significantly different conclusions are reached and the internal quality assurance reviewer did not identify the audit documentation specifically excluded from review, then the external reviewer may determine that the internal quality assurance reviewer's conclusions are incorrect.

DCAA has structured the internal quality assurance reviews using the PCIE Guide procedures for an external quality assurance review as much as possible so that organizations conducting external peer reviews of DCAA can place maximum reliance on the DCAA internal quality assurance program. Unless DCAA documents which subactivity assignments they included in the quality assurance review, properly retesting the work or placing maximum reliance on the work will be difficult for an external reviewer. Without knowing the scope of the DCAA work, retesting could lead an external reviewer to draw substantially different conclusions and, thereby, erroneously determine that the DCAA quality assurance work could not be relied on.

## **Presentation of Final Report**

The final report that DCAA presented to the Executive Steering Committee (ESC) adequately identified significant noncompliances with GAS for which DCAA has either implemented or initiated corrective action (Appendix C). However, as discussed above, DCAA did not adequately describe the scope of review of

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individual audits to the ESC. In addition, DCAA prepared the final report before completing the summary working papers. As a result, the final report did not adequately summarize the final results of the review.

**Results Reported to the ESC.** DCAA presented the final report to the ESC before completing the quality assurance review work. In September 2001, DCAA prepared and presented a briefing to the ESC that summarized the results of the review along with proposed corrective actions. DCAA considered the September 2001 briefing to be the final report on the quality assurance review of incurred cost audits. DCAA prepared the briefing based on the results of the 97 annual incurred cost audit summary assignments. The PCIE Guide recommends that internal quality assurance reviewers gather competent evidential matter and conduct sufficient testing to determine whether the organization is in compliance with applicable auditing standards, policies, and procedures and that a written report that summarizes the results be prepared. Determining whether the results in the final report were based on competent evidential matter requires that the preparer of the final report have documentation summarizing the evidence. DCAA documents the results using the DCAA Checklist and summarizes the results for each FAO in an MFR. At the time DCAA briefed the ESC, however, DCAA had not completed all of the 26 MFRs. Specifically, at the time of the ESC briefing, DCAA had not:

- provided 8 (30.8 percent) draft MFRs to the FAOs for comment;
- received FAO comments on 16 (61.5 percent) draft MFRs; and
- signed out 17 (65.4 percent) final MFRs.

DCAA did not update the final report once the quality assurance review of incurred cost audits was completed. For the eight draft MFRs that had not been provided to the FAOs, the Chief of the DCAA headquarters Quality Assurance Division explained that he was able to review the results “. . . in sufficient detail to know that the overall results significant to Agency [DCAA] management would not materially change as a result of completing our established written reporting process.” In addition, the Chief of the DCAA headquarters Quality Assurance Division stated that he reviewed each draft MFR to become knowledgeable of the significant issues raised at each FAO. Also, both the Assistant Director and Deputy Assistant Director of the Policy and Plans Directorate were required to review the draft MFRs for the FAOs with a satisfactory except for or a less than satisfactory rating before the draft MFR was sent to the FAO for comment.

**Results Reported to the Inspector General of the Department of Defense.** At the time that DCAA briefed the Inspector General of the Department of Defense (IG DoD) in December 2001, DCAA had completed all but 3 (11.5 percent) of the 26 MFRs. However, the data that DCAA provided to the IG DoD were different than the data provided to the ESC in the September 2001 report. DCAA indicated which data changed. The following table shows numerical differences in the DCAA-identified significant noncompliances between the final report that DCAA presented to the ESC and the briefing that DCAA presented to the IG DoD.

### DCAA Review Results

<u>Nature of Noncompliance*</u>	<u>Number of Noncompliances Reported to</u>	
	<u>ESC</u>	<u>IG DoD</u>
Due Professional Care	11	12
Quality Control	36	37
Consider Control Risk	21	20
Evidence	25	20
Working Paper Documentation	37	39
Testing Compliance with Laws and Regulations	16	17

\* For additional information, see Appendix C.

