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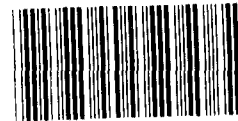
GAO

Report to the Chairman, Committee on  
Armed Services, House of Representatives

February 1988

# NAVAL AUDIT SERVICE

## Effectiveness of Navy's Internal Audit Organization Is Limited



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United States  
General Accounting Office  
Washington, D.C. 20548

Accounting and Financial  
Management Division

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February 24, 1988

The Honorable Les Aspin  
Chairman, Committee on Armed Services  
House of Representatives

Dear Mr. Chairman:

This report presents the results of our review of the effectiveness of the Naval Audit Service, as requested by the former Chairman of the Subcommittee on Readiness.

We found that the effectiveness of the Navy's internal audit organization has been limited. Serious deficiencies in planning, conducting, and reporting on audits have resulted in few significant findings and recommendations in Naval Audit Service reports and the reporting of comparatively low potential monetary benefits resulting from audit recommendations.

In responding to a draft of our report, the Navy, through the Department of Defense, concurred with each of our findings and recommendations. As a result of briefings to the auditor general and his staff, some of the recommendations already have been or are currently being implemented.

Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of this report. At that time, we will send copies of the report to the Secretary of Defense, the Secretary of the Navy, the Auditor General of the Navy, the Director of the Office of Management and Budget, interested congressional committees, and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

Frederick D. Wolf  
Director

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# Executive Summary

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## Purpose

The former Chairman, House Committee on Armed Services, Subcommittee on Readiness, requested that GAO review the effectiveness of the internal audit organizations within the Department of Defense (DOD). The Naval Audit Service (NAS) was selected for the first review because it did not appear to be reporting on significant issues, and the potential monetary benefits resulting from NAS audit recommendations were far below those of internal audit organizations in the Army and Air Force.

The former Chairman requested that GAO review the effectiveness of NAS by examining its allocation of audit resources, report quality, and independence. GAO's examination of NAS resource allocation focused on the types of audits planned and conducted, audit hours devoted to various types of audits, and planned changes in the types of audits conducted. In reviewing audit report quality, GAO examined the adequacy and accuracy of audit evidence for findings, conclusions, and recommendations. To review NAS independence, GAO examined the relationship between NAS and the Office of the Assistant Secretary for Financial Management and the use of military officers in key NAS positions.

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## Background

NAS was established in 1966 as the Navy's internal audit organization. It is headed by the Auditor General of the Navy, who reports directly to the Under Secretary of the Navy. The current auditor general was appointed in January 1986. NAS's mission is to perform independent reviews and evaluations of the effectiveness and efficiency with which Department of the Navy and Marine Corps managers carry out their responsibilities.

Since 1977, GAO, the DOD Office of Inspector General, and a public accounting firm have identified and reported deficiencies in the areas of evidence, reporting, supervision, and independence at NAS. Moreover, during 1985, NAS performed internal Technical Standard Reviews in each of its four regional offices to assess performance in areas such as supervision, training, and planning. Auditors' responses indicate their awareness of deficiencies in audit quality and supervision as well as their concerns over the types of audits being done and the perceived lack of independence at NAS.

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## Results in Brief

GAO found serious deficiencies in the planning, execution, and reporting phases of NAS's work. GAO believes these deficiencies significantly reduced the effectiveness of NAS's audits.



Among the problems noted were the following:

- An inordinate amount of audit resources were being devoted to areas not likely to produce significant monetary findings.
- Auditors felt that they were unable to fully develop certain issues because management placed undue emphasis on strict adherence to standard work programs and to time limitations.
- Some findings were reported without adequate evidence.
- Findings that seemed to warrant reporting were dropped without adequate justification.
- Reports contained important errors and omissions.
- Excessive delays in reporting occurred due to efforts to get management agreement on audit findings.
- Recommendations to correct systemic weaknesses were not made when appropriate.

GAO believes that these problems, many of which had been identified in earlier reviews of NAS, contributed to NAS's relative lack of success in identifying potential monetary benefits. In addition, GAO noted certain factors which could be perceived as impairing NAS's independence. GAO believes that by addressing these factors, the Navy can further enhance the effectiveness of its internal audit function.

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## Principal Findings

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### Planning and Use of Resources

The current auditor general has changed the way NAS allocates its resources to address more Navywide issues with greater potential for detecting significant audit issues. Previously, however, resources were devoted largely to single-activity audits, which resulted in few significant findings. Management's emphasis on adhering to standardized audit programs and on meeting staff-hour estimates may have caused some auditors to terminate audits before findings could be fully developed. GAO believes these factors contributed to NAS reporting lower potential monetary benefits than the other service audit organizations.

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### Audit and Report Quality

Many of the NAS audits GAO reviewed had deficiencies in evidence, supervision, and reporting. For instance, some well-supported findings were not reported, while other findings were included in reports although there was insufficient evidence to support the auditors' conclusions.

