DEPARTMENT OF THE ARMY
U.S. ARMY AUDIT AGENCY
OFFICE OF THE DEPUTY AUDITOR GENERAL
POLICY AND OPERATIONS MANAGEMENT
3101 PARK CENTER DRIVE
ALEXANDRIA, VA 22302-1596

SAAG-PMZ

12 July 2005

MEMORANDUM FOR Mr. Jonathan Kleinwaks, Director Policy and Oversight, Naval Audit Service, 1006 Beatty Place SE, Washington Navy Yard, DC 20374-5000

SUBJECT: Letter of Comments on the Fiscal Year 2005 External Quality Control Peer Review of the Naval Audit Service (Project A-2005-PMZ-0243.000), Audit Report: A-2005-0227-PMZ

1. We have reviewed the system of quality control for the audit function of the Naval Audit Service in effect for the year ended 30 September 2004 and have issued our report dated 12 July 2005. Our formal report concludes that the system of quality control for the audit function of the Department of the Navy was designed in accordance with the quality standards established by the President's Council on Integrity and Efficiency. We found reasonable assurance that Naval Audit Service personnel complied with the system of quality control and conducted audits in compliance with professional auditing standards and internal policies. This letter contains observations and recommendations regarding issues that didn't warrant inclusion in the formal report.

2. The purpose of our review was to report whether the Naval Audit Service's internal quality control system was designed in accordance with the quality standards established by the President's Council on Integrity and Efficiency and was being complied with for the year reviewed to provide reasonable assurance of material compliance with professional auditing standards in the conduct of its audits. We conducted our review in conformance with standards and guidelines established by the President's Council on Integrity and Efficiency and in accordance with the Memorandum of Understanding signed in November 2004.

3. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of quality control. In the performance of most control procedures, departures can result from misunderstanding of instructions, mistakes in judgment, carelessness, or other personal factors. Projecting any evaluation of a system of quality control to future periods is subject to the risk that one or more procedures may become inadequate because of changes in conditions or because the degree of compliance with procedures may deteriorate.
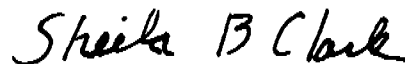
SAAG-PMZ
SUBJECT: Letter of Comments on the Fiscal Year 2005 External Quality Control
Peer Review of the Naval Audit Service (Project A-2005-PMZ-0243.000), Audit
Report: A-2005-0227-PMZ

4.   During our review, we identified reportable conditions that we considered in
determining the opinion we set forth in our report dated 30 June 2005. A reportable
condition for peer review purposes represents a deficiency in the design or operation
of the reviewed organization's internal control that could adversely affect the
organization's ability to comply with applicable auditing standards and established
auditing policies and procedures. We didn't find that any of these conditions affected
the reported results of the various audits. We identified our scope and methodology
in Enclosure 1. We identified reportable conditions in Enclosure 2. The Naval Audit
Service reports that we reviewed are listed in Enclosure 3. Your verbatim comments/
corrective actions dated 28 June 2005 are in Enclosure 4. Your memorandum dated
20 April 2005 addressing your corrective actions taken is in Enclosure 5. Your action
memo dated 21 April 2005 is in Enclosure 6. Army Audit's evaluation of Naval Audit
Service comments is in Enclosure 7.

FOR THE AUDITOR GENERAL:

Sheila B Clark

7 Encls   SHEILA CLARK
                                       Peer Review Program
                                       Director

SCOPE AND METHODOLOGY

We conducted our review from 18 January to 18 April 2005. We performed the review in accordance with the Draft President's Council on Integrity and Efficiency Guide for Conducting External Quality Control Operations of Offices of Inspector General, dated July 2004.

We tested compliance with the Naval Audit Service's system of quality control to the extent we considered appropriate. We interviewed auditors, reviewed internal audit related policies and procedures, and applied checklists based on the President's Council on Integrity and Efficiency Guide for conducting external quality control reviews. These tests included a review of 7 performance audits, 1 quality assurance review, and 1 contractor-conducted audit from a sample of 44 audit/quality control review reports issued from 1 April to 30 September 2004.

During the review Naval Audit Service informed us that audit work would no longer be contracted out. The decision was made that contracted audit work would be done in-house. This occurred between 2003 and 2004.

We visited the Headquarters, Naval Audit Service located at the Washington Navy Yard. The audits covered work performed by Naval Audit Service offices at the Washington Navy Yard, Norfolk, and San Diego.

OBSERVATION A: QUALITY CONTROL

Audit teams sometimes didn't comply with the Naval Audit Service's quality control requirements established to provide reasonable assurance that audits are conducted in accordance with internal policies and procedures and audit standards. The Naval Audit Service Handbook identifies quality control requirements for the audit process.

We found deficiencies in some areas. While we didn't find that any of these deficiencies materially affected the Navy's audit results, we believe that the Naval Audit Service's supervisors could improve how they are ensuring that auditors follow government audit standards and that audit reports are fully supported.

Independence

We reviewed seven performance audits and one quality control review and tested whether prescribed policies and procedures for independence were followed. We found no indications of external or personal impairments to independence during our review; however, personal impairment statements often weren't prepared for assigned personnel and the independent referencer. Additionally, some impairment statements were not dated, not signed at the beginning of the audit, or not signed at all.

The audit organization needs to be alert for personal impairments to independence of its staff members. The Naval Audit Service Handbook requires auditors and the independent referencer to complete impairment statements when assigned to the audit. Government auditing standards require the audit organization to have an internal quality control system to help determine whether auditors have any personal impairments to independence that could affect their impartiality or the appearance of impartiality. Seventy-six Naval Audit Service personnel should have prepared personal impairment statements for the audits and quality control review that we selected.

We found that for:

- Five performance audits, 15 required personal impairment statements weren't prepared.

- A quality control review report and 2 performance audits, 23 personal impairment statements weren't dated or we couldn't determine when the statements were signed.

- One performance audit, seven impairment statements weren't timely.