The final report that DCAA presented to the ESC did not reflect the overall magnitude of the significant noncompliances. In addition, DCAA reported in the September 2001 final report that 3 (11.5 percent) of the 26 FAOs were operating at a less than a satisfactory level. However, in the December 2001 briefing to the IG DoD, DCAA reported that 4 (15.4 percent) of the 26 FAOs were operating at a less than satisfactory level. Had DCAA completed its work and finalized the MFRs before briefing the ESC, the results presented to the ESC would have been complete. DCAA did not present a revised final report to the ESC. Although the differences found after reporting to the ESC did not change the overall results or the proposed corrective actions for the review, having differences does point out a problem with reporting the results before the work is complete. If DCAA continues to issue final reports before completing the work, the reliability and the value of the final report could be impaired. As a result, the ESC would not have the best information for making decisions on corrective actions.

**Resolution of Final Report Issue.** As the result of IG DoD concerns about presenting a final report before the quality assurance work is complete, DCAA determined that the final report on a quality assurance review would be the report provided to the IG DoD or any other external organization. DCAA has agreed that, should the results presented to the ESC be substantially different than the results presented to the IG DoD in the final report, then DCAA will provide a revised briefing to the ESC. DCAA is revising the draft policies and procedures to incorporate the agreement.

## Summary

Although DCAA is not required to issue quality assurance review reports that comply with GAS reporting standards, GAS reporting standards provide sound guidance on preparing an audit report so that the reader of a report can rely on the

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information presented. GAS requires that reports include objective, scope and methodology, results (findings and conclusions), and recommendations. Scope and methodology should include an explanation of the:

- relationship between the universe and what was audited;
- evidence gathered and analysis techniques used;
- sample design and why that design was chosen when sampling significantly supports the findings; and
- work that was or was not performed, particularly when the work was limited because of constraints on time or resources.

The results should include sufficient, competent, and relevant information that promote adequate understanding of the matters reported and provide convincing but fair presentations in proper perspective. If a DCAA final report on an internal quality assurance review does not accurately reflect the scope of the review and the review findings, then IG DoD will not be able to place maximum reliance on the DCAA internal quality assurance program by simply relying on the report with no retesting. For the external quality assurance reviewers or other users of DCAA audit services to rely on the DCAA internal quality assurance program, the information provided in the final report must be accurate and complete.

## **Management Comments on the Finding and Oversight Response**

**Management Comments.** DCAA expressed concern that in five places in the report, the IG DoD repetitively describes a single finding that DCAA believes is somewhat overstated and out of balance as presented.

**Oversight Response.** The concern that DCAA expressed is related to how the IG DoD structures reports.

## **Recommendations, Management Comments, and Oversight Response**

**We recommend that the Director, Defense Contract Audit Agency:**

**1. Fully document and report on the scope of review of all quality assurance reviews.**

**Management Comments.** DCAA concurred, stating that for all future quality assurance reviews, the DCAA reviewers will identify the working paper sections including incurred cost subactivity assignments that were not included when evaluating an assignment. If no working papers were specifically identified as

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excluded from review, the IG DoD can and should assume that the DCAA reviewers evaluated all working paper sections, and detailed working papers within the sections, as part of the assignment review.

**2. Complete all work and finalize all Memorandums for Record on the quality assurance reviews before providing the final report to the Inspector General of the Department of Defense.**

**Management Comments.** DCAA concurred, stating that DCAA inaccurately described its presentation to the ESC as “the Agency’s *final* report for that round of PCIE-based QA [Quality Assurance] reviews.” in draft DCAA Instruction, “DCAA Audit Quality Assurance Program.” DCAA stated that the description was inaccurate because the DCAA briefing to the IG DoD would be after the presentation to the ESC and, therefore, was the final report. In addition, DCAA never intended to wait for all of the official reporting and documentation requirements to be completed before presenting the significant noncompliances to the ESC. The expectation was that DCAA would report interim review results when the significance and timing of the findings and issues justified such reporting. As soon as the IG DoD pointed out the above inaccuracy, DCAA revised the draft instruction to specify that the DCAA briefing of quality assurance review results to the IG DoD was to be considered the final report.