Other audit reports were inaccurate or incomplete in reporting audit findings. Additionally, summary reports on multilocation audits contained findings not reported to local management and did not make recommendations for correcting systemic deficiencies. Finally, audit reports were significantly delayed to obtain management concurrence on findings and recommendations, and some findings were dropped when management did not concur.

GAO believes these types of deficiencies show a need to strengthen the performance of the supervisory function in NAS to provide greater assurance that audit work will be performed in accordance with generally accepted government auditing standards.

## Perception of Impaired Independence

No hard evidence came to light during GAO's review that showed that NAS was conducting its activities in less than a fully independent and impartial manner. However, the perception of a lack of independence can be as harmful to the effective operation of an audit organization as situations where a lack of independence has been established. The following conditions at NAS could cause a perception of impaired independence and, therefore, warrant top management attention.

- A close working relationship exists between NAS and the Office of the Assistant Secretary of the Navy for Financial Management, and NAS relies on that office for technical and legal advice. This relationship and the corresponding reliance create the appearance of impairing NAS's independence because the Office of the Assistant Secretary is responsible for many important activities audited by NAS.
- Military officers are assigned on a rotational basis as deputy auditor general and regional office directors, and steps have not been taken to ensure that they (1) have knowledge and experience in auditing and accounting, (2) will not be responsible for audits of those military units from which they were recently assigned, and (3) are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit.

## Recommendations

Each chapter of this report contains a number of specific recommendations designed to improve the use of audit resources and the quality of audit supervision and reports and to enhance the independence of NAS. Because of the importance of having a properly functioning and effective internal audit organization to review Navy programs and activities and the lack of positive responses in addressing similar deficiencies

identified in the past, GAO recommends that the Secretary of the Navy report to the Secretary of Defense on actions taken to resolve the issues raised in this report. GAO also recommends that the Secretary of Defense evaluate the effectiveness of the Navy's actions.

## Agency Comments

The Naval Audit Service reviewed GAO's draft report and provided comments through the DOD Office of the Inspector General, which is the standard procedure followed by DOD in responding to GAO draft reports.

NAS has revised or is in the process of revising its policies relating to the reporting of significant findings, the documentation of decisions not to report findings, and supervisory involvement in those decisions. NAS has also instituted a revised policy on independent referencing of draft audit reports and has increased the number of audit reports selected for pre-publication quality assurance review. However, more specific actions are needed to clarify some of the policy issues discussed in chapters 2 and 3.

The Navy has also taken actions to reduce the appearance of impairments to Naval Audit Service independence. Although the Navy's actions differ in some respects from GAO's recommendations, the actions taken, together with NAS's commitment to take further actions if the current ones do not provide continuity of qualified, independent, leadership, should improve the internal audit function within the Navy.

The DOD Office of Inspector General has agreed to review the actions taken to implement GAO's audit recommendations and the impact of these actions on the effectiveness of the Naval Audit Service. This review is scheduled for fiscal year 1989.

The complete text of DOD's comments is included in appendix 1.

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**Abbreviations**

DOD	Department of Defense
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
gsf	gross square feet
IG	inspector general
NAS	Naval Audit Service
NAVFAC	Naval Facilities Engineering Command
NAVSEA	Naval Sea Systems Command
PWC	Public Works Center

# Introduction

Internal audit organizations within the Department of Defense (DOD) play an important role in preventing and detecting fraud and abuse and in promoting economy, efficiency, and effectiveness in DOD programs and operations. In the early 1980's, DOD programs and their budgets began to grow, and programs became more complex and diverse, thereby placing increased demands on DOD internal audit organizations. Recognizing this challenge to limited DOD internal audit resources, the former Chairman, House Committee on Armed Services, Subcommittee on Readiness, asked us to review the operations of DOD internal audit organizations. The former Chairman noted that the limited audit resources within DOD require careful planning and coordination of audit efforts.

The Naval Audit Service (NAS) was chosen for the first review because it was not reporting on significant issues and the potential monetary benefits resulting from NAS audit recommendations were below those of internal audit organizations in the Army and Air Force.

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## Background

NAS was established in 1966 and is the Department of the Navy's internal audit organization. Its mission is to perform independent reviews and evaluations of the effectiveness and efficiency with which Department of the Navy and Marine Corps managers carry out their responsibilities. To accomplish this, NAS determines whether management controls, practices, and procedures at all levels are adequate in concept and effective in application, whether they ensure the integrity and reliability of financial and other records, and whether available resources are used effectively.

NAS is headed by the Auditor General of the Navy, who reports directly to the Under Secretary of the Navy. The auditor general receives policy guidance and technical assistance from the Assistant Secretary for Financial Management (who also serves as the comptroller). The under secretary appointed a new auditor general in January 1986, the previous auditor general having served in that position for almost 6 years.