Individual personal impairment statements help an audit organization determine that individuals assigned to a particular audit are free from personal impairments. Supervisors should ensure that all personnel assigned to the audit, including the independent referencer, complete and sign personal impairment statements. These completed statements should then be placed in the audit workpapers.

During the Peer Review, the Naval Audit Service initiated action to correct this deficiency by tasking the Policy and Oversight Division to review, evaluate, and consider having each auditor meet this requirement by annually signing a statement agreeing to alert the Project Manager/Audit Director/Assistant Auditor General of any personal impairments. Additionally, if annual statements aren't possible, the Naval Audit Service intends to identify controls that ensure personal impairment statements are prepared for each auditor/referencer for each audit. Details for these corrective actions are in Enclosures 4, 5 and 6.

Audit Planning

We reviewed seven performance audits and one quality control review and tested whether prescribed policies and procedures for audit planning were followed. The auditors generally adhered to the policies and procedures outlined in the Naval Audit Service Handbook in developing audit program guides. The audit program guides were adequate as to the nature and scope of work to be performed and sufficient to attain the stated audit objectives. Audit plans defined audit objectives, scope, and methodology. Audit plans also satisfied the audit requestor's need for information and provided for collection of sufficient background information, including prior audit reports and regulatory requirements. However, in four performance audits, we found no evidence that the audit program guides and changes were properly approved by the Audit Director and Assistant Auditor General in accordance with paragraph 415.2 of the Naval Audit Service Handbook.

In planning the audit, auditors should define the audit objectives, as well as the scope and methodology, to achieve those objectives. An audit program fulfills this purpose and describes the procedures and techniques that will be used to execute an audit in the most efficient and effective manner. Generally accepted government auditing standards require written audit plans to be updated, as necessary, to reflect any significant changes to the plan.

We found for:

- Three audits, no evidence that the audit program was approved by the Audit Director or the Assistant Auditor General and, for one of these audits, no evidence that changes to the audit program were properly approved.

- One audit, no evidence that the audit program was approved by the Assistant Auditor General.

Audit programs are used to ensure that program objectives are accomplished. Audit programs should be prepared for each audit and should include documentation of key decisions about the audit objectives, scope, and methodology and the auditor's basis for these decisions.

During the Peer Review, the Naval Audit Service initiated action to correct this deficiency by tasking the Policy and Oversight Division to review, evaluate, and consider the necessity for having the Assistant Auditor General approve audit programs and adding the requirement for the audit program to be approved to the referencer guidesheet, and consider adding it to the 90-day briefing requirements. Details for these corrective actions are in Enclosures 4, 5 and 6.

Audit Supervision

Audit supervision standards in the Naval Audit Service Handbook require that supervisors review and initial, as a minimum, all workpapers referenced in the audit report. Whether all workpapers should be reviewed depends on the skill level of the auditors, the complexity of the audit, and the day-to-day supervision. The handbook also requires that the project manager should prepare a workpaper review sheet (or similar automated form) to provide comments, auditor's actions on the comments, and supervisor's acceptance of the action.

The level of instruction provided to the audit staffs was appropriate considering the knowledge level and experience of the staffs. The audits also showed sufficient evidence of supervisory involvement. However, we found that for:

- Five of seven performance audits, 45 of 377 workpapers reviewed didn't have higher level supervisory initials and dates documenting workpaper reviews.

- Three of seven performance audits, 22 of 377 workpapers had reviews and subsequent corrective actions that weren't fully documented according to paragraph 510.5 of the Naval Audit Service Handbook.

- Three of seven performance audits, 13 of 377 workpapers were reviewed more than 60 days after they were prepared. In some instances, the elapsed time from workpaper completion to workpaper review and approval was several months.

- Two of seven performance audits, delegation of responsibility for review of non-critical workpapers wasn't documented.

Supervisors should follow Naval Audit Service standards to review all workpapers referenced in an audit report, document their reviews, and follow up to make sure that the auditors take any corrective actions needed. Supervisory reviews of workpapers are important to ensure well-documented audit results. This is a repeat observation from the 2002 peer review and was also identified in the internal quality control review report that we included in our scope.

During the Peer Review, the Naval Audit Service initiated action to correct this deficiency by tasking the Policy and Oversight Division to review, evaluate, and consider overall policy to determine if changes needed to be made to the existing handbook guidance pertaining to supervision and 100 percent reviews. Details for these corrective actions are in Enclosures 4, 5 and 6.

Quality Control Process for Individual Audits

The Naval Audit Service Handbook contains quality control steps and procedures to aid the organization in conducting quality audits and producing quality products. For example, paragraph 511 is dedicated to referencing. This paragraph defines referencing, denotes the agency's policy, gives the characteristics of a referencer, and defines the process the referencer should use.

Although the controls and procedures provided assurance that Naval Audit Service conducted quality audits and produced quality products, these quality control procedures sometimes weren't followed. During our review of seven performance audits and one quality control review, we determined that:

- Three of the seven performance audits didn't have the final Defense Audit Management Information System report filed in the workpapers. Paragraph 507.2b(3) of the Handbook states, "A control/summary working paper section will be organized and/or hyperlinked to a copy of the Defense Audit Management Information System Project Detail Report as of the final report publication date."

- In three of the seven performance audits, Independent Referencer reviews weren't adequately documented.

- In three of the seven performance audits, the final audit report wasn't cross-referenced or wasn't in the workpapers. Paragraph 507.2b(4) of the Handbook states, "A control/summary working paper section will be organized and/or

hyperlinked to a copy of the final audit report cross-referenced to supporting working papers."

During the Peer Review, the Naval Audit Service took action to correct this deficiency by changing policy to require full referencing (100 percent) for all audit reports. Additionally, the Policy and Oversight Division will conduct individual training with all personnel assigned to referencing for the first time. Details for these corrective actions are in Enclosures 4, 5 and 6.

Protection of Audit Documentation

Precautions should be taken to safeguard workpapers and ensure that they are accessible only by authorized persons and protected from theft or destruction. The workpapers for one of seven performance audits reviewed weren't properly marked to show that the workpapers contained sensitive data. The indexes linked to the workpapers indicated the presence of sensitive data, but the workpapers could be accessed directly without using the indexes. This occurred because the instructions in paragraph 512.2 of the Naval Audit Service Handbook that deals with personal, proprietary, and other sensitive data are primarily directed at manually prepared workpapers, not automated workpapers.