**Oversight Response.** The DCAA comments were responsive and should resolve the issue of presenting the final report before completing the work.

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## Appendix A. Scope and Methodology

**Review of DCAA Quality Assurance Program.** 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,” January 2002; DCAA strategic plan goals and objectives; and DCAA policies and procedures in force from October 1998 through August 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, “Defense Contract Audit Agency Quality Assurance Program,” December 6, 2001, and IG DoD Report No. D-2002-6-007, “Defense Contract Audit Agency Quality Assurance Review of Internal Control System Audits,” August 6, 2002. In addition, we reviewed the FY 2001 DCAA quality assurance review of incurred cost audits. Specifically, we reviewed the:

- FAO and assignment selection process;
- DCAA documentation files for all of the 26 FAOs visited;
- 26 MFRs; and
- corrective actions that DCAA headquarters, the regions, and Field Detachment had either completed or proposed.

We independently tested two FAOs (the Northrop Grumman Corporate Resident Office in California and the Northern Ohio Branch Office) to determine whether the systemic noncompliances DCAA identified existed at FAOs that DCAA did not review. In addition, we determined whether other systemic issues existed that DCAA did not identify in the internal quality assurance review. 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 quality assurance review of incurred cost audits. We conducted this oversight review from April 2002 through October 2002 in accordance with IG DoD standards.

**IG DoD Oversight of DCAA.** 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 Inspections and Policy, Deputy Assistant Inspector General for Audit Policy and Oversight. As part of that responsibility, Audit Policy and Oversight evaluates the quality assurance reviews that the DCAA headquarters Quality Assurance Division and

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the Regional Quality Assurance Divisions (RQAs) perform. Audit Policy and Oversight uses the PCIE Guide as a tool when conducting oversight reviews of the quality assurance reviews.

**Evaluation of Results of the FY 2001 Quality Assurance Review of Incurred Cost Audits.** 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 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 and IG DoD Report No. D-2002-6-007. To evaluate the results of the FY 2001 quality assurance review of incurred cost audits, we reviewed the:

- ESC briefing charts and meeting minutes;
- MFRs;
- completed DCAA Checklists;
- documentation supporting significant deficiencies that DCAA found; and
- corrective actions DCAA completed or proposed.

We independently tested the DCAA results by visiting 2 (2.5 percent) of the 79 FAOs that existed as of June 2002. The two FAOs we tested had not been reviewed by DCAA during the first 3-year cycle of quality assurance reviews. At the 2 FAOs, we reviewed 2 corporate office annual incurred cost audit summary assignments and 14 (51.9 percent) of the 27 associated subactivity assignments. In addition, we reviewed five annual incurred cost audit summary assignments at nonmajor contractors. When reviewing the assignments, we used the same DCAA Checklist that DCAA used when they conducted the quality assurance review. For the review of the corporate office assignments, we prepared a checklist for each of the 14 subactivity assignments that we reviewed instead of paralleling the DCAA methodology by only preparing a checklist for the 2 annual incurred cost audit summary assignments.

**Use of Computer-Processed Data.** We relied on computer-processed data from the DCAA Management Information System. Specifically, we used information from the “Analysis of World” report for FY 2000 as an aid in our selection of FAOs to visit and assignments to review. In addition, for each of the 97 annual incurred cost audit summary assignments, DCAA provided data from the DCAA Management Information System summarizing the hours expended completing the assignments, dollars examined, questioned costs, number of associated subactivity assignments, and hours expended completing the subactivity assignments. We did not perform tests of system general and application controls to confirm the reliability of the data because errors would not have significantly affected our selection of FAOs or assignments or our conclusions on planning for and documenting the review of subactivity assignments. Therefore, not evaluating the controls did not affect the results of the audit.

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## **Prior Coverage**

### **IG DoD**

IG DoD Report No. D-2002-6-007, "Defense Contract Audit Agency Quality Assurance Review of Internal Control System Audits," August 6, 2002

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

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## **Appendix B. Structure of DCAA 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 organizations establish 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 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.

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## 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,<sup>12</sup> audit quality review, and management improvement efforts. As of September 30, 2002, DCAA is organizationally divided into a headquarters, 5 regions, Field Detachment, and 80 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.

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<sup>12</sup>External audit followup includes following up on findings and recommendations in General Accounting Office and IG DoD reports.

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## 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 RQAs, including Field Detachment, assist 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.

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**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.<sup>13</sup> DCAA decided to conduct separate quality assurance reviews for each of the major audit categories. DCAA completed all four reviews and briefed the ESC on the last one 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 incurred cost audits and continues to meet the intent of the PCIE Guide for the characteristics of written responses. However, as discussed in the finding, DCAA needs to improve its process for preparing written results to meet the intent of the PCIE Guide. For the characteristics of formal quality assurance review procedures, staffing, independent review, evidence, followup, 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 four 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 date to September 30, 2002. In October 2002, DCAA again revised the milestone date to December 31, 2002.

**Staffing.** DCAA established the headquarters Quality Assurance Division primarily to develop and execute an agency-wide quality assurance program. DCAA has subsequently added responsibilities, such as providing assistance in preparing the DCAA FY 2000 financial statements. 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.

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<sup>13</sup>Examples of other audits include defective pricing audits, progress payment audits, operations audits, and termination audits.

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**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 based on 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 throughout the continental United States. 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 quality assurance review process by requiring the Deputy Director, DCAA to select Field Detachment FAOs for review, review and sign draft and final MFRs, and review working papers if necessary. While involving the Deputy Director, DCAA in the review of Field Detachment FAOs does not result in complete independence, involving the Deputy Director, DCAA 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 be accomplished to determine whether the organization is in compliance with applicable auditing standards, policies, and procedures. DCAA developed an understandable and methodical process for selecting which FAOs and incurred cost audit assignments to review. However, DCAA did not develop an objective methodology for selecting subactivity assignments for review and did not document which subactivity assignments were actually reviewed in the MFRs (see Finding). DCAA documented the results of the quality assurance review of incurred cost audits by completing a DCAA Checklist and Supplemental Checklist for each of the 97 annual incurred cost audit summary assignments reviewed, preparing exit conference notes, and writing an MFR summarizing the results of the review for each of the 26 FAOs visited. We conducted independent testing at two FAOs and concluded that the same type of systemic noncompliances existed and that the DCAA results were valid. In addition, our independent review did not identify any systemic issues not previously identified by DCAA. DCAA completed the quality assurance review of incurred cost audits and briefed the ESC in September 2001 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 incurred cost audits. However, DCAA took action to implement the recommendations related to documentation as well as cross-referencing MFRs once IG DoD Report No. D-2002-6-001 was issued.

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**Documentation Supporting the DCAA Checklists.** The DCAA quality assurance staff improved their documentation of work performed and conclusions reached during the review. In response to IG DoD Report No. D-2002-6-001, DCAA modified the DCAA Checklist<sup>14</sup> 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 a computer-based date 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 an understanding of the contractor's internal controls;
- 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 Internal Control Audit Planning Summary, an Internal Control Questionnaire, or some other procedure if the auditor performing the audit under review had not; and
- separated question 4.2 on supervision into five questions to more accurately assess supervisory involvement during an audit.

In addition, our review of DCAA Checklists prepared at two pilot sites for the review of all other audits 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—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 MFRs to the supporting quality assurance documentation because of the improvement in documenting the answers to the DCAA Checklist questions. DCAA wrote an MFR for each of the 26 FAOs reviewed. The MFRs 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 MFR identifies the incurred cost audit 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 answers, we have a clear audit trail from the MFRs to the DCAA Checklist answers to the auditor working papers.

**Followup Procedures.** The PCIE Guide recommends that procedures be established for resolution and followup of recommended corrective action. A good followup system should provide information on what improvements were

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<sup>14</sup>DCAA considers the DCAA Checklist to be a living document; therefore, changes are made as needed.

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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 the headquarters-led quality assurance reviews. If the ESC adopts a corrective action and assigns the action to a headquarters element, that component is responsible for followup. The ESC and the headquarters Quality Assurance Division are responsible for monitoring the followup. 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. However, beginning with the quality assurance review of incurred cost audits, the ESC is requiring the regions to independently follow up on each other's corrective action to ensure that the proposed corrective actions were implemented.

**Scope of Headquarters-Led Quality Assurance Reviews.** We raised concerns in IG DoD Report No. D-2002-6-001 about the scope of the DCAA headquarters-led quality assurance reviews related to the review of FAOs, assessment of due professional care, review of qualifications and independence, and assessment of the DCAA quality control system. DCAA took corrective action to improve the characteristics.

**Review of FAOs.** All of the 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 FAOs<sup>15</sup> in the headquarters-led quality assurance reviews. DCAA notified us on March 30, 2001, that they would begin to include both of the 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 the two overseas offices, every FAO will likely be covered during the first and subsequent review cycles. DCAA included the European Branch Office in the internal quality assurance review of all other assignments. However, DCAA did not include the Northern Ohio Branch Office, the Northrop Grumman Corporate Resident Office, or the Pacific Branch Office in any headquarters-led review conducted during the first 3-year cycle.

**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.

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<sup>15</sup>The 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.

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**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 in June 2002 briefed the ESC.

**DCAA Quality Control System.** The DCAA quality assurance reviews of forward pricing assignments and 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 the 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.

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## Appendix C. Results of DCAA Quality Assurance Review of Incurred Cost Audits

**Significant Noncompliances.** The DCAA quality assurance review of incurred cost audits identified significant noncompliances with GAS for which DCAA has either implemented or initiated corrective action. In the briefing presented to the IG DoD in December 2001, DCAA discussed significant noncompliances related to the following GAS standards.

**Due Professional Care.** Auditors on 12 (12.4 percent) of the 97 audits did not meet the due professional care standard.

**Quality Controls.** Auditors on 37 (38.1 percent) of the 97 audits did not appropriately complete key procedures and forms.

**Planning.** Auditors on 31 (32 percent) of the 97 audits did not coordinate with report users to document their needs. In addition, auditors on 20 (20.6 percent) of the 97 audits did not adequately document how the assessed risk affected the scope of work.

**Supervision.** On 20 (20.6 percent) of the 97 audits, supervisory involvement was not appropriate and timely to provide for adequate planning, for supervisors to be kept informed of significant problems, and for supervisors to ensure that the work was adequately performed in accordance with the audit program and the working papers support the conclusions in the audit report.

**Evidence.** Auditors on 20 (20.6 percent) of the 97 audits did not obtain sufficient, competent, and relevant evidence to support audit report findings, judgments, and conclusions. In addition, auditors on 20 (20.6 percent) of the 97 audits did not include the audit objectives or scope and methodology (including any sampling criteria used) or adequately document the work performed in the working papers.

**Compliance with Laws and Regulations.** Auditors on 39 (40.2 percent) of the 97 audits did not assess the risk that noncompliances or illegal acts significant to the audit objective could have occurred.

**Reporting.** The reports for 11 (11.3 percent) of the 97 audits did not present information in a manner that was accurate, fair, complete, convincing, objective, and clear. In addition, the reports for 14 (14.4 percent) of the 97 audits did not include a listing of all auditable contracts and subcontracts for the fiscal year under review and designate the contracts to which advance agreements, special provisions or the penalty clause applied.

In conducting our retesting and independent testing, we reached the same general conclusions that DCAA reached when they performed the quality assurance review. Our concern about adequately documenting the scope of the review, discussed in the finding, does not adversely impact the nature of the significant noncompliances DCAA identified and the IG DoD confirmed.

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**Factors Contributing to the Significant Noncompliances.** DCAA determined that a number of factors contributed to the occurrence of the significant noncompliances. The factors included not:

- using the most current standard audit program;
- coordinating adequately with Field Detachment;
- preparing an adequate and complete risk assessment;
- preparing an adequate and complete transaction testing plan;
- using special purpose standard audit programs when appropriate;
- documenting the accomplishment of mandatory annual audit requirements; and
- including relevant control risk and accounting system information in audit reports.

The factors contributing to the significant noncompliance are related primarily to either auditors not following DCAA policies and procedures or to inadequate DCAA policies and procedures.

**Corrective Actions.** DCAA headquarters, the regions, Field Detachment, and FAOs implemented or initiated corrective action to prevent the occurrence of the significant noncompliances in future audits.

**DCAA Headquarters.** DCAA headquarters revised the CAM and modified standard audit programs in the Audit Planning and Performance System to include audit steps on coordinating with the requester of an audit, assessing the risk of fraud, and reviewing executive compensation. In addition, DCAA adopted a strategic plan objective to develop and implement an incentive program designed to motivate, recognize, and reward excellence in supervision. Also, DCAA headquarters established a process action team that developed new standard working papers for documenting risk assessments for incurred cost audits at major contractors and at nonmajor contractors. On August 8, 2002, DCAA provided training to the IG DoD on use of the new standard working papers for risk assessments.

**Regions and Field Detachment.** The regions and Field Detachment distributed the systemic findings and guidance reminders. In addition, the regions and Field Detachment conducted training detailing the significant noncompliances and what auditors could do to prevent recurrence in the future. Also, to ensure that the significant noncompliances were corrected once corrective actions were implemented, the regions and Field Detachment required the regional audit managers and detachment audit managers to review incurred cost audits.

**FAOs.** Each FAO was required to implement corrective actions to resolve the significant noncompliances that the DCAA reviewers found at the FAO. The regions are required to verify that the FAOs took corrective action and that the

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corrective action resolved the significant noncompliances. DCAA is requiring the regions to prepare close out reports on the implementation of corrective actions at the FAOs within 60 days of completion or verification of the last corrective action. The regions expect to complete the close out reports between November 30, 2002, and February 28, 2003.

Timely implementation of corrective actions and assessing whether the corrective action resolved the significant noncompliances should help ensure that the DCAA quality assurance program is effective.

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## **Appendix D. 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

IN REPLY REFER TO

PQA 720.7.203

December 4, 2002

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

SUBJECT: Response to Draft DoDIG Report on DCAA Quality Assurance Review of Incurred  
Cost Audits (Project No. D2002OA-0105)

Thank you for the opportunity to respond to the subject draft report and the results of the evaluation reported therein. The overall objective of the evaluation, as stated on page 3, "was to review the status of the DCAA quality assurance (QA) program and to assess how DCAA performed the quality assurance review of incurred cost audits." Our management comments follow:

## I. General Comments

A. The IG's review, in our opinion, was thorough and generally balanced, and we are pleased to hear that the IG's independent review, as stated on page 2 of its report, "did not identify any systemic issues not previously identified by DCAA."

B. In five places in the report, the IG repetitively describes a single finding that we believe is somewhat overstated and out of balance as presented. The finding addresses how DCAA reports the *final* results of its PCIE-based QA reviews and is first presented in the *Executive Summary* at the front of the IG report as follows:

... DCAA prepared the final report before completing the summary working papers. As a result, the final report presented to the Executive Steering Committee did not fully disclose the scope of the review or adequately summarize the final results.

The same basic finding is also presented on pages 4, 8, 9, and 10 of the report. Pages 8 and 9 provide the detailed write-up of the finding.

The IG finding is based, in part, on the following occurrences:

- (1) During the IG's evaluation, the Quality Assurance Division at DCAA Headquarters (PQA) drafted a new Agency Instruction (DCAAI 7640.20) entitled, *DCAA Audit Quality Assurance Program*; and

PQA 720.7.203

SUBJECT: Response to Draft DoDIG Report on DCAA Quality Assurance Review of Incurred Cost Audits (Project No. D2002OA-0105)

- (2) In the draft Instruction, PQA inaccurately described its presentation to the ESC of the PCIE-based review results as "the Agency's *final* report for that round of PCIE-based QA reviews."

The description was inaccurate for two reasons. First, immediately following the preceding statement in the draft Instruction was the requirement that:

After briefing the ESC on the summary review results, P and/or PQA will arrange and provide a briefing to the DoDIG's Deputy Assistant Inspector General for Audit Policy & Oversight on (1) the summary results of each round of PCIE-based QA reviews and on (2) the associated ESC-action items established to correct the significant/systemic noncompliances reported/concurred to by the ESC.

In other words, DCAA's report to the IG *followed* the ESC presentation and was therefore the final report. Second, it was never DCAA's intent that PQA should wait for all of the official QA reporting and documentation requirements to be completed before it presented its significant/systemic findings and issues to DCAA's Executive Steering Committee (ESC) members. In fact, the expectation was that PQA would report interim review results when the significance and timing of the findings and issues justified such reporting.

As soon as the IG brought the above inaccuracy to PQA's attention, PQA revised its draft instruction to say that DCAA's reporting of the PCIE-based results to the DoDIG was to be considered the Agency's *final* report for that round of PCIE-based QA reviews. In a paragraph on page 9 of the report, the IG to its credit acknowledges the above sequence of events and PQA's straightforward fix for it. The IG report paragraph is restated in full below.

**Resolution of Final Report Issue.** As the result of IG DoD concerns about presenting a final report before the quality assurance work is complete, DCAA determined that the final report on a quality assurance review should be the report provided to the IG DoD. DCAA has agreed that, should the results presented to the ESC be substantially different than the results presented to the IG DoD in the final report, then DCAA will provide a revised briefing to the ESC. DCAA is revising the draft policies and procedures to incorporate the agreement.

In our opinion, while the "Resolution" paragraph does not present the complete bases for the IG's finding, adding it to the description of the finding on pages 8 and 9 of the report does help put the finding into proper perspective. However, none of the other four descriptions of the finding in the report, including the one in the Executive Summary, even mentions or references the resolution. As a result, we believe the IG's total reporting of the finding is somewhat out of balance.

PQA 720.7.203

**SUBJECT:** Response to Draft DoDIG Report on DCAA Quality Assurance Review of Incurred Cost Audits (Project No. D2002OA-0105)

## **II. DCAA Responses to Individual Report Recommendations**

On page 10 of the draft report, the IG presents two recommendations to the Director, DCAA. The specific recommendations and DCAA's responses follow:

**IG Recommendation No. 1.** Fully document and report on the scope of review of all quality assurance reviews.

**DCAA. Concur.** For all future PCIE-based reviews, the QA reviewers will document in their review files those lead working paper sections for the reviewed assignments (including subsidiary DCAA incurred cost assignments) that were NOT evaluated by the reviewer. Absent this documentation, the IG can and should assume that all lead working paper sections (and the detailed working papers within the sections) were evaluated as part of the assignment review.

**IG Recommendation No. 2.** Complete all work and finalize all Memorandums for Record on the quality assurance reviews before providing the final report to the Inspector General of the Department of Defense.

**DCAA. Concur.** (See Section I.B of DCAA's full management comments for additional explanation on the basis for DCAA's concurrence.)

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



Robert DiMucci  
Assistant Director  
Policy and Plans

## **Team Members**

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

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