NAS operates out of a headquarters office and four regional offices. The headquarters office is in Falls Church, Virginia, and the regional offices are located in Crystal City, Virginia; Virginia Beach, Virginia; Camden, New Jersey; and San Diego, California. In fiscal year 1986, NAS had an authorized personnel ceiling of 593 individuals and a budget of \$26.8 million.

NAS regional offices are responsible for conducting audits and issuing audit reports under the regional directors' signatures. NAS headquarters staff reviews draft audit reports prior to publication if the auditee disagrees with the auditors' conclusions and recommendations or if the report is considered to be of significant interest to the Congress, the Secretary of the Navy, or the general public. After multilocation audits, NAS headquarters issues summary reports which consolidate the findings of local reports into broad issues for top Navy management.

Since 1977, the DOD Office of Inspector General, the public accounting firm of Arthur Andersen and Co., and the General Accounting Office (GAO) have evaluated NAS. Each has reported deficiencies similar to those identified in this evaluation of NAS. (See table 5.1) In addition, NAS auditors expressed concerns about these same deficiencies in response to an NAS questionnaire in 1985.

The Congress has become aware of the Navy's inaction in improving its internal audit capabilities and has taken initial budgetary actions to emphasize its concern. In an April 15, 1987, report of the House Committee on Armed Services, on the National Defense Authorization Act for fiscal years 1988 and 1989, the Committee expressed its dissatisfaction with inattention to NAS problems. The Committee report states:

"Navy management has allowed these deficiencies to continue for ten years. The committee questions why it should continue to fund such an ineffective organization.... Navy management must understand that the committee will not tolerate this continued inattention to NAS problems."

The Committee deleted \$100 million from the Navy's Operation and Maintenance budget request for fiscal year 1988, based on the results of our review. The message was that an effective audit organization would have identified at least \$100 million in potential monetary benefits from its recommendations.

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## Objectives, Scope, and Methodology

The former Chairman of the Subcommittee on Readiness, House Committee on Armed Services, asked us to review several aspects of NAS activities and operations. The request arose from congressional concerns about the lack of significant findings and recommendations in NAS audit reports and about the possible ineffective use of audit resources. The specific review objectives were to evaluate NAS's allocation of resources to the various types of audits it conducts and to evaluate its effectiveness by examining its audit report quality.

Our examination of NAS's allocation of resources focused on three areas: the types of audits conducted; the staff days allocated to the various types of audits conducted; and planned changes in the types of audits conducted and in the Navy programs, activities, and functions reviewed.

Primary emphasis in our review of audit report quality was on evaluating the accuracy and adequacy of audit evidence for reported findings, conclusions, and recommendations; determining whether audit reports contain all significant findings, including potential monetary benefits, identified during the audits; and analyzing the timeliness of audit report issuance.

To evaluate the independence of NAS, we reviewed the reporting structure between the auditor general and Navy management. We also reviewed the establishment of the legal counsel position within NAS. In addition, we reviewed the role of military officers in NAS.

To accomplish the audit objectives, we reviewed NAS policies and procedures for conducting audits. Applicable policies and procedures appear in NAS's Naval Audit Handbook, NAS policy letters, and DOD instructions. The Naval Audit Handbook and DOD instructions require compliance with generally accepted government auditing standards (GAGAS). These standards are prescribed by the Comptroller General of the United States in Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.

We first identified all NAS reports listed in the NAS management information system as being issued from October 1, 1985, through March 31, 1986. We checked the accuracy of the NAS listing of audit reports issued in the specified 6 months by selectively comparing it to the reports in the NAS library; one report on the shelf was not included in the listing provided to us. Despite this one omission, further work led us to believe that the listing was otherwise complete. The NAS management information system showed that NAS issued 176 audit reports during this period, and we randomly selected a sample of 40 of those reports for review. To ensure fair regional coverage, we selected 10 reports from each of the four NAS regions with at least one potential monetary benefit reported from each region. The selection was made by

- identifying all reports issued by each regional office and separating them into those with and those without potential monetary benefits,



- selecting 11 of the 22 reports that had potential monetary benefits by choosing the two reports with the largest monetary benefits and randomly selecting 9 additional reports, and
- randomly selecting an additional 29 of the remaining 154 audit reports that did not have potential monetary benefits to yield a total of 10 reports for each region.

For each report, we interviewed and discussed all potential findings with auditors-in-charge or regional managers. In all cases where we identified deficiencies, NAS had an opportunity to provide additional evidence or other information to support the reports' findings, conclusions, and recommendations or otherwise resolve our questions.

Finally, we reviewed NAS actual fiscal year 1986 and planned fiscal year 1987 staff allocations to the types of audits conducted and Navy programs, activities, and functions that were or would be audited. To obtain NAS resource allocation information, we interviewed headquarters and regional office personnel. We also reviewed documentation on the types of audits NAS conducts, the audit-hour allocations to each type of audit conducted during fiscal year 1986, and the planned allocations in fiscal year 1987.

We did not review operations of NAS's Management Consulting Group. This group performs a review function at the request of Navy management and makes recommendations to correct identified problems. The Management Consulting Group is staffed by nine military officers and is a very small part of the total NAS operations. Distribution of management consulting reports is restricted to the requester.

We performed our review between February 1986 and May 1987 in accordance with generally accepted government auditing standards. We obtained official comments from the Department of the Navy on a draft of this report and have incorporated the Department's comments, as appropriate.

# Audit Resource Utilization

A number of factors relating to resource allocation and utilization, and deficiencies in the quality of audit conduct and reporting have impacted the effectiveness of the NAS. NAS policies and procedures in these areas have resulted in few significant audit findings and potential monetary benefits in audit reports.

First, the previous auditor general had allocated 29 percent of audit resources to single-activity audits which were unlikely to result in significant findings or potential monetary benefits. The current auditor general reallocated resources in the fiscal year 1987 Annual Audit Plan to more Navywide issues which we believe could identify systemic problems and recommendations.

Moreover, auditors in each of the NAS regional offices told us that their skills have not been fully utilized. Auditors believe they are constrained by requirements to use standardized audit programs and compelled to complete every step in those audit programs, even when unwarranted. Our review of 40 audit reports and supporting working papers provides evidence of their perceived limitations. At the time of our audit, management had not changed the use of standardized audit programs.

Finally, Naval Audit Service effectiveness has also been impacted by serious deficiencies in conducting and reporting on audits. We discuss our findings and recommendations on these issues in chapter 3.

## Resource Allocation

The previous auditor general dedicated 29 percent of available audit-hours in fiscal year 1986 to single-activity audits, which determine compliance with laws and regulations and which evaluate internal controls at a single Navy activity. Activity audits are generally short-term audits that provide broad coverage of the activity but lack depth in audit scope. It appears these audits result in few significant audit findings and recommendations for improvements in Navy operations beyond addressing noncompliance with existing regulations.

The previous auditor general stressed the importance he placed on compliance auditing as early as 1983 when he wrote to regional offices that auditors are "not to 'appraise' the performance of the activity in accomplishing its assigned mission, and I doubt that we could find anyone who cares about the auditors' opinion as to whether the assigned mission is performed satisfactorily." Documents show that the previous auditor general intended to devote 50 percent of the total NAS audit work load to activity audits in fiscal year 1987.

The present auditor general, who assumed his position in January 1986, revised the allocation of audit resources, reducing the level of resources dedicated to activity audits in the fiscal year 1987 Annual Audit Plan to 6.8 percent. These resources have been shifted predominantly to functional audits, which are audits of a particular function (such as procurement or payroll), usually conducted at multiple sites. NAS believes these audits should identify more Navywide deficiencies and potential monetary benefits and lead to systemic recommendations.

We believe the shift to more functional audits should lead to the identification of more systemic recommendations. In turn, this may lead to an increase in potential monetary benefits to be derived from NAS audit recommendations. This evaluation can be made only after the changes are in place and audits are completed. However, as discussed in chapter 3, we found deficiencies in multilocation audits conducted by NAS, such as differences in scope and methodology among audit sites and a lack of recommendations in summary reports prepared for Navy management. These deficiencies must be corrected before additional functional audits will improve the effectiveness of NAS.

The audits, other than single-activity audits, conducted by NAS during fiscal year 1986 covered a variety of issues, such as the Navy's ship modernization program, procurement, and operation of naval air rework facilities. Although these issues could be productive audit topics, NAS reported a very limited number of significant findings and potential monetary benefits. We believe a number of factors contributed to the lack of significant findings and recommendations in these reports, including strict adherence to standard audit programs, time limitations placed on audit work, and deficiencies in the quality of the audit work, as discussed in chapter 3.

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## Adherence to Standard Audit Programs and Time Constraints

The Naval Audit Service has developed a series of standardized audit programs which auditors are to use as guides in conducting audits, especially for those audits conducted on a recurring basis. We believe standardized audit programs can be useful as basic guides for recurring audits, provided that auditors are able to adapt the programs to specific audits and auditors are given flexibility to pursue tentative audit findings. However, auditors and regional managers have interpreted guidance from the prior auditor general as requiring completion of all audit steps in standardized programs regardless of their utility. Time spent performing these audit steps prevents auditors from pursuing unanticipated audit findings or from fully developing other findings.

The previous auditor general issued a guidance letter to NAS regional offices stating that auditors are to use selected steps in standardized audit programs which are relevant to their specific audits and that auditors are free to supplement the standardized audit program with additional steps. In a subsequent letter dated January 1983, the auditor general reemphasized the importance he placed on the use of standardized audit programs. He wrote:

“Commencing with any audit starting from the date of this letter, every applicable standard audit program is to be used on every periodic audit, and every applicable audit step is to be performed. For continuous audits, the appropriate standard audit program will be used for each audit.”

Although the auditor general’s letter refers to “applicable” programs and audit steps, auditors in each NAS regional office told us that this policy had been implemented to require strict compliance with standardized audit programs.

During a May 1985 meeting between regional management and auditors-in-charge in one region, auditors expressed concern to management over this audit approach. A summary of discussions at the meeting states, “As a general consensus, it was concluded that a considerable amount of resources were being expended to complete audit guides and prepare workpapers for areas which contained little or no audit potential.” The memo continued by stating, “Under the current perceived format, we are basically providing audit guide coverage without devoting audit emphasis to areas possibly having potential, but not included in an audit guide.” (See Figure 2.1 for an excerpt of the NAS document.)

**Figure 2.1: Excerpt From Naval Audit Service Memorandum of July 18, 1985, Regional Office Conference**

2. Audit findings and coverage

a. The ADs (assistant directors)/AICs (auditors-in-charge) are of the impression that we are coverage oriented. As such, emphasis has been placed on completing audit guide steps (in many instances knowing that audit steps were being completed as a matter of routine) without regard to placing emphasis on developing audit findings at the expense of coverage. Special areas of consideration are:

(1) Auditors no longer rewarded for findings or savings generated.

(2) Auditors no longer bird-dog for unique or unusual areas not contained in audit guides. Primary emphasis is on completing audit guides.

General Discussion. Prior to the agenda meeting it was generally agreed that auditors thought all audit guide steps had to be completed. Therefore, audit guide steps were being completed when auditors and AICs knew that no audit potential would be derived. In fact, because quality control reviews provide an emphasis on coverage, AICs admitted during the conference that Southeast auditors were in fact over documenting to ensure full compliance with Naval Audit Service intent. Also, ADs and AICs indicated that they were performing audit guide steps simply for the sake of completing the steps, although reasonably assured that audit potential did not exist. In the above instances, the ADs or AICs were quick to relate that they thought completing all audit guide steps was what they were supposed to do. After all, NAH (Naval Audit Handbook), par. 201-5, specifically states that NAVAUDSVC (Naval Audit Service) policy is that every applicable audit step in every applicable audit program will normally be completed on every audit. Although the word normally is contained in the reference, auditors were of the opinion that with minor exception all audit guide steps had to be completed. Therefore, time was being expended for the documentation process, which ultimately resulted in consuming total LOE (level of effort or initial estimate of staff-hours needed to complete an audit). As such, time was not expended for other unique areas not covered by audit guides. With regard to coverage versus findings, it was pointed out that the AICs primary interest was to complete all audit guide steps within LOE constraints. Therefore, the depth of coverage required to develop quality type findings was not being expended. In other words, there may be quality potential within an audit guide step; however, because of the time required to complete audit guides assigned, AICs were unwilling to take a chance on expending considerable amounts of time on one audit step at the expense of completing others. Also, it was pointed out that auditors were, for the most part, not finding oriented but rather coverage oriented. In this respect, it was easy to document audit guide steps. It was not as easy to go those necessary extra steps to identify audit potential that may have existed within the step. After all, auditors were of the impression that they were being rewarded for coverage not audit findings.

In summarizing the discussions of the meeting, the memo further stated:

“ADs and AICs were quick to relate that they thought completing all audit guide steps was what they were supposed to do. After all, NAH, para. 201-5, specifically states that Naval Audit Service policy is that every applicable audit step in every applicable audit program will normally be completed on every audit. Although the word “normally” (emphasis added) is contained in the reference, auditors were of the opinion that with minor exception all audit guide steps had to be completed.”

In our sample, standardized audit programs were not used for audits of a non-recurring nature, such as audits done at the request of Navy management and multilocation audits. However, standard audit programs were used in 19 of the 40 audits we reviewed. Auditors did not deviate from the standard program in 12 of the 19 audits.

We did not review the individual standardized audit programs used by NAS since the DOD/IG was planning a review of the use of standardized audit programs by all DOD audit organizations. However, we do not believe standardized audit programs should cause auditors to feel restricted in the scope of work or the pursuit of significant issues identified during an audit. The current auditor general has not acted to change the audit approach instituted by the previous auditor general. We believe the auditor general should clarify NAS policy on the use of standardized audit programs as general guides that should be supplemented with additional audit steps, as appropriate, and that only applicable audit steps should be completed when standardized audit programs are used. Auditors should document their justification for not completing any segment of the audit program.

The problems posed by strict adherence to standard audit programs have been compounded by auditors' perceptions that the estimated number of staff-hours to complete each audit is an inflexible guideline. Although the NAS handbook allows auditors to request additional hours, auditors believe that making such requests would reflect negatively on their ability and thus are reluctant to do so. Auditors expressed their concerns to us and to NAS management, and these concerns are reflected in another section of the previously cited memorandum:

“With regard to coverage versus findings, it was pointed out that the AICs primary interest was to complete all audit guide steps within LOE constraints. Therefore, the depth of coverage required to develop quality type findings was not being expended. In other words, there may be quality potential within an audit guide step; however, because of the time required to complete audit guides assigned, AICs were unwilling

to take a chance on expending considerable amounts of time on one audit step at the expense of completing others.”

In our review of a sample of 40 NAS audit reports and working papers (see chapter 3), we found references to time constraints placed on completing 7 audits and to the fact that auditors reduced the audit scope as they neared the limit of authorized staff-hours. In other cases, auditors told us that some issues had not been fully developed and therefore were not reported because the auditors could not exceed the time allotted for the audit.

We understand the necessity of establishing estimated staff-hours or staff-days to complete audit assignments as a management tool. However, we believe these estimates should be used as guidelines and should not limit the ability of auditors to fully develop findings or complete the scope of work assigned. Auditors should be able to request resources beyond the initial estimates and those resources should be granted when properly justified. We also believe the auditor general should reemphasize the policy that allows for additional staff-hours to complete audits when properly justified.

## Impact on Potential Monetary Benefits

One measure of the effectiveness of an audit organization is the potential monetary benefits to be derived from audit recommendations. The House Armed Services Committee has expressed concern over the “extremely low” potential monetary benefits reported by NAS compared to the internal audit organizations in other military services, and this was one reason we were asked to review NAS. We believe that NAS potential monetary benefits have been comparatively low in recent years for several reasons, including the concentration of resources on compliance audits, the rigid adherence to standard audit programs that does not allow auditors to pursue findings with potentially greater monetary benefits, and a deemphasis by NAS headquarters on reporting monetary benefits.

NAS efforts to identify monetary benefits had mixed results in 1986 and in the first half of fiscal year 1987. NAS auditors and managers told us they believe the auditor general appointed in January 1986 has more interest in reporting potential monetary benefits. Potential monetary benefits reported in fiscal year 1986 totaled \$983 million, the highest for NAS in the five DOD semiannual reports to the Congress between March 31, 1985, and March 31, 1987. One audit which was requested by top Navy management accounted for \$699 million of these monetary

benefits. The balance of \$284 million is an improvement over the \$6 million in potential monetary benefits reported by NAS in fiscal year 1985. However, NAS's report for the first half of fiscal year 1987 shows a substantial decrease in monetary benefits to \$19 million.

Table 2.1 compares the level of potential monetary benefits reported by the Army, Navy, and Air Force audit organizations in the DOD inspector general semiannual reports to the Congress.

**Table 2.1: Potential Monetary Benefits Reported by Military Audit Organizations**

Dollars in millions

Six months ending:	Navy	Air Force	Army
March 31, 1985	\$3.6	\$589.2	\$224.8
September 30, 1985	2.4	242.0	391.9
March 31, 1986	817.0	260.3	1,600.0
September 30, 1986	166.0	902.0	968.0
March 31, 1987	19.0	581.5	320.3

Note: The authorized personnel levels for each of the internal audit organizations for fiscal year 1986 were as follows: Navy, 593; Air Force, 1,045; Army, 857.

We did not validate the total monetary benefits reported by NAS or by the other military audit organizations, but our review of a sample of NAS audit reports and working papers raised questions as to the reliability of some of the monetary benefits reported by NAS for the 6-month period ending March 31, 1986. Two reports in our sample contained unsupported findings which had associated potential monetary benefits. For example, a \$33 million benefit claimed from the reduction of construction criteria for child care and enlisted dining facilities is not well supported. (See detailed discussion in chapter 3.) Because we believe these findings were not adequately supported, the recommendations and associated potential monetary benefits may be overstated.

On the other hand, some of the examples of unreported findings and recommendations described in chapter 3 would have had a positive impact on the potential monetary benefits claimed by NAS. For instance, the \$400,000 in uncollected accounts receivable which was not reported by NAS should have been reported with a \$400,000 potential monetary benefit.

When NAS reports monetary benefits in audit reports, these benefits are to be related to applicable appropriations. The Navy comptroller requires that all budget submissions be accompanied by a schedule of audit findings and recommendations with monetary benefits that have



been used in the budget preparation. The comptroller's staff told us that compliance with this requirement is inconsistent. The comptroller's budget analysts review budget submissions and the schedule of monetary benefits.

In addition to the potential monetary benefits quantified in audit reports, the comptroller's budget analysts told us they read audit reports and identify monetary benefits beyond those claimed by auditors and agreed to by Navy management. The Navy comptroller notified NAS that audit reports had been used in the fiscal year 1987 budget development process to make adjustments of \$22.3 million to the fiscal year 1986 budget and \$25 million to the fiscal year 1987 budget request. For example, NAS reported a "weakness in the accounting and controlling of Navy components undergoing repair at commercial contractor plants and other military services repair centers. Navy understated assets thus overstating procurement requirements." The comptroller reported to us that the budget submission was reduced by \$17.6 million for fiscal year 1986 and \$17.6 million for fiscal year 1987 based on this NAS report although the NAS report did not identify any quantifiable monetary benefits. In cases such as this, the comptroller does not ask NAS for concurrence on the amount of the monetary benefits unless the amount is "significant." Although we did not validate the monetary benefits identified by the comptroller's budget analysts, we believe this indicates a potential for NAS auditors to quantify monetary benefits more frequently than has been done.

## Conclusions

The present auditor general has increased resources dedicated to audits he believes will identify more systemic problems within the Navy. The effect of this redirection of audit resources will not be discernible until a number of these audits have been completed. In addition, deficiencies we found in the conduct of and reporting on multilocation audits (see chapter 3) must also be improved.

In our opinion, potential monetary benefits are a byproduct of the effective use of audit resources. Monetary benefits identified in audit reports should increase if NAS allocates its resources to significant issues and eliminates time constraints and strict adherence to standard audit programs. These measures must be accompanied by improved quality in conducting and reporting on audits, as discussed in chapter 3.

NAS management has implemented policies relating to use of standardized audit programs and estimated time for completing audits in a way

which has led to auditors restricting the scope of some audits and not reporting significant findings in other audits. To further improve the overall effectiveness of NAS and the reporting of potential monetary benefits, the auditor general needs to clarify these policies to prevent restrictions on audit scope from occurring and to allow the pursuit of additional audit issues. The auditor general's clarification may need to be reinforced over time to ensure that changes are effective.

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## Recommendations

We recommend that the auditor general

- issue clarifications on the use of standardized audit programs for certain types of audits and for segments of other audits, so that auditors are able to pursue potentially significant issues identified during audits even though these issues are not included in standardized audit programs and
- issue policy clarifications to ensure that authorized staff-hours for completing audits are viewed as flexible milestones which can be extended to allow for developing audit issues.

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## Agency Comments and Our Evaluation

DOD provided official comments on a draft of our report. The complete text of the DOD comments is included in appendix 1. DOD concurred with the findings and recommendations in this chapter.

DOD responded that NAS has discontinued the use of standardized audit programs, precluding the need for the recommended change in policy. However, NAS could take more specific actions to implement our recommendation relating to needed flexibility in staff-hour estimates for completing audits. The DOD response reiterates existing policy but does not address the need to change auditors' perceptions that requesting additional staff-hours to complete audit work will reflect negatively on their ability to complete assignments.

# Audit Reports and Supervision

We identified reporting, evidence, and supervision deficiencies in 26 of the 40 reports and related working papers reviewed. Our review of the 40 sample audit reports, related working papers, and discussions with NAS personnel revealed that

- working papers for 15 reports contained material audit findings which were not included in the final audit reports, but which, in our opinion, were well supported and should have been reported;
- 2 reports contained findings and recommendations that were not adequately supported and should not have been reported without additional audit evidence;
- NAS significantly delayed publishing audit reports to obtain management concurrence on findings and recommendations;
- 7 audit reports contained inaccuracies, including erroneous reporting of data, failure to identify repeat findings, and omission or partial reporting of significant information;
- 8 reports, some of which are included in the above figures, contained inaccurately reported potential monetary benefits or did not report monetary benefits which were identified by auditors; and
- summary reports on multilocation audits contained findings not reported to local management and did not make recommendations for correcting systemic deficiencies.

## Unreported Material Findings

Generally accepted government auditing standards require that written audit reports be prepared to give the results of each government audit. The standards say that written reports are necessary to (1) communicate the results of audits to officials at all levels of government, (2) make findings and recommendations less susceptible to misunderstanding, (3) make findings available for public inspection, and (4) facilitate follow-up to determine whether appropriate corrective measures have been taken.

The NAS Naval Audit Handbook requires reporting of material audit findings. It states:

“Normally, all material audit findings will be reported in a single formal report. An exception to this rule would be a material finding unrelated to the audit objective(s), which the auditor just happens to find, and which is directed to a command other than the primary auditee. In this instance, the material finding will be reported separately in a formal report after consultation with Naval Audit Service Headquarters.”

The handbook details 15 criteria for judging the materiality of a finding. Findings involving one or more of the conditions are usually considered material and therefore are included in the formal audit report. For example, the criteria include findings that

- describe material internal control weaknesses,
- involve net potential monetary benefits of \$10,000 or more,
- describe substantial noncompliance with laws and regulations, and
- involve major inefficiencies in the use of resources or management of operations.

In 15 audits, NAS omitted at least one material finding from the final audit report. Our analysis of the working papers showed the findings were developed by the auditors and supported. NAS generally discussed these findings with Navy management as audit “concerns” but did not report them. The reasons material findings were not reported were not documented in the working papers.

For example, during a multilocation review of debt collection efforts, NAS auditors selected a sample of demand letters, representing funds due to the government, that had been filed in a dead-letter file. The auditors found 11 active demand letters totaling \$403,882 which had been incorrectly filed and, consequently, not pursued. Auditors discussed the letters with management at the closeout conference and recommended that all dead letters be verified by the disbursing officer before filing. They also suggested that management actively pursue collection of the \$403,882 identified in the 11 letters selected by the auditors. However, this finding was not included in the audit report.<sup>1</sup>

NAS’s assistant deputy director in the regional office told us that the finding was a local issue and not significant enough to be included in the audit report. This finding meets NAS criteria for a material finding for inclusion in the written report—a net potential monetary benefit of \$10,000 or more and a potential material internal control weakness. Also, by not including the finding in a written report, NAS does not comply with GAGAS on presenting written findings; NAS did not communicate the results to all officials, did not make the finding and recommendation less susceptible to misunderstanding, did not make the finding available for public inspection, and did not facilitate follow-up actions to ensure that appropriate corrective measures were taken.

<sup>1</sup>Debt Collection (T18404, December 2, 1985).

In this and other cases, we found that the decision not to report findings was made at various levels within NAS, including by auditors-in-charge, by assistant directors and deputy directors in regional offices, and by managers at NAS headquarters. Based on our analysis, we could not identify valid reasons for their decisions not to report material findings, since the findings did meet criteria set out in the NAS Naval Audit Handbook.

One noteworthy reason for omitting a finding from an audit report was given by an auditor who justified deleting a finding from a draft report by referring us to section 602 of the Naval Audit Handbook, which includes guidance on resolving differences between auditors and management on audit report findings. The handbook states that in evaluating unresolved issues, the “issue itself must also be sufficiently significant to warrant action by higher management levels after report publication.” The handbook continues by stating that if the difference cannot be resolved by correction of the report, the auditor general “requires that the issues be deleted from the published report and an explanation included in the audit work papers.” The auditor told us that the issue he deleted from the draft report, relating to local training needs, was not significant enough to require action by higher levels of Navy management. Therefore, he deleted the finding. We believe this language in the Naval Audit Handbook could be used as a basis for deleting any audit finding of a local nature if management disagrees with the auditors.

GAGAS and the Naval Audit Handbook require the reporting of significant audit findings. In most cases, NAS auditors did not document their reasons for not reporting findings and recommendations developed during audits. Furthermore, in some cases personnel involved in these decisions were no longer employed by NAS, making it even more difficult to determine the reasons for not reporting findings. Regardless of the reasons for dropping material findings, audit working papers should document the justification for not reporting material findings.

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## Unsupported Material Findings

GAGAS require that auditors obtain sufficient, competent, and relevant evidence to afford a reasonable basis for their judgments and conclusions. Auditors should carefully consider whether there is any reason to doubt the validity or completeness of their evidence. The standards also state that an audit report should “include only information, findings, and conclusions that are adequately supported by sufficient evidence in

the auditor's working papers to demonstrate or prove the bases for the matters reported and their correctness and reasonableness."

Two of the reports we reviewed contained findings and conclusions that were not adequately supported in the working papers. The auditors had not gathered sufficient and competent evidence and, consequently, may have reached incorrect conclusions. As a result, the report recommendations also may have been inappropriate.

For example, the Principal Deputy, Assistant Secretary of the Navy, Shipbuilding and Logistics, requested a review of various criteria used for construction of Navy facilities. The audit report,<sup>2</sup> which was addressed to the commander of the Naval Facilities Engineering Command (NAVFAC), stated that a space allowance of 75 gross square feet (gsf) per child for construction of child care facilities is "excessive when compared with an allowance of 45 to 55 gsf used by two major child care organizations which offer similar services." NAS recommended that NAVFAC "revise planning criteria factors to reduce space allowances for child care centers from 75 to approximately 55 gross square feet per child." NAS claimed a potential monetary benefit of \$9.3 million for reductions in child care facilities and, based on a similar recommendation, claimed \$24 million for reductions in enlisted dining facilities. The cost avoidance was based on construction between fiscal years 1986 and 1991.

The evidence on which this report was based was incomplete and insufficient. NAS issued this report after preliminary work and did not complete its review of the planning criteria. NAS obtained information on the size of private sector child care facilities through one telephone call to each of two facilities.

In replying to the audit report, NAVFAC officials stated:

"Both private and federal standards for child care centers specify a minimum net area of 35 square feet per child. The gsf allowance becomes a function of the types of services planned which exceed a basic custodial type service."

Although NAS reported that NAVFAC concurred with the recommendation, NAVFAC in fact agreed only to study the planning criteria before making any changes.

<sup>2</sup>Assessing the Validity of Planning Criteria Factors Used for Navy Construction Projects (S40315, February 21, 1986).

There was nothing in NAS working papers to indicate that auditors were aware of the comparable 35 net square feet per child standard for private and federal child care centers. There was no evidence in the working papers that NAS had reviewed those factors which differentiate gross and net square feet calculations. Also, there was no evidence that auