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Inspector General

Department of Defense



Internal Audit Manual

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FOREWORD

One of the highest priorities within the Office of the Inspector General, DoD, is to promote the effective use of DoD audit resources. Cooperation and coordination between the various DoD oversight activities are necessary to avoid duplication of review effort and to increase sharing of techniques and results.

The Manual is designed to assist DoD audit organizations in complying with the auditing standards, policies, and procedures issued by the Comptroller General of the United States and in providing highly credible internal audit support to the DoD.

The Manual is reissued under the authority of DoD Directive 7600.2, "Audit Policies," February 2, 1991. It replaces the June 1990 version of the DoD Internal Audit Manual, as changed. The revised Manual is effective immediately and is applicable to the internal audit organizations within the Office of the Inspector General, Department of Defense; the Military Departments; the Chairman, Joint Chiefs of Staff; the Unified Commands; and the Defense agencies (hereafter referred to collectively as "DoD Components").

Guidance contained in interim audit policy memoranda issued by this office in the future will be incorporated in periodic Manual revisions. Please forward recommended changes to:

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Donald Mancuso
Acting Inspector General

INTERNAL AUDIT MANUAL

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CHAPTER 1

Standards and Guidance for Internal Auditing

A. Purpose

1. The purpose of this Manual is to provide policy for conducting audits of DoD operations, systems, programs, and functions. It is designed to assist DoD auditors, internal review, and non-Federal audit organizations in complying with the standards, policies, and procedures issued by the Congress, the Comptroller General of the United States, the Office of Management and Budget (OMB), the President's Council on Integrity and Efficiency (PCIE), and the Department of Defense (DoD).

2. This chapter provides guidance to these audit organizations to conduct audits and to perform other related services for DoD management.

3. The remaining chapters in this Manual provide details on the areas discussed in this chapter. Additionally, chapter 6 addresses potential benefits and chapter 10 addresses contracting for audit services.

B. Standards

1. The Inspector General Act of 1978, as amended, (reference a.) requires that all audit and audit related work performed by DoD audit and internal review organizations and non-Federal auditors must comply with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States, (reference b.). GAGAS relates to the scope and quality of audit efforts and to the characteristics of professional and meaningful audit reports. The statements on auditing standards and other pronouncements issued by the American Institute of Certified Public Accountants (AICPA) are incorporated into GAGAS unless specifically excluded by a formal announcement from the General Accounting Office (GAO).

2. The Institute of Internal Auditors (IIA) and the PCIE also have issued standards, (references c. and d.) applicable to audit activities. The IIA and PCIE standards are compatible with GAGAS. While GAGAS deals primarily with the performance of individual audit projects, references c. and d. provide guidelines for the management of both audit projects and audit organizations.

3. OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," (reference e.) established uniform audit requirements for

non-Federal entities that administer Federal awards and implements the Single Audit Act Amendments of 1996 (the Act) (reference f.). The AICPA issued the Statement of Position 98-3, March 17, 1998, (reference g.) that includes guidance on the performance of audits according to the Single Audit Act Amendments of 1996 and OMB Circular A-133. These standards should be considered by DoD internal audit organizations when monitoring or reviewing the audits conducted under provisions of this Act. The Office of the Assistant Inspector General, Auditing, has oversight responsibility for non-Federal audit work for the Inspector General, DoD.

C. DoD Guidance

GAGAS contains specific guidance on professional proficiency; independence; supervision; internal controls; planning; quality control; and the types of audits and other services provided by an audit organization. These areas are covered in this manual.

1. **Professional Proficiency (GAGAS 3.3).** Auditor staffing, knowledge, skills, disciplines, supervision, compliance with standards of conduct, human relations and communication, and continuing professional education should be considered in complying with this standard.

2. **Independence (GAGAS 3.11).** The audit function of the central internal audit organizations¹ should be administratively located under and report to the heads of their Components. Other audit organizations, such as installation-level internal review staffs should report to the head, deputy head, or chief of staff of a command or activity but should be organizationally independent.

3. **Supervision (GAGAS 4.2.a. and 6.22).** The staff are to be properly supervised.

4. **Internal Controls (GAGAS 4.21 and 6.39).** Internal auditing should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal controls.

5. **Planning (GAGAS 4.6 and 6.2).** Audit work should include planning the objectives and scope of the audit as well as designing the methodology to provide sufficient, competent, and relevant evidence to achieve the objectives of the audit.

¹ Army Audit Agency, Naval Audit Service, Air Force Audit Agency, and Office of Assistant Inspector General for Auditing, OIG, DoD

6. **Quality Control (GAGAS 3.31).** Internal quality control reviews will be performed periodically by members of the audit staff to appraise the quality of the audit work performed. Also, external quality control reviews must be conducted at least every 3 years as required by this standard.

7. **Types of Audits and Other Services (GAGAS 2.2 and 2.10).** Audits are defined in GAGAS as financial or performance audits. In addition to audits, auditors may perform consulting and advisory-type services for DoD management. GAGAS covers these types of services in general terms, but the AICPA has issued specific standards for performing this type of work.

D. Management of the DoD Internal Audit Organization

The head of each DoD internal audit organization should ensure the following:

1. **Planning.** Plans should be established to carry out the responsibilities of the DoD internal auditing organization including strategic planning requirements established by the executive agency in compliance with the Government Performance and Results Act of 1993 (reference h.).

2. **Written Policies and Procedures.** Written policies and procedures should be provided to guide the audit staff including procedures for receiving, controlling, screening, and assuring appropriate disposition of allegations involving waste, mismanagement, fraud, and abuse.

3. **External Coordination.** Each of the DoD internal audit organizations should coordinate its activities with other Government audit organizations and with independent external auditors, as appropriate. Each DoD internal audit organization should also coordinate with agency management as applicable.

CHAPTER 2

Professional Proficiency

A. Purpose

This chapter sets forth the requirements needed for DoD internal audit organizations and auditors to achieve and maintain auditor proficiency.

B. Auditor Proficiency

1. DoD internal audit organizations must perform internal audits with professional proficiency (GAGAS 3.3). The DoD internal audit organizations are responsible for ensuring that audit staffs conducting audits collectively have the knowledge and skills necessary for internal audits. Auditors should also have a thorough knowledge of government auditing and the specific or unique environment in which the audited entity operates, relative to the audit being conducted.

2. Formal training and career development programs should be established to attract, select, develop, and maintain a competent and effective professional audit staff; and appropriate historical records should indicate the type and length of training and experience of each auditor. The DoD internal audit organization may refer to the President's Council on Integrity and Efficiency Training Program Guide for Government Audit Activities, (reference i.) when developing such programs.

C. Responsibilities

The heads of the DoD internal audit organizations should ensure that the technical proficiency and education are appropriate for the audits to be performed. Specifically, auditor training and career development programs should meet the requirements of GAGAS and include:

1. Publication of training policies and procedures;
2. Determination of auditor skill requirements;
3. Development of on-the-job training programs and formal training courses;
4. Maintenance of training history records; and
5. Development of auditor annual training plans.

D. Auditor Training Program

1. A successful auditor training program requires management's constant assessment of changing needs, present and future; encouragement of, and support for, individual development to meet those needs; and a commitment of sufficient resources to make it possible. A training program should contain the following elements.

a. **Policies and Procedures.** The policies and procedures covering the management and execution of the auditor training program should: (a) define organizational training responsibilities; (b) establish training requirements for individual auditors; (c) provide for the preparation of annual training plans; and (d) prescribe criteria covering reimbursement to auditors for job-related training.

b. **Auditor Training History Record.** A history of training should be maintained for each auditor and should be retained and used to evaluate training needs.

c. **On-the-Job Training.** The DoD internal audit organizations should develop a formal on-the-job auditor training program to train newly hired auditors through self-study and supervised instruction while actually working on various types of audit assignments.

2. The DoD internal audit organizations should encourage their auditors to seek professional certifications, such as Certified Public Accountant, Certified Internal Auditor, Certified Information Systems Auditor, Certified Fraud Examiner, the various DoD auditor training certifications, etc. The DoD internal audit organizations should also encourage their staffs to belong to and actively participate in professional organizations such as the American Institute of Certified Public Accountants, the American Society of Military Comptrollers, the Association of Government Accountants, and the Institute of Internal Auditors.

E. Staff Qualifications (GAGAS 3.10)

The staff members conducting audits must meet the GAGAS staff qualification requirements that include, but are not limited to, possessing knowledge of the methods and techniques applicable to government auditing and the education skills, and experience to apply such knowledge to the audit being conducted. The Auditors General of the Army, Navy, and Air Force, and the Assistant Inspector General for Auditing, Office of Inspector General, DoD, must be qualified civilians.

CHAPTER 3

Planning

A. Purpose

This chapter covers the planning process and the audit plan. The size and complexity of the DoD make universal audit coverage on a cyclical basis generally impractical. Accordingly, it is essential that the available audit resources be allocated so as to provide maximum benefit to DoD management and other stakeholders. Chapter 5., Performing Audits, addresses planning individual audit projects.

B. Development of a Strategic Plan

The Government Performance and Results Act (GPRA) of 1993, (reference h.) requires Federal agencies to more effectively plan, budget, execute, evaluate, and account for Federal programs. GPRA is intended to change the way many programs and operations are managed. In essence, agencies are required to develop strategic plans, set performance goals, and measure their performance against those goals. The DoD internal audit organizations should develop strategic plans that align their goals with those of their parent organizations.

C. Planning Process

The DoD internal audit organizations need to ensure that the most important areas are selected for audit coverage. Each organization should establish policies and procedures for preparation and execution of an audit plan. The audit planning process should focus on:

1. Identifying potential audit areas after consideration of regulatory and statutory requirements,
2. Identifying potential audit areas that are consistent with the strategic management plan and assist the parent organization in achieving its performance goals,
3. Responding to the concerns of management and Congress for the oversight of key programs, and
4. Identifying potential audit areas after consideration of high-risk areas.

In addition, to assist in identifying potential audit areas, the DoD central internal audit organizations will participate in the DoD Joint Audit Planning Groups. The Joint Audit

Planning Groups are responsible for jointly researching, planning, and prioritizing proposed coverage for key issues.

D. Audit Plan

1. The DoD internal audit organizations should prepare, based on the guidance established, an audit plan identifying the audits scheduled to be performed. The plan should meet the following criteria.

- a. Meet all statutory or regulatory requirements.
- b. Provide audit coverage that supports the parent organization in achieving its strategic management plan performance goals and addresses high-risk areas. For each proposed audit, the strategic management goal or high-risk area that the audit applies to should be identified in the audit plan.
- c. Meet the needs of management and the organization's mission.
- d. Respond to the concerns of the Congress for oversight of key programs.
- e. Provide balanced and adequate audit coverage of substantive DoD operations, programs, and high-risk areas.
- f. Maximize the use of all available audit resources.

2. The audit plan should be used as a planning and scheduling tool and as a notice to management of the audits planned in their areas of responsibility. The plan should be flexible and should be adjusted, as necessary, to keep it current and to apprise management officials of audit scheduling changes affecting their organizations.

CHAPTER 4

Coordinating Audit Activities

A. Purpose

This chapter prescribes policy and suggests procedures for coordinating audit activities.

B. Policy

1. The Inspector General Act of 1978, as amended, (reference a.), directs the Inspector General, DoD, to give particular regard to the activities of the internal audit, inspection, and investigative units of the Military Departments with a view toward avoiding duplication and ensuring effective coordination and cooperation.

2. The DoD internal audit organizations should coordinate and cooperate with each other and with other DoD investigative, inspection, and management review groups to ensure effective use of audit resources, preclude unnecessary duplication or overlap of review efforts, and permit efficient oversight of DoD programs and operations. The DoD internal audit organizations should also coordinate and cooperate with the General Accounting Office (GAO) and other Federal and non-Federal audit organizations where there is a common interest in the programs subject to audit. If an internal audit includes the procurement function, the Defense Contract Audit Agency (DCAA) should be apprised of the effort. Coordination should begin as early in the audit planning process as practical.

C. Responsibilities

Coordination responsibilities of the DoD internal audit organizations extend beyond merely exchanging audit schedules with other review groups and providing audit reports upon request. Coordination also involves establishing close liaison and good working relationships with other DoD review groups, external review groups, and DoD managers. For the DoD central audit organizations, the coordination will include participation in Joint Audit Planning Groups as established by the IG, DoD.

D. Relationships With Management

Prior to beginning an audit, the DoD internal audit organizations should provide advance notice to appropriate managers in the activity under audit and their chain of command. The notice should include the audit scope, objectives, and other relevant information.

E. Coordination With DCAA

DoD Directive 7600.2, (reference j.) stipulates that to avoid duplication of work, the DoD internal audit organizations should coordinate all reviews involving contractor records with DCAA and with the appropriate contract administration office. In addition, whenever data must be obtained directly from contractors, the DoD audit organizations may request the services of DCAA. Contract Audit Policy Memorandum No. 1 (reference k.) should be reviewed when DCAA is not able to participate in a particular internal audit effort.

F. Coordinating Audit Information With the GAO

1. The DoD internal audit organizations are encouraged to maintain communications with the GAO because of the changing nature of GAO audit plans (congressional requests, etc.) and the potential for duplication of effort.

2. Whenever instances of potential overlap or duplication are identified, audit personnel should attempt to reach an agreement with the GAO to eliminate the potential for conflict. If mutually acceptable agreements cannot be reached, audit management should raise the issue for appropriate action with the organization's planning staff as well as the IG, DoD, Audit Followup and Technical Support Directorate.

G. Liaison With Other Review Groups

The DoD internal audit organizations should establish procedures for identifying review efforts completed, in process, or planned by other audit, investigative, and inspection review groups and consider those efforts in the planning process.

CHAPTER 5

Performing Audits

A. Purpose

This chapter provides policy and guidance on the stages of performing an audit as well as guidance for other activities associated with an audit to include access to records and relations with management. This chapter also provides guidance on conducting consulting-type services requested by management.

B. Background

Auditors perform audits primarily to help management arrive at solutions to problems and devise better ways to do business. To achieve these objectives, auditors must exercise due professional care (GAGAS 3.26) and conduct audits in a logical and methodical way that conforms to Generally Accepted Government Auditing Standards (GAGAS) (reference b.).

C. Phases of Audit

Audits generally progress through three phases: survey, field work, and reporting.

1. **Survey Phase.** The survey is a process for quickly gathering the needed information on the most significant and material areas and for identifying risks and exposures in order to decide whether the audit should continue into the field work phase. The emphasis should be on identifying the primary audit objectives and designing an audit approach that will maximize audit effectiveness. If the survey work warrants proceeding into the field work phase, a written audit program is prepared.

2. **Field Work Phase.** The field work phase is performed to collect, analyze, interpret, and document such information as necessary to accomplish the audit objectives, complete the audit program, and support the audit results.

a. Findings and recommendations should be identified as early as possible in the audit and should be discussed with officials in the organization being audited before being presented in writing. Management should be given an opportunity

to correct adverse conditions identified by the auditors, and credit should be given for the planned actions that will significantly improve operations, including any alternative actions initiated independent of the audit recommendations.

b. A draft report should normally be prepared and staffed with management for every assignment. Management should be asked to comment specifically on any potential monetary benefits or other benefits shown in the draft report. Based on management staffing, changes should be made to the report to reflect agreement on facts, clarify points that may be misinterpreted, and remove any unnecessary irritants that would preclude management's acceptance of the report. Management views on the report contents including opposing views as well as the auditors' position on management views should be incorporated into the report as appropriate.

c. An exit conference should be held with management unless management declines. This is generally the last informal opportunity to ensure accuracy of the reported information and resolve any matters still in dispute prior to release of the draft report.

3. **Reporting Phase.** In the reporting phase, a written audit report is prepared for each audit. DoD internal audit organizations should develop reporting procedures and policies covering form, distribution, timeliness, contents, and presentation.

4. **Other Activities.**

a. **Computer-Based Systems.** Auditors should obtain sufficient competent and relevant evidence that computer-processed data are valid and reliable when those data are significant to the auditors' findings. To aid in determining the validity and reliability of such data, the auditor should refer to Comptroller General of the United States publications, "Federal Information System Controls Manual," January 1999, and "Assessing the Reliability of Computer-Processed Data," April 1991, (references l. and m.).

b. **Legal and Regulatory Requirements.** Compliance with applicable requirements of laws and implementing regulations must be assessed when necessary to satisfy the audit objectives.

c. **Fraud and Illegal Acts.** Auditors will be alert to situations or transactions that could be indicate fraud or illegal acts. More specific guidance on preventing, detecting, and reporting fraud and illegal acts is in chapter 8 of this Manual.

d. **Followup.** Auditors should follow up on known findings and recommendations from previous audits that could affect the current audit objectives. The audit report should disclose the complete status of any uncorrected significant findings and recommendations and their effect on current audit objectives.

e. **Potential Benefits.** Auditors will estimate potential monetary and nonmonetary benefits of audit recommendations, and report those benefits in the audit report. Chapter 6 of this Manual provides guidance on reporting potential benefits.

D. Access to Records

According to DoD Directive 7600.2, "Audit Policies," (reference j.) auditors are entitled to all records needed to accomplish an announced audit objective if they possess the necessary security clearances. Only the head of a DoD Component may deny auditors access to the area under his or her control. In the case of OIG, DoD, auditors, reference a. stipulates that only the Secretary of Defense can take such action. An explanation of the procedures to be followed in case of a denial are found in DoD Directive 7600.2, (reference j.) and DoD Instruction 7050.3 (reference n.). Procedures for obtaining information from the Joint Chiefs of Staff are set forth in the Memorandum of Understanding Between the Organization of the Joint Chiefs of Staff and the Inspector General, Department of Defense, "To Establish Procedures for Processing Requests for JCS Papers/Planning Information," (reference o.).

E. Relations with Management

1. **Notifying Management.** Management should be given reasonable advance notification of an audit unless the work involves cash counts or other similar audits where surprise is essential to accomplish the audit objectives. The advance notification, which may be in either, electronic or written form, should include the purpose and scope of the audit and the time period during which the audit is to be performed.

2. **Management Conferences.** The first meeting with management is usually the entrance conference prior to beginning the audit. Also, periodic discussions should be held with management to convey such things as progressing from one audit phase to another, when work is curtailed or expanded, or to inform management of significant events of the audit. An exit conference should be held with management as well unless they decline.

F. Management Requests for Consulting-Type Services

When management requests consulting-type services from a DoD internal audit organization, the results of the effort usually have limited distribution and are not subject to the normal followup requirements. The procedures that follow should generally be used in responding to these requests. Also, the American Institute of

Certified Public Accountants Statement on Standards for Consulting Services 1 Consulting Services: Definitions and Standards, October 1991 should be considered when conducting this type of work.

1. **Acceptance of Requests.** The nature of requests for consulting-type services may preclude their inclusion in the audit plan and therefore their inclusion in the plan is subject to the discretion of the audit organization. Such requests should meet the following criteria to be accepted.

a. Requests are documented and are for services that require independent opinions, professional capability, and resources not available from the manager's staff or from other assistance or investigative groups responsible for providing special services to the manager.

b. Requested services do not duplicate an audit or a portion of an audit already in process or scheduled during the current fiscal year or in the near future and do not involve circumstances where fraud, criminal conduct, or violation of law is known or suspected.

2. **Performance of Consulting-Type Services.** The head of each DoD internal audit organization should establish policies and procedures to conduct consulting-type services as stated in GAGAS 2.11. However, the head of the audit organization shall reserve the right to issue an audit report requiring normal followup and distribution if recommendations are to be made to officials other than the requesting official, or in other situations if considered appropriate. If fraud or illegal activity is identified, procedures identified in chapter 8 of this Manual apply.

CHAPTER 6

Potential Benefits

A. Purpose

This chapter provides guidance for identifying, classifying, and reporting potential benefits.

B. Background

1. Information on potential monetary and nonmonetary benefits is used in various ways. Potential benefit estimates give the reader a perspective in judging the importance of the condition and the recommended corrective action. Information on benefits achieved because of audits should be considered in evaluating the effectiveness of the DoD central internal audit organizations.

2. The Inspector General (IG) DoD, includes information on potential monetary benefits identified by the DoD central internal audit organization and Defense Contract Audit Agency auditors in semiannual reports to the Congress. The IG DoD, is also required to report to the Congress on the potential monetary benefits that have been agreed to by management, as well as those with which management has disagreed and actual amounts realized through management's action.

C. Types of Benefits

1. **Potential Monetary Benefits.** Many of the benefits arising from internal audits can be expressed in monetary terms. For semiannual reporting purposes, potential monetary benefits are classified as "Funds Put to Better Use" or as "Questioned Cost," and are defined in the Inspector General Act of 1978 (reference a.).

2. **Nonmonetary Benefits.** Many audits result in valuable benefits to the Government but cannot be expressed readily in monetary terms. Such benefits may stem from recommendations relating to matters such as operational readiness, personnel safety, data accuracy, compliance with laws and regulations, or streamlining of organizations or processes.

3. **Areas of Special Consideration.** Some areas present unique problems on appropriateness and classification of benefits. Those areas are discussed below:

a. **Personnel.** Recommendations regarding military and civilian personnel authorizations and assignments usually do not affect end strength. Those

recommendations generally are designed to remedy overstaffing at a particular location. Generally, those spaces are transferred to other activities or organizations that were understaffed because of personnel or funding limitations. Although those types of actions will not result in a reduction of overall personnel strength for the component, the benefits still should be reported as funds put to better use.

b. **Materiel Excesses.** Reports often contain recommendations to redistribute excess materiel to satisfy operating requirements or to fill inventory shortages. The determination of benefits will depend on what effect the redistribution action would have on current and future acquisition and holding costs.

(1) **Supplies.** Distribution of supplies to activities having a current need can result in monetary benefits through canceling requisitions or planned procurements. Distribution avoids variable inventory holding costs including storage and obsolescence. It is not necessary to identify and cancel outstanding requisitions to report potential benefits, but the supplies should be demand-supported, have a high turnover rate, and be reordered periodically. The auditors should include information in their working papers which specifically shows how the amount of potential monetary benefit was determined.

(2) **Equipment.** Most equipment items are centrally funded, procured, and managed at the Department or agency level. When procurement is based on the total Department or agency asset position, a redistribution of local excess that does not affect the net requirements or procurement decisions does not result in a potential monetary benefit. If the excess items were also unrecorded assets (not on an accountable record), the recording of the asset could result in funds being put to better use if it would increase the total recorded asset position and, thus, affect procurement decisions. Only identification of excess equipment that affects a procurement, specific, or general budget line item may be reported as a potential monetary benefit.

c. If a recommendation is made to defer the procurement of supplies or an item of equipment, the deferment should be for at least 2 years if the benefits (funds put to better use) are to be identified in an audit report.

4. **Military Construction Projects and Multi-Year Contracts.** Funds for military construction projects are approved by the Congress on a project line-item basis. Certain economies may be achieved through the use of multi-year contracts. Both situations may require special consideration when auditors determine that such projects or contracts should be cancelled or reduced in scope. In either case, a benefit in excess of the amount currently funded may be identified in the audit report if the auditors can show that it was likely that funding would have been approved had the auditors not identified the situation in the finding. The amount of the benefit identified in the audit report should not exceed the amount planned for the next 6 years.

5. **Nonappropriated Funds.** Benefits identified to nonappropriated funds, including the military exchange organizations, should be reported following the same criteria as for appropriated funds.

6. **Benefits Involving Other Activities.** Audit work at one DoD Department or agency may result in benefits at another DoD Department or agency. Those types of benefits must result in a net benefit to the DoD and may be reported as part of the audit that produced them using the criteria presented in this chapter. Collections or reimbursements from other Federal organizations to a DoD Component are reportable if they result in a net benefit from a DoD perspective. Intra-Defense collections or reimbursements which result in "wash" transactions within the DoD are not reportable.

7. **Statistical Sampling.** The use of statistical sampling to project potential monetary benefits is encouraged and is limited to the sampled universe.

8. **Deobligation of Funds.** Auditors may identify unliquidated obligations that may be deobligated. So long as funds are not canceled, they can be reported and are considered funds put to better use. Deobligation of canceled funds cannot be reported as potential monetary benefits.

9. **Independent Audit Verification.** The validity of potential monetary benefits must be ascertained independently by the auditors before the benefits can formally be attributed to the audit; that is, the auditors must not accept an estimated amount provided by management without reviewing the support for that estimate.

D. Computation of Monetary Benefits

Benefits from internal audits should be computed whenever the benefits are due directly to the audit recommendations; that is, the benefits reported can be expected to result once management completes recommended actions. Benefits should be computed in a reasonable manner and should consider all offset costs.

1. Many recommendations produce only a one-time benefit. Examples would be reduction in requisitioning objectives, return of funds erroneously paid out, or reductions of materiel requirements. There are instances when a one-time management action will result in benefits affecting several identifiable fiscal years, such as canceling plans to acquire major items of equipment over a number of years or leasing rather than purchasing computer equipment. Certain recommendations result in recurring annual benefits that continue for an indefinite period of time. Examples would be reductions in payrolls and other operating expenses.

2. Amounts reported for both one-time and annual benefits may be based on budget projections. For both types of benefits, the amounts that may be reported are

limited to a 6-year period covered by the most current Program Objective Memorandum, DoD Program Decision Memorandum, or Approved Future Years Defense Program.

E. Reporting Benefits

1. Audit reports should indicate the amount of monetary or nonmonetary benefits that will accrue if the recommendations are implemented. The report should contain a complete description of each monetary benefit, either in the findings or as an attachment, to ensure that the reader understands the nature of the benefit and the basis upon which it was determined. The description of each monetary benefit could also be a separate document as long as it is available to management and is referred to in the report. The appropriation account and year of funds affected should be determined whenever possible and included in the monetary benefits description to aid management in taking corrective measures.

2. Auditors should reach agreement with management on the reasonableness of potential benefits cited in the report and document the agreement in writing. Management is required by DoD Directive 7650.3 (reference p.) to comment on the reasonableness of auditor-estimated benefits as part of its review of draft reports. If management does not comment when responding to the draft report, management must again be asked to comment on the potential benefits in a response to the final report and before the report is sent to the audit followup activity. If management nonconcur with the auditors' estimate of the potential benefits, the amount may still be reported if, in the auditors' judgment, the estimate is valid and management's comments have been carefully considered. The matter must be resolved through the procedures specified in DoD Directive 7650.3, (reference p.).

3. During the audit and before the audit report is issued, discussions with management may bring about improved operations that result in potential monetary benefits. When this occurs, a written record of the discussions should be placed in the working papers if the auditors plan to report that monetary benefits were realized because of their audit work. A record of the discussions that resulted in the potential benefits should also be included in the audit report to show that management took corrective action as a result of the audit.

4. Data collection instructions issued by the IG, DoD, include guidance for reporting statistical data on potential monetary benefits for the Semiannual Report to the Congress. The guidance is contained in DoD Directive 7650.3, (reference p.), and DoD Instruction 7750.6, (reference q.).

CHAPTER 7

Quality Control Program

A. Purpose

This chapter provides guidance for establishing a quality control program according to Generally Accepted Government Auditing Standards (GAGAS) (reference b.), and describes the elements of such a program in DoD internal audit organizations.

B. Background

Each DoD internal audit organization must establish and maintain a viable and effective quality control program to provide reasonable assurance that DoD auditors comply with applicable auditing standards and DoD audit policies. Each organization's quality control program must incorporate the elements of internal quality control reviews and external quality control reviews as described in GAGAS 3.31.

C. Internal Quality Control Reviews

Internal quality control reviews are independent reviews of selected audits, organizational functions, or internal processes conducted within the audit organization. During a review, the adequacy and effectiveness of the audit organization's policies and procedures are evaluated to determine whether the audit work meets applicable auditing standards and DoD auditing policies.

1. The nature and extent of an organization's internal quality control system varies depending on its size, the degree of independence allowed its personnel and its audit offices, the nature of its work, its organizational structure, and cost-benefit considerations.

2. Each DoD internal audit organization should develop and issue formal policies establishing an internal quality control review program consistent with this chapter. Formal policies should prescribe responsibilities and procedures for planning and performing internal quality control reviews and reporting the results of reviews.

3. Annual and long-range plans should be developed and published for internal quality control reviews. The reviews should emphasize matters relating to the accomplishment of audit projects.

4. Compliance with GAGAS is the basis for how audit work is judged by external quality control review teams. Accordingly, those standards and DoD auditing policies should form the basis for planning internal quality control reviews.

5. Procedures and guidance for performing external quality control reviews have been developed by the President's Council on Integrity and Efficiency (PCIE), "Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General" (reference r.). Internal quality control reviews can be performed using guidance adopted from that guide.

6. Review objectives should be established, and conditions found during the internal quality control review should be documented. All working papers and reports of reviews should be retained for 3 years for use by external quality control review teams.

D. External Quality Control Reviews

Within the DoD, internal audit organizations are responsible for obtaining a triennial external quality control review. For quality control reviews of DoD component audit organizations, the Assistant Inspector General for Auditing will provide technical advice and assistance, as required, and will act as the resolution official.

1. The objectives of the external quality control reviews are to ensure that DoD internal audit organizations comply with GAGAS and DoD auditing policies.

2. Reviews should be conducted according to applicable auditing standards and quality control review guidelines as well as the PCIE guide (reference r.).

3. Team members should be selected based on the requirements of a particular review. Functional experts may augment the teams in certain specialized or technical areas. Because some organizations may be using automated working papers, review team members need to be capable of reviewing such working papers. The staff members nominated for the review team should not have been associated in the past 2 years with the organization subject to review.

4. A written report will be prepared and issued to the head of the audit organization on the results of each external quality control review.

a. The report should specifically address each review objective and express an opinion, as appropriate, as to the audit organization's compliance with GAGAS and DoD auditing policies. In addition, the report should recommend corrective actions when appropriate; include comments from the organization reviewed, followed by an evaluation of the comments; and establish target dates for implementation. Recommendations should be tracked by the reviewing organization

until implemented. A follow up review by the reviewing organization to determine whether corrective actions were adequate may be appropriate if significant deficiencies are identified. The results of any followup reviews should be furnished to the OAIG-AUD. Working papers and reports of reviews should be retained by the reviewing organization until the next external quality control review.

b. The reviewed organization will provide the OAIG-AUD with a copy of the report, within 15 days of its issuance, as well as a statement and documentation that the agreed-upon corrective actions have been or will be taken. In the event of disputed recommendations that cannot be resolved by the reviewing and reviewed organizations, the reviewed organization will bring the matter to the attention of the Assistant Inspector General for Auditing, who shall adjudicate the issues.

CHAPTER 8

Preventing, Detecting, and Reporting Fraud and Illegal Acts

A. Purpose

This chapter establishes guidance for auditing areas susceptible to fraud and illegal acts and alerting investigators that such acts may have occurred.

B. Definitions

1. **Fraud.** Fraud is an action that violates a fraud-related statute of the United States Code. The term includes Government theft/embezzlement, bribery, gratuities, conflicts of interest, and violations of antitrust laws, as well as false statements and false claims, etc. in such areas as pay and allowances, procurement, contract performance, and nonappropriated funds.

2. **Illegal Act.** An illegal act is a type of noncompliance in which the source of the requirement not followed or the prohibition violated is a statute or implementing regulation. If incarceration, as well as other penalties, is available if the Government obtains a guilty verdict, the act is considered a criminal act. If penalties do not include incarceration but may include monetary payments and corrective actions, the act is considered a civil act.

C. Guidance

The guidance that follows includes applicable standards from Generally Accepted Government Auditing Standards (GAGAS).

1. The DoD internal audit organizations may establish a fraud monitor at the headquarters level for fraud referrals and other fraud-related actions. A fraud monitor maintains liaison with the applicable investigative organizations regarding the status of all referrals. An acceptable alternative is to perform this function through functional areas or other procedures that management considers best for their organization.

2. During every audit, as appropriate, a review and evaluation should be made of the management control system applicable to the organization, program, activity, or

function under audit. Management's responsibilities are in DoD Directive 5010.38, Management Control Program (reference s.). The applicable standards are at GAGAS 6.39.

3. Where an auditor's work includes an assessment of compliance with laws and regulations, it should be designed to provide reasonable assurance of detecting fraud or illegal acts that could significantly affect the audit objectives. The applicable standard is at GAGAS 6.26.

4. When the review or the extended audit steps and procedures indicate that fraud or other criminal acts may have occurred, the auditor should refer the matter to the appropriate DoD investigative organization as required by DoD Directive 7600.2 (reference j.). Once a referral is made, the matter should be handled in accordance with DoD Instruction 5505.2, "Criminal Investigations of Fraud Offenses," (reference t.). Following notification of the investigators, the auditor should notify the top official of the entity under audit unless advised otherwise by investigators or it is obviously inappropriate.

5. The method of reporting the audit results will vary depending upon individual circumstances. Audit matters dealing with fraud or irregularities should be covered in a separate written audit report if this would facilitate the timely issuance of an overall report on other aspects of the audit. The opinion of legal counsel should be obtained to determine the appropriate reporting method.

6. Appropriate audit support of criminal investigations is authorized under DoD Directive 7600.2 (reference j.) and is encouraged to the greatest extent possible within legal limitations and availability of resources. Also, DoD internal audit organizations should work with their criminal investigative counterpart organizations to exchange information on situations discovered during audits where, although no fraud may be suspected, weaknesses in controls and procedures could lead to fraud.

D. Fraud Indicators

1. Fraud encompasses the entire array of illegal acts and irregularities and is characterized by intentional deception or manipulation with adverse effects.

2. The key to preventing and detecting fraud and illegal acts is recognizing conditions that allow these practices to go undetected. The auditor is responsible for recognizing fraud indicators. Several sources are available for information on fraud and indicators of fraud including:

a. American Institute of Certified Public Accountants AU Sections, 230, Due Professional Care in the Performance of Work; 316, Consideration of Fraud in a Financial Statement Audit; 317, Illegal Acts by Clients; and 319, Consideration of Internal Control in a Financial Statement Audit.

b. Institute of Internal Auditors Statement on Internal Auditing Standards No. 3, "Deterrence, Detection, Investigation, and Reporting of Fraud."

c. The Air Force Audit Agency also has issued a handbook, Audit Agency Handbook 65-109, "Fraud and Waste Indicators," December 1997.

d. Two private associations have developed health care fraud indicators. They both have internet sites which includes their lists of indicators. The National Health Care Anti-Fraud Association has a site at <http://www.nhcaa.org>. The Workgroup for Electronic Data Interchange site is <http://www.wedi.org/htdocs/resource/report/file29.htm>.

E. Training

Because fraud is a continuing concern to the DoD, the DoD internal audit organizations must provide appropriate auditor training. Internal auditors must have adequate skills in the areas of detecting, preventing, and reporting fraud and illegal acts.

F. Relations With DoD Criminal Investigative Organizations

1. When indications of potential fraud are identified, the audit organization should formally refer the matter to the appropriate investigative organization. Joint Policy Memorandum Number 2 (reference u.) requires DoD criminal investigative organizations to provide periodic status reports on referrals made from auditors.

2. The DoD internal audit organizations should respond timely when investigative organizations request audit assistance in performing formal investigations. Also, internal audit organizations are urged to participate with investigative organizations in joint reviews of programs and operations highly susceptible to fraudulent activities.

3. DoD internal audit organizations are encouraged to assist criminal investigative organizations by providing information they may come across during their audits (information referrals) that could alert investigators to weaknesses in internal controls and to procedures that could create conditions conducive to fraud, even though no fraud may actually be suspected.

4. The DoD internal audit organizations should develop guidelines for audit support of fraud investigations and coordination on fraud referrals as appropriate.

G. Additional Guidance

The General Accounting Office pamphlet, "Assessing Compliance with Applicable Laws and Regulations," December 1989 (reference v.) provides additional

guidelines for implementing GAGAS related to fraud and illegal acts. The guide was prepared to help the GAO staff implement the strengthened requirement for detecting noncompliance. The provisions of the guide are equally applicable to the work of DoD internal auditors in evaluating noncompliance and designing audit steps to detect instances of fraud and illegal acts.

CHAPTER 9

Working Papers

A. Purpose

This chapter provides guidance for the preparation, review, and retention of audit working papers.

B. Requirement for Working Papers

Working papers are the connecting link between field work and the audit report. They serve as the systematic record of work performed and encompass all documents, papers, and electronic media prepared or collected by the auditor that contain the evidence to support the auditor's findings, opinions, conclusions, and judgments. The evidence in the working papers must be adequate to support the findings and thus, the audit report. The preparation and review of working papers must conform to Generally Accepted Government Auditing Standards (GAGAS) (reference b.).

C. Working Paper Planning, Preparing, and Arranging

Well-planned and organized working papers are necessary to achieve professional quality audits. Adequate planning is the key to the development and preparation of good working papers. Before preparing any working papers, the auditor should have a clear concept of the primary purpose of the working paper and any subordinate purposes. The following guidance provides key points that must be considered in working paper planning, preparing, and arranging.

1. Planning.

a. Working papers should be designed to provide data required for the audit areas and should not include data that are or will be available from another source.

b. The overall plan for each audit should include working paper instructions that cover file structure, indexing and cross-referencing procedures, and provisions for reviews.

c. Only relevant working papers prepared during an audit should be retained and included in the files.

d. Working papers should document supervisory guidance, review, and comments. If auditing in a particular area is discontinued prematurely, the reasons should be recorded in the working papers. If a finding is not part of the final report, the reasons for the deletion should be documented in the working papers to enable reviewers to track the disposition of tentative audit findings.

2. Preparing.

a. Working papers should be complete and accurate to provide proper support for findings, conclusions, and judgments, and to demonstrate the nature and scope of the auditor's examination.

b. Working papers should be understandable to a knowledgeable reader. Detailed supplementary oral explanations should not be needed.

c. Working papers should be legible and neatly prepared.

d. The information in working papers should be restricted to matters that are materially important and relevant to the objectives of the assignment.

3. Arranging.

a. There are two general classes of working paper files: permanent and current. Permanent files should contain materials of a continuing nature that would be useful in future audits. Background data, prior audit, and inspection reports are examples of what should be included in this file.

b. Current files should be arranged according to the file structure developed for the audit. For large audits, the current files may consist of several distinct segments: one file for each segment examined, others for general segments pertaining to the audit as a whole, and one for audit administrative matters. As a minimum, current files should contain the table of contents, review sheets, summary of the audit area, cross-referenced audit program, and analyses, schedules, exhibits, and other supporting documentation.

D. Principles of Documentation

1. Working papers should be sufficiently documented so as to be understood by readers having some knowledge of the subject and to lead a reviewer to the same conclusion the auditor reached without requiring supplementary oral explanations. Working paper information should be clear and complete, yet concise. Adequate working papers also permit another auditor to pick up the examination at any point (for example, at the completion of the survey phase) and carry it to its conclusion.

2. As a general rule, all working papers or groups of closely related working papers should contain certain basic information. The exception might be for example, correspondence files, administrative files, etc., where it may be more appropriate to annotate the working paper file cover or the first page of the working papers with the information required here. The exception option is left to the discretion of the audit manager or auditor-in-charge.

3. The requirements for documentation to include on most working papers are:

- the subject or title of the working paper;
- the activity being audited and the function being examined, the name of the preparer and the reviewer;
- the date prepared and reviewed;
- explanation of any signs, symbols, or acronyms used; and,
- the working paper index number for filing and reference.

Other information is also essential to understand the individual working papers supporting the audit including purpose, source, scope and methodology, criteria, and conclusions.

E. Working Paper Summaries

A narrative summary prepared by the auditor for each audit area should be included in the working papers whether or not deficiencies are found. Summaries should support the development of audit findings and spell out deficiencies surrounding facts, effects, causes, and recommended actions.

F. Indexing

The indexing system should be simple but capable of expansion and should be tailored to the overall focus of the audit, the selection of areas for emphasis, and the planned sequence of the audit. Working papers should be indexed concurrent with or as soon after their preparation as possible.

G. Cross-Referencing

The cross-referencing of working papers ensures that all pertinent facts and conclusions have been considered and that support exists for the auditor's position. Corrections made to supporting information should also be cross-referenced to other

affected sections of the working papers. A copy of the draft audit report should be cross-referenced. If any new information is added to the final audit report as a result of the audit reply process, that information should be cross-referenced as well.

H. Automated Working Papers

Electronic technology has provided new methods for producing, reviewing, and storing working papers. However, the standards for what must be included in working papers remain unchanged. Automated working papers must be retrievable and provide data integrity and security that at least equal that of paper documents.

I. Working Paper Review

1. Working papers should be periodically reviewed to ensure that they comply with GAGAS. Frequent reviews give the reviewer the opportunity to appraise working paper quality, the relationship of the audit work to the objectives, and the completeness of the auditor's examination. It also permits the reviewer to assess the auditor's conclusions, determine what additional steps are necessary, and decide whether to revise the audit coverage.

2. The reviewer should prepare written notes on the results of the review and the auditor should revise working papers and perform additional work, if needed. The reviewer and the auditor should reach a mutual agreement on the disposition of comments and further actions required. The process should be documented.

3. To ensure the accuracy of the facts and figures and their support in the audit report, a cross-referenced copy of the report should be reviewed by an independent reviewer (referencer). The referencer should be a senior auditor not involved in the assignment under review. In addition, if possible, the referencer should not be under the direct supervision of the supervisor responsible for the assignment being reviewed. The review should be documented in the working papers and should contain the reviewer's comments and how they were resolved.

J. Retaining and Safeguarding Working Paper Files

1. Working papers should be retained for a minimum of 2 years after issuance of the final audit report. There may be certain factors, such as congressional or other investigations or unsettled issues that would necessitate holding working papers for longer periods. Audit material that is no longer needed may be destroyed and should not be sent to records holding centers.

2. Working paper files should be adequately safeguarded, and prescribed security procedures should be followed for classified and For Official Use Only material. Access to working paper files should be restricted to authorized personnel.

CHAPTER 10

Contracting for Audit Services

A. Purpose

This chapter provides policy and delineates responsibilities for the engagement and oversight of non-Federal auditors when they perform audit services on DoD projects or entities.

B. Policy

1. DoD Directive 7600.2 (reference j.) provides policy on contracting for audit services. The Directive states that DoD Components shall not contract for audit services unless expertise required to perform the audit is not available within the DoD audit organization or temporary audit assistance is required to meet audit reporting requirements mandated by law or DoD regulation. Audits of nonappropriated funds and related activities are exceptions to this policy.

2. DoD Directive 7600.2 is supplemented by a March 28, 1996, Inspector General (IG), DoD, Interim Policy Guidance Memorandum, Subject: Contracting for Audit Services (reference w.). The memorandum requires that all solicitations for procuring audits from outside sources other than for audits of nonappropriated fund activities, be submitted to the Assistant Inspector General for Auditing (AIG-AUD) for review prior to release to prospective bidders. This review will ensure the appropriate use of non-Federal auditors and compliance with applicable auditing standards. Additionally, a June 26, 1998 IG, DoD, Interim Policy Memorandum, same subject, (reference x.) states that solicitations for financial statement audits will only be considered if the entity's last two financial statements received a favorable audit opinion. Exceptions to this policy will be considered for audits of the financial statements of organizations and funds that are not designated by the Office of Management and Budget as reporting entities; however, the requirement for prior approval by the AIG-AUD is not changed.

3. The policies and requirements for the acquisition by DoD components of audit services by non-Federal auditors, are also described in Subpart 237.2, of the DoD Supplement to the Federal Acquisition Regulation (FAR) (reference y.). The subpart delineates general policies, requesting activity responsibilities, and compliance with auditing standards.

4. Non-Federal auditors who perform work for DoD Components are subject to General Accepted Government Auditing Standards (GAGAS) (reference b.) and are

required to be licensed or to work for a firm that is licensed in the state or other political jurisdiction where they operate their professional practice.

C. Reviewing Solicitations For Non-Federal Audit Services

1. Unless the AIG-AUD has agreed to an alternative procedure, the cognizant component's audit organization will provide the solicitation package to the AIG-AUD for review prior to its release to prospective bidders. The solicitation package normally includes the following elements: administrative information, work and reporting requirements, time requirements, proposal information, and contractual information. The AIG-AUD will review the proposed contract to determine whether it contains provisions that require the contractor to do the following.

a. Comply with GAGAS.

b. Provide a statement prior to award of the contract that the firm is not currently doing work for the component that would impair its independence.

c. Unless the AIG-AUD has agreed to an alternative procedure, allow Component's internal audit organization to control the contracting and administration process, determine whether deliverables are sufficient, and to review and make copies of working papers, including draft reports, during and after contract performance.

d. Explain audit procedures, working papers, and findings until all findings or disputes are resolved.

e. Refer instances of suspected fraud to appropriate DoD officials.

f. Unless the AIG-AUD has agreed to an alternative procedure, provide the final audit report to the head of the DoD Component's internal audit organization, not directly to a management component.

g. Preserve working papers for at least 3 years following the audit report date and make them available upon request to DoD procurement officials, the DoD internal audit organization, and the OIG, DoD.

2. The absence of any of the above provisions in the contract should be brought to the attention of the contracting officer prior to a solicitation action.

D. Providing Technical Assistance

The DoD Component's internal audit organization should furnish technical advice to the contractor as requested. The DoD internal audit organization should ensure that the contract requirements to provide technical assistance to the non-Federal auditor do not constitute management of the work. The internal audit organization must

maintain its independence when providing technical assistance because it is also responsible for monitoring and reviewing the work for acceptability.

E. Monitoring Performance

The DoD Component's internal audit organization should develop appropriate guidelines for their staff to monitor contract performance and provide input to the contracting officer for contractor interim and final performance reporting. Contract performance should be monitored as needed and as requested by the contracting officer. When warranted, the monitoring may result in a review of the audit plans and working papers. Any adverse conditions found should be reported to the contracting officer and the users of the services. In selecting contracts to monitor, primary considerations should be given to the size and audit history of the activity or fund being audited and to the sensitivity of the subject and its susceptibility to fraud, abuse, or mismanagement.

F. Performing Acceptance Reviews

Unless the AIG-AUD has approved an alternative procedure, the DoD Component's internal audit organization should perform acceptance reviews of completed audit work before final contract payment is made. This review, as a minimum, should consist of a desk review of the audit report or other final written product required by the contract. The desk review should determine whether the non-Federal auditors have complied with the reporting requirements of GAGAS, (reference b.) and the statement of work. When the tests indicate that non-Federal auditors are not in compliance, the internal audit organization should inform the non-Federal auditors, the contracting officer, and the requesters of the audit services.

G. Debarments, Suspensions, and Referrals

1. There may be instances of substandard work by the non-Federal auditor that warrant referral for sanctions by the appropriate state licensing authorities or suspension and debarment by the contracting authority. A referral would be appropriate when work has significant inadequacies that make the audit so pervasively deficient that users cannot rely on it. Criteria on what constitutes a referral condition to state licensing authorities and the procedures to be followed in making a referral are set forth in the President's Council on Integrity and Efficiency Position Statement No. 4 (reference z.). Procedures to be followed by DoD officials for debarment or suspension are outlined in Subpart 9.4 of the Federal Acquisition Regulation (FAR) (reference aa.) and in Subpart 209.4 of the DoD Supplement to the FAR (reference y.). The Regulation provides guidance on cause for debarments or suspension, procedures to be followed in investigation and referral for debarment and suspension actions, period of debarment and suspension, reporting requirements relative to debarment and suspension, and identification of debarment and suspending officials.

2. The AIG-AUD is the only official authorized to make referrals for sanctions by appropriate licensing authorities. The DoD central internal audit organizations should take the steps described in reference z. to resolve discrepancies with the non-Federal auditor prior to proposing a referral. The appropriate documentation and a memorandum with the reason for the proposed referral action will be forwarded to the AIG-AUD if circumstances justify a referral.