In addition, auditors didn't follow the guidance in paragraph 512.1 on how to mark workpapers that show the vulnerability of Navy programs, assets, or personnel and the guidance in paragraph 512.3 on how to handle classified workpapers. One of the audit reports we reviewed was marked – FOR OFFICIAL USE ONLY (FOUO) – however, none of the workpapers for the audit contained similar markings. For this same audit, a classified document used for support had a front and back cover marked Secret, but none of the individual pages were marked to indicate which parts contained or revealed classified data. No downgrading instructions were included with the document. Also, part of the data was extracted from the classified document and used in the audit report and workpapers, but the process used to determine the classification of the extracted data wasn't documented in the workpapers. Furthermore, the document wasn't marked with a section or workpaper number to indicate that it was part of or a source for another workpaper.

During the Peer Review, the Naval Audit Service took action to correct this deficiency by issuing guidance that delineates and reminds auditors of procedures to be followed when unmarked e-mails and documents are received via SIPRNET. Details for these corrective actions are in Enclosures 4, 5 and 6.

Professional Judgment

Generally accepted government auditing standards for professional judgment require auditors to exercise reasonable care and diligence and to observe the principles of serving the public interest and maintaining the highest degree of integrity, objectivity, and independence in applying professional judgment to all aspects of their work. If auditors state they are performing their work in accordance with generally accepted government auditing standards, they should justify any departures from the standards.

The auditors used sound judgment in deciding the extent of work and materiality in conducting tests and procedures. Also, the auditors showed sound judgment in evaluating and reporting the audit results.

However, Naval Audit Service personnel used poor judgment when they modified/added files to workpapers for five of seven performance audits after we announced the audits selected for review on 18 January 2005. Our review of the automated workpapers showed that at least 17 files from the 5 audits were modified after 18 January 2005.

During our review of modified files, we also found that one report contained files that were backdated. This condition doesn't demonstrate good ethical behavior.

We expanded our review of workpapers using the Microsoft statistics tool which showed the files modified/added between the dates the final audit reports were issued and the start of our peer review (18 January 2005). Microsoft statistics tools showed that 173 workpaper files from 6 performance audits were modified after the final report dates and before our review on 18 January 2005. We found that some of these files were new additions to the workpaper folders and modifications of existing files.

We also examined and compared previous versions of modified files and compared versions of cross-referenced drafts of reports. Additionally, we held discussions with auditors responsible for the modifications. We concluded that the audit reports were generally supported by the workpapers current at the time Naval Audit Service issued the final report. Although the reports were generally supported, modifying files after the report date could give the appearance that the report wasn't adequately supported.

Naval Audit Service contacted Microsoft to determine which of the tool bar options in Microsoft Word or Excel would prompt a user to save a document/spreadsheet without actually making any changes to the document/spreadsheet. In an e-mail to Naval Audit Service, dated 18 March 2005, Microsoft provided a list of 19 options that could cause an individual to inadvertently save a document/spreadsheet without

actually making any changes. Whenever, a document/spreadsheet is saved – regardless if changes are made or not – the file properties for that document/ spreadsheet will show it was modified. Considerable research is generally required to determine the extent of, if any, changes made. Quite often exact changes can't be determined.

During the Peer Review, the Naval Audit Service took corrective actions by establishing a Naval Audit Service Action Plan that describes actions both taken and planned by The Auditor General and Deputy Auditor General of the Navy. The Action Plan includes:

- Policy and Oversight review of documents related to backdating.

- Workpaper "lock-down" of all workpapers associated with the Peer Review.

- Implementation of a policy to make workpapers "Read Only" on the day of report publication.

- The combination of efforts by the Policy and Oversight Division, Planning and Support Division and newly designated full-time Automated Workpaper Project Manager to ensure the integrity of the automated workpaper process.

- Policy and Oversight Division and Planning and Support Division will determine if any additional internal and management controls are needed to provide maximum assurance that backdating cannot occur.

- The Auditor General and Deputy Auditor General will give an ethics brief to all headquarters and field office staff in the near future. The brief will also address the importance of issues raised during the Peer Review.

- After planned actions are completed, the Policy and Oversight Division will schedule a Quality Control Review addressing these issues.

Details for these corrective actions are in Enclosures 4, 5 and 6.

OBSERVATION B: TRAINING SYSTEM

The continuing professional education statistics in the Naval Audit Service's Defense Audit Management Information System sometimes weren't complete and accurate. (This is a repeat observation from the 2002 peer review.)

We found that the continuing professional education (CPE) data contained in the Management Information System didn't agree with training documentation provided by Naval Audit Service personnel for 28 of 97 auditors. However, only 1 of the 97 auditors couldn't document CPEs.

We didn't find that these deficiencies materially affected the Naval Audit Service's ability to comply with the CPE standard contained in the government auditing standards. But accurate records should be maintained to substantiate compliance with standards.

During the Peer Review, the Naval Audit Service provided an e-mail dated 20 April 2005 that describes corrective actions taken to implement a procedure to require all auditors to scan their training documents into a central database. The corrective action was addressed in a quality control review report number N2005-0004 dated 18 October 2004, Compliance with Auditor Competence Standard for Continuing Professional Education Requirements. Recommendation 1 addressed to the Director, HCD states, "Establish a process in which auditors provide training staff with electronic (e.g., scanned, etc.) copies of training certificates, evaluations, or attendance sheets." HCD responded to the recommendation by stating "Concur. HCD will establish and have in place by 1 March a process in which individual auditors can scan in electronic copies proof of training courses (i.e., training certificates, evaluations, or attendance sheets) into a training record database." Details for these corrective actions are in Enclosures 4, 5 and 6.

AUDIT REPORTS REVIEWED

Report Number	Report Date	Report Title
N2004-0036	12 April 2004	Military Personnel Support for Supply Administration and Operations within the Marine Corps
N2004-0037	12 April 2004	Naval Travel Card Delinquencies and Outstanding Advances
N2004-0040	15 April 2004	Department of the Navy's Strategic Information Technology Planning for Human Resources
N2004-0051	19 May 2004	AN/SPY-1D (V) Upgrade Program
N2004-0060	17 June 2004	Termination of Basic Allowance for Housing for District of Columbia and Maryland Activities
N2004-0065	19 July 2004	Internal Controls over Naval Allowance for Housing in the San Diego, CA area and Suspension of Government Debt for Navy Personnel
N2004-0071	13 August 2004	Department of The Navy Antiterrorism Risk Assessment Management Approach for Navy Region Mid-Atlantic – FOUO
N2004-0042	29 April 2004	Emergency Action Plans at Naval Criminal Investigative Service Facilities (Classified)
N2004-0069	30 July 2004	Quality Control Review of Automated Work Papers and Audit Supervision

DEPARTMENT OF THE NAVY
NAVAL AUDIT SERVICE
1006 BEATTY PLACE SE
WASHINGTON NAVY YARD, DC 20374-5005

28 Jun 2005

MEMORANDUM FOR THE AUDITOR GENERAL, ARMY AUDIT AGENCY

Subj: **Comments on Army Audit Agency Peer Review of Naval Audit Service**
(A-2005-PMZ-0243.000)

Ref: (a) Memorandum for Mr. Richard Leach, The Auditor General, Department of
the Navy - Opinion Report on the Fiscal Year 2005 External Quality Control
Peer Review of the Naval Audit Service (Project A-2005-PMZ-0243.000) of
13 June 2005

(b) Memorandum for Mr. Jonathan Kleinwaks, Director Policy and Oversight,
Naval Audit Service – Letter of Comments on the Fiscal Year 2005
External Quality Control Peer Review of the Naval Audit Service (Project
A-2005-PMZ-0243.000), Audit Report: A-2005-XXXX-PMZ (Draft)

(c) Memorandum for Director Policy and Oversight, Naval Audit Service –
Peer Review of Naval Audit Service (Project A-2005-PMZ-0243.000)
of 13 June 2005

Encl: (1) Naval Audit Service Response to AAA Letter of Comments
(2) Naval Audit Service Status of Corrective Actions Taken or Planned as a
Result of the AAA Peer Review

1. We have reviewed the Opinion Report [reference (a)] and are pleased the Army Audit
Agency (AAA) has provided us with an unqualified opinion on our system of audit
quality control for the year ended 30 September 2004.

2. In a separate Letter of Comments [reference (b)], AAA noted issues that came to their
attention that did not affect the overall opinion, but that they believe warrant
management attention. We appreciate the peer review team identifying areas that
could benefit from additional management attention. We have either taken or plan to
take actions to address many of the identified issues and, as requested, have provided
specific target dates and actions in Enclosure (2).

3. We discussed our views of issues presented in the Letter of Comments at length with
the peer review team and provided written explanatory comments. Although the peer
review team considered all of our issues, and made a number of changes, we still
have some concerns. We disagree with the presentation of some issues in the Letter
of Comments, primarily because they either lack perspective or are presented out of
context. As suggested by the peer review team, we have addressed our remaining
concerns in Enclosure (1).

Enclosure 4

VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

Subj: **Comments on Army Audit Agency Peer Review of Naval Audit Service**
   (A-2005-PMZ-0243.000)

4. We also disagree with some information included in nine of the Point Papers that AAA provided to the Department of Defense Inspector General (DoDIG). As discussed with AAA and DoDIG, we plan to provide DoDIG with detailed rebuttal comments on areas of disagreement with each point paper to ensure the official files are accurate and complete.

5. If you have any questions or would like additional information, please contact Vicki McAdams, Deputy Director of Policy and Oversight, at vicki.mcadams@navy.mil or (202) 433-5685; or me at jonathan.kleinwaks@navy.mil or (202) 433-5854.

JONATHAN KLEINWAKS
Director, Policy and Oversight

VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

Naval Audit Service Response to AAA Letter of Comments

Audit Supervision

* We agree that in some instances audit supervision and corrective actions were not always fully documented, and in some cases the delegation of responsibility for review of non-critical working papers may not have been documented. While this means our handbook was not fully complied with, the fact is that Generally Accepted Government Auditing Standards (GAGAS) were fully met and this should be noted in the Letter of Comments to provide proper context.

* We question the materiality of some of the findings included in this section. For example, the third bullet in this section of the Letter of Comments states that 13 of 377 working papers were reviewed more than 60 days after preparation. Since this represents only 3.4 percent of the working papers reviewed, we do not agree that this is a material, reportable condition. Also, there is no GAGAS elapsed day standard for timely review and approval of working papers. AAA has arbitrarily established and inappropriately used 60 days as a measure of timeliness for supervisory review. Another example of a lack of materiality is the second bullet in this section of the Letter of Comments. Here, AAA states that 22 of 377 working papers had reviews and subsequent corrective actions that were not fully documented. In our opinion, this is not material as it represents only 5.8 percent of the working papers reviewed. Also, for the fourth bullet in the Letter of Comments addressing delegation of responsibility for review of non-critical working papers, the number of working papers is not noted, making it impossible for the reader to assess materiality. The total number of working papers and the number for which delegation of responsibility was not clearly established should be added to put the issue in context.

Quality Control Process for Individual Audits

* The Letter of Comments states: "Although the controls and procedures provided assurance that Naval Audit Service conducted quality audits and produced quality products, these quality control procedures sometimes weren't followed." The Letter of Comments lacks important context for this issue. It correctly states that we did not always follow our handbook procedures pertaining to the filing of Defense Audit Management Information System (DAMIS) reports, and the cross-referencing and the filing of final reports in the working papers. However, the Letter of Comments does not note that failure to comply with these particular handbook requirements had no effect on audit or product quality, and that, in fact, these requirements are essentially administrative record-keeping issues. Furthermore, it should be noted that (1) the DAMIS reports existed (they simply weren't filed); and (2) while 3 of 7 cross-referenced final reports were not in the working papers, the cross-referenced and

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VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

referenced draft reports for these audits were included in the working papers, and the final reports did not significantly differ from these referenced drafts.

Protection of Audit Documentation

- We agree with AAA's comment that working papers for one audit containing sensitive data were not always marked in accordance with the Naval Audit Service handbook. However, the Letter of Comments should also note that the data was and is adequately safeguarded because it resides in electronic files that are only accessible to those auditors who are granted permission due to their need to know. Auditors provided access were aware of the sensitive nature of the data. This level of working paper protection fully complies with the GAGAS requirement that "Audit organizations need to adequately safeguard the audit documentation associated with any particular engagement."

- In a separate example, AAA considered a classified document forwarded to us by DON management over a classified network to be improperly marked. While we agree that management sent us an improperly marked document, to provide proper perspective and context, the Letter of Comments should also note the following:

  o We do not have classification authority and, therefore, could not add security markings to the document.

  o We took steps available to us to properly protect the document by adding "Secret" cover pages and locking the document in the safe.

Professional Judgment

- The Letter of Comments addresses files modified/added between the dates that final reports were issued and the start of the peer review. The Letter states that "modifying files after the report date could give the appearance that the report wasn't adequately supported." This statement has no basis in fact, and we strongly disagree. GAGAS states "Audit documentation should contain support for findings, conclusions, and recommendations before auditors issue their report." In every case, AAA found that our reports were supported at the time of publication, and we met that standard. There are no GAGAS, DoDIG, or Naval Audit Service handbook prohibitions to making modifications/additions to working papers that do not impact support for findings, conclusions, and recommendations after report publication. Therefore, this is not a matter of professional judgment. In fact, making such post-publication modifications/additions to working papers is a necessary business practice and is done by all three of the service audit organizations. Examples of modifications/additions we made include adding administrative and resolution documents, cross-referencing final reports, adding audit follow-up documentation, modifying indices to reflect additions, and making repairs to and additions of hyperlinks. By expressing their opinion that modifying files after the report date

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VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

could give the appearance that the report was not adequately supported, AAA is, in effect, inappropriately creating policy where none now exists and retroactively applying self-generated criteria to audits reviewed during the peer review.

- We also disagree with AAA's statement that the reports reviewed were only "generally" supported. AAA has not brought to our attention any instances of reports not being fully supported. The word "generally" improperly implies that there are aspects of the reports that are not supported.

Training System

- This section of the Letter of Comments discusses a problem with training documentation, but does not clearly explain that the Naval Audit Service had already identified and taken corrective action on the problem prior to the peer review as the result of our own internal Quality Control (QC) review. The corrective action, implemented on 1 October 2004, well before the start of the peer review, was to require auditors to scan their training documentation into a central database. That QC review report and the email implementing this corrective were provided to AAA during the peer review. In implementing the QC review recommendation to begin scanning training documents, we consciously chose to implement the new procedure from the time of the QC review forward, and not to expend resources to centrally capture training documentation from the audit staff for prior periods. The peer review team looked at training documentation for those prior periods, which preceded implementation of the new procedure. Accordingly, their review identified the same problem on which we had previously reported and initiated corrective actions as the result of our internal QC review. We made AAA aware of these facts during the peer review, and on 20 April 2005 sent the team an e-mail describing this previously implemented procedural change.

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VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

Naval Audit Service Status of Corrective Actions Taken or Planned as a Result of the AAA Peer Review

As a result of information and/or issues brought to our attention by the Army Audit Agency (AAA) peer review team, we have taken a number of significant corrective actions to improve processes and internal controls. The following actions have been taken or planned:

CORRECTIVE ACTIONS			
Issue	Description of Action	Status	Target Completion Date
1. Action Memo	An Action Memo signed by the Auditor General will be sent out in an "All-Hands" email to Naval Audit Service employees, and a copy will be forwarded to AAA. A draft copy of the action plan was provided to AAA on 31 March.	The Action Memo was signed 21 April 2005 and provided to AAA on the same date. Aspects of the [...] DRAFT 2005 [...] posted on the Naval Audit website and accessible by all employees. In addition, an all-hands memo will be issued by 31 August 2005.	31 August 2005
2. Referencing	Full referencing (100%) is now required for all audit reports. Referencing in the Washington, DC, and Norfolk areas will be conducted primarily by GS-14 Project Managers. Because of the absence of GS-14 personnel in San Diego, GS-13s may be used at that site. The Policy and Oversight Division will conduct individual training with all personnel assigned to referencing for the first time.	Policy describing the new requirements was issued on 5 April 2005. The Policy and Oversight Division continues to [...]	5 April 2005

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Enclosure 4

VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

CORRECTIVE ACTIONS			
Issue	Description of Action	Status	Target Completion Date
	Determine whether there should be a minimum final referencing requirement to address such things as: a. Whether the work papers contain a final cross-referenced report. b. Are all editors' comments included? c. Are all management responses included? d. Have all significant changes to the report since the original referencing assignment was completed been referenced? e. Has supervision been documented on all work papers?	Evaluation to begin. [illegible] expected to be completed by the completion date.	31 October 2005
3. [illegible]	New Policy and Oversight guidance requires that a fraud risk assessment be completed during the survey phase of every performance audit. This policy is effective immediately for all new audits started.	Policy [illegible]	19 April 2005
4. Classified material [illegible]	Guidance was issued on procedures to be followed when unmarked emails and documents are received via SIPRNET	Policy describing procedures to [illegible] was sent to all SIPRNET account [illegible] 2 March 2005	2 March 2005
5. Work papers	Work paper folders are now made "read only" on the date of publication. All additions to the work papers post publication must be added to a special folder called "ZZ Post Pub." Personnel assigned to the audit will have "read/write" privileges to this folder. The Information Technology staff will create the ZZ Post Pub folder when they make the other work paper folders for the audit "read only." This new procedure will ensure full visibility over any changes/additions to the work papers made after the report is published.	Policy describing this process issued on 7 April 2005. [illegible]	7 April 2005

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VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

CORRECTIVE ACTIONS			
Issue	Description of Action	Status	Target Completion Date
	Review overall policy to determine if changes need to be made to the existing handbook guidance pertaining to supervision and 100 percent reviews.	Review to begin shortly. If needed, policy to be revised by target completion date.	31 October 2005
	Explore with the Information Technology staff ways to electronically prevent future backdating of work papers.	[illegible] The first [illegible] audit team member [illegible] on one audit to use Word versions and electronic signatures and dates [illegible] working papers. The result will be discussed after that audit is complete and a decision will [illegible]	30 June 2006
6. Statistical sampling	Explore the possibility of obtaining expert statistical support as needed from Department of Defense Inspector General or an equally qualified source.	Exploration to begin shortly. A decision will be made and actions to [illegible]	30 December 2005
7. Personal impairment statements	Explore having each auditor meet this requirement by annually signing a statement agreeing to alert the Project Manager/Audit Director/AAG of any personal impairment. Alternately, if annual statements are not possible, identify controls that ensure personal impairment statements are prepared for each auditor/referencer for each audit.	Policy/legal review to begin shortly. Decided-upon action to be implemented by the target completion date.	31 October 2005
8. Audit program [illegible]	a. Consider adding to the referencer guidesheet and 90-day briefing a requirement for the audit program to be approved. b. Determine the necessity for having the AAG approve audit programs.	Review to begin shortly. If needed, policy to be revised by target completion date.	31 October 2005

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VERBATIM NAS COMMENTS/CORRECTIVE ACTIONS

ENCLOSURE 2: STATUS OF CORRECTIVE ACTIONS TAKEN OR PLANNED AS A RESULT OF THE ARMY AUDIT AGENCY PEER REVIEW

CORRECTIVE ACTIONS			
Issue	Description of Action	Status	Target Completion Date
9. Supporting	Develop guidelines for what constitutes timely supervision.	Review to begin shortly. Guidelines to be issued by target completion date.	31 October 2005
10. Town hall briefings	"Town hall" briefings to all staff are planned by the Auditor General to address peer review issues.	briefings scheduled and completed by the target completion date.	31 October 2005

CORRECTIVE ACTIONS TAKEN Dated 20 April 2005

Attachment to an email from Ms. Vicki McAdams dated April 20, 2005

CORRECTIVE ACTIONS TAKEN OR PLANNED AS A RESULT
OF ARMY AUDIT AGENCY PEER REVIEW

As a result of information and/or issues brought to our attention by the Army Audit Agency (AAA) peer review team, we have taken a number of significant corrective actions to improve processes and internal controls. The following actions have been taken or initiated:

Sensitive information was deleted by AAA pending resolution of issue.

- An action plan signed by the Auditor General addressing this issue will be sent out in an "All-Hands" email to Naval Audit Service employees, and a copy will be forwarded to AAA. A draft copy of the action plan was provided to AAA on 31 March.

- Referencing: Full referencing (100%) is now required for all audit reports. Referencing in the DC area will be limited to GS-14 Project Managers. Due to the absence of GS-14 personnel in San Diego, GS-13 may be used at that site. The Policy and Oversight Division will conduct individual training with all personnel assigned to referencing for the first time.

- Fraud Procedures: New Policy and Oversight guidance requires that a fraud risk assessment be completed during the survey phase of every performance audit. This policy is effective immediately for all new audits started.

- Classified Material Procedures: Guidance was issued which delineates and reminds auditors of procedures to be followed when unmarked emails and documents are received via SIPRNET.

- Work papers: Work paper folders are now made "read only" at the date of publication. All additions to the work papers post publication must be added to a special folder called "ZZ Post Pub." Personnel assigned to the audit will have "read/write" privileges to this folder. The Information Technology staff will create the ZZ Post Pub folder when they make the other work paper folders for the audit "read only." This new procedure will ensure full visibility over any changes/additions to the work papers made after the report is published.

In addition to the above completed/ongoing actions, the DEPAUDGEN has tasked Policy and Oversight to review, evaluate and consider a number of other issues and recommend necessary changes. The taskings include:

- Referencing: Determine whether there should be a minimum final referencing requirement to address such things as:
  a. Whether the work papers contain a final cross-referenced report.
  b. Are all editor's comments included?
  c. Are all management responses included?
  d. Have all significant changes to the report since the original referencing assignment was completed been referenced?
  e. Has supervision been documented on all work papers?

- Work Papers:
  a. Review overall policy to determine if changes need to be made to the existing handbook guidance pertaining to supervision, and 100 percent reviews.
  b. Explore with the Information Technology staff ways to electronically prevent future backdating of work papers.

- Statistical Sampling: Explore the possibility of obtaining expert statistical support as needed from DoDIG or an equally qualified source.

- Personal Impairment Statements:
  a. Explore having each auditor meet this requirement by annually signing a statement agreeing to alert the PM/AD/AAG of any personal impairment.
  b. Alternately, if annual statements are not possible, identify controls that ensure personal impairment statements are prepared for each auditor/referencer for each audit.

- Audit Programs:
  a. Determine the necessity for having the AAG approve audit programs.
  b. Add the requirement for the audit program to be approved to the referencer guidesheet, and consider adding it to the 90-day briefing requirements.

- Supervision: Develop guidelines for what constitutes timely supervision.

- "Town hall" briefings to all staff are planned by the Auditor General to address peer review issues.

Finally, with regard to CPE documentation, the Naval Audit Service was aware prior to the peer review that there were weaknesses in record keeping. The recent QC of CPE documentation made recommendations to improve record keeping practices. All auditors are now required to scan in their training documentation into a central storage database. We chose to implement this procedure from the time of the QC forward. Since the peer review universe included fiscal years 2002 and 2003, deficiencies in documentation were identified. The QC team had already identified weaknesses in this area, and corrective actions had been implemented prior to the start of the peer review. We should be given credit for being proactive in identifying deficiencies in this area and taking corrective actions.

ACTION MEMO

21 April 2005

For: Auditor General of the Navy
 Deputy Auditor General of the Navy

From: Director, Policy and Oversight

SUBJECT: APPROVAL REQUEST FOR NAVAL AUDIT SERVICE PEER REVIEW
           ACTION PLAN RE: BACKDATING OF SUPERVISORY REVIEWS,
           OTHER PEER REVIEW ISSUES, AND ETHICS

ISSUE: Senior Leadership Staff Meeting Notes from recent Auditor General staff
        meetings have referred to preliminary peer review findings, and have
        emphasized the working paper backdating issue. The Action Plan at Tab
        A has been prepared to make our plan for corrective action a matter of
        record. An initial draft of Tab A, in the form of a memo to the staff, was
        provided to the Army Audit Agency (AAA) peer review team on
        31 March 2005. There are no significant differences between the draft
        memo provided to AAA and the Action Plan now being presented for your
        approval with regard to the backdating issue. However, the action plan
        has been updated to recognize that AUDGEN and DEPAUDGEN "town
        hall" meetings will also address other peer review issues in addition to the
        backdating issue. The Action Plan at Tab A provides general background
        on peer reviews, describes the peer review finding concerning backdating,
        and details the actions NAVAUDSVC has taken to date and plans to take
        to address this.

        Sensitive information was deleted by AAA pending resolution of this
        issue.

        The Action Plan also addresses other peer review issues that have been
        brought to our attention.

RECOMMENDATIONS:
           1. Sign the Action Plan at Tab A.
           2. Discuss Action Plan specifics at the next Auditor General Staff meeting.
           3. Attach Action Plan to Senior Leadership Staff Meeting Notes, thereby
              bringing it to the attention of all NAVAUDSVC staff.

Attachments:
As stated

Naval Audit Service Peer Review Action Plan Re: Backdating of Supervisory Reviews, Other Peer Review Issues, and Ethics

Purpose

This document establishes a Naval Audit Service (NAVAUDSVC) Action Plan for addressing the 2005 Peer Review finding related to "Sensitive information deleted by AAA pending resolution of issue". The plan describes actions both taken and planned by the Auditor General and Deputy Auditor General of the Navy to address this.

Sensitive information was deleted by AAA pending resolution of issue.

Additionally, although not the primary focus of this action plan, the plan recognizes the Auditor General's and the Deputy Auditor General's intent to also address other peer review issues during "town hall" briefings of all staff.

Background

NAVAUDSVC and its sister service audit organizations [Army Audit Agency (AAA) and Air Force Audit Agency (AFAA)] are currently undergoing peer reviews. Government Auditing Standards require organizations conducting government audits and attestation engagements to undergo an external quality control review at least once every 3 years by an organization not affiliated with the organization being reviewed. The Department of Defense Inspector General (DOD-IG) is responsible for overseeing peer reviews of the three service audit organizations, and requires them to conduct peer reviews of each other. Thus, NAVAUDSVC is conducting a peer review of the AFAA, the AFAA is conducting a peer review of the AAA, and AAA is conducting a peer review of the NAVAUDSVC.

Actions Taken To Date

Peer Review Finding:

Sensitive information was deleted by AAA pending resolution of issue.

Immediate review of documents in question - Policy and Oversight conducted an immediate review of the documents questioned by AAA and concluded that AAA had a basis for its concern.

Sensitive information was deleted by AAA pending resolution of issue.

- *Working papers "locked down"* – Policy and Oversight worked with Planning and Support to secure all working papers associated with the audits being peer reviewed. The IT staff accomplished this by making all of the automated working papers associated with the peer review "read only." Once this was done, the IT staff began the process of making all automated working papers for all issued reports "read only."
- *"Read Only" to be implemented at time of report publication* – All automated working papers are now made "read only" on the day of report publication. No action is required of the audit staff to do this. The editing staff will notify the IT staff when a report is published. The IT staff will then make the working paper folders "read only" in order to preclude additions or modifications. Audit staff will be able to add additional documents to the audit working papers after the report publication, but only in a special subfolder (discussed in the following bullet). These procedures will allow us to provide future quality control review and peer review teams with assurance that documents supporting a published report were part of the working papers prior to the report publication date.

- *Other automated working paper (AWP) changes* - Policy and Oversight, Planning and Support, and the newly designated, full-time AWP Project Manager are combining efforts to assure the integrity of the AWP process. For example, the IT staff will investigate software changes that will ensure that the date of a digital signature cannot be changed. The IT staff is also creating a subfolder called "ZZ - Post Pub" to which all working papers created or modified after report publication should be added. All auditors assigned to the audit will have "modify" privileges for this folder. Other issues are being identified and addressed.
- *Auditor General staff meeting topic* - At their weekly staff meeting, the Auditor General and Deputy Auditor General informed NAVAUDSVC senior leadership about actions taken and planned, and emphasized the importance of high ethical standards. Summaries of the discussions were included in the meeting minutes, which are made available to the entire organization.

Planned Actions

Sensitive information was deleted by AAA pending resolution of issue.

- *Develop policy and procedural changes* – Policy and Oversight, along with Planning and Support, will, as needed, develop and implement policy and procedures to address shortcomings identified during our continuing evaluation.
  - *Town hall briefings* – AUDGEN and DEPAUDGEN will give an ethics brief to all headquarters and field office staff in the near future. The brief is being developed and will emphasize the importance of ethical behavior, that ethical violations are unacceptable, and that there will be serious consequences for unethical behavior. The brief will be incorporated into new employee training and incorporated into other recurring training for existing staff. Additionally, the brief will address other issues raised during the peer review that will benefit from AUDGEN and DEPAUDGEN attention. These issues will include, but not necessarily be limited to, presentations on the (1) importance of and improvements made to the referencing process; (2) the importance of and controls added to assure the timely completion and dating of impairment statements; and (3) the importance of and controls added to assure more complete reporting of CPE information by individual auditors. Additionally, during the town hall meetings, the AUDGEN and DEPAUDGEN will address the peer review lessons learned document being prepared for NAVAUDSVC-wide distribution by the Director, Policy and Oversight.

• *Quality Control Review* – After completing the evaluations and implementing the changes noted above, Policy and Oversight will schedule a Quality Control Review addressing the dating of documentation of supervision, the adequacy of controls in our automated working paper software, and the adequacy of our internal controls as they relate to this specific issue.

Richard A. Beach

Randall Exley

ARMY AUDIT AGENCY EVALUATION OF NAS COMMENTS

Audit Supervision

We used standards and guidelines established by the President's Council on Integrity and Efficiency when evaluating the Naval Audit Service's system of audit quality control to determine if the policies and procedures in place were adequate and if the Naval Audit Service complied with those policies and procedures. As stated in our Opinion Report, we issued an unqualified opinion on their system of audit quality control. An unqualified opinion means that the Naval Audit Service met GAGAS and would negate making further reference to having met GAGAS throughout the Letter of Comments.

We didn't agree with the Naval Audit Service's comments that some of the findings in this section aren't material. We used 377 workpapers reviewed as a matter of uniformity. We concluded that some improvements are needed in the area of supervision. Here are some details on our results.

- Reference the second bullet under supervision – 22 of 377 workpapers had reviews and subsequent corrective actions that weren't fully documented. The 22 workpapers referred to are from 3 audit reports: report 0037 (equated to 5 of 38 or 13%); report 0071 (equated to 5 of 22 or 23%); and report 0042 (equated to 12 of 70 or 17%).

- Reference the third bullet under supervision – 13 of 377 workpapers were reviewed more than 60 days after preparation. The 13 workpapers referred to were from 3 reports: report 0037 (equated to 8 of 71 workpapers or 11%); report 0051 (equated to 3 of 29 workpapers or 10%); and report 0036 (equated to 5 of 152 workpapers or 3%). We agree that GAGAS doesn't have an established standard for the timely review of workpapers. However, guidelines established by the President's Council on Integrity and Efficiency required us to determine whether supervisory review of workpapers were conducted in a timely manner. Absent of any specific standard for measuring timeliness and given today's business environment and the application of electronic workpapers, we initially used 30 days as our criterion. Based on previous discussions and agreements with the Naval Audit Service we changed our criterion to 60 days.

- Reference the fourth bullet under supervision – delegation of responsibility for review of non-critical working papers. Two audit reports didn't have the delegation of responsibility for review of non-critical workpapers documented. For audit report 0051, 8 of 71 workpapers or 11% were reviewed by someone other than the supervisor, and for audit report 0037, 3 of 29 workpapers or 10% were reviewed by someone other than the supervisor.

We felt compelled to address supervisory reviews in the Letter of Comments because the 2002 peer review and your internal Quality Control review identified the same condition and because we found instances of backdating reviews of workpapers.

Quality Control Process for Individual Audits

The Letter of Comments adequately puts this issue in context as it discusses the scope of what we found and the specific policy references in the handbook. Not having the final Defense Audit Management Information System report filed in the workpapers (3 of 7 performance audits), not adequately documenting Independent Referencer reviews (3 of 7 performance audits), and not having the cross-referenced final audit report in the work-papers (3 of 7 performance audits) are part of the Naval Audit Service's system of quality control. While not performing these actions didn't affect the audits or product quality, they are part of the Naval Audit Service's quality control program. Not implementing these controls increases the risk of not meeting standards or producing quality products.

Protection of Audit Documentation

We addressed the issue of protection of sensitive information because Naval Audit Service's policies and procedures in their handbook addressed protecting sensitive information only when preparing manual workpapers and not for electronic workpapers. The assertion that sensitive data is adequately safeguarded because it resides in electronic files that are only accessible to those auditors who are granted permission due to their need is a conclusion made by the Naval Audit Service. We weren't tasked to make that determination as part of the Peer Review; therefore, we can't reach the same conclusion without conducting tests.

We agree that the Naval Audit Service doesn't have classification authority. However, the Naval Audit Service does have a classified document with a front and back cover marked "Secret" on file, and data was extracted from this document and used in workpapers and an audit report. There aren't any markings within the document to indicate the classification of the information. Paragraph 512.3f(2) of the Naval Audit Handbook states, "Classified material will be physically marked in accordance with the procedures in SECNAVINST 5510.36. All classified material, including third-party proprietary information, shall be marked in a manner that leaves no doubt about: the level of classification assigned to the material, which parts contain or reveal classified information, how long the material must remain classified, and any additional measures necessary to protect the material. The SECNAV Instruction must be followed **explicitly.**"

In paragraph 512.3c, the handbook states, "Paraphrasing, restating, or summarizing classified information may or may not change the level of or remove the basis for classification. When in doubt, auditors should consult the designated security official at the audited activity, or

the office that classified the original document for a specific determination. The Naval Audit Service doesn't have original classification authority. Paragraph 618.1b provides related information."

We didn't find any documentation to show that the Naval Audit Service complied with either paragraph. During the Peer Review, the Security Officer for the Mid-Atlantic Region determined that the data the Naval Audit Service extracted from the classified document wasn't classified. We accepted the Security Officer's determination.

Professional Judgment

The Naval Audit Service correctly cites the GAGAS standard that states, "Audit documentation should contain support for findings, conclusions, and recommendations before auditors issue their reports." However, we stand by our opinion that modifying files after the report date could give the appearance that the report wasn't adequately supported. As a result of this peer review, both the Naval Audit Service and the U.S. Army Audit Agency established new policies and controls to make workpapers as "read only" documents just after the date of publication. To maintain the integrity of the audit work supporting the issued report, any additions or modifications to workpapers must be put in a separate folder. The purpose of this control is to prevent supporting workpapers from being modified and to eliminate the perception that reports weren't adequately supported when issued.

We used the term "generally supported" because we couldn't be sure that the final audit reports were fully supported at the time of publication. We found several instances where the Microsoft statistics tool showed that supporting workpapers were modified after the final audit report was published. However, in most cases, we couldn't determine the full extent of modifications made or even if modifications were made.

Training System

Paragraph four of the Letter of Comments accurately addresses and acknowledges all the actions taken by the Naval Audit Service on improving their training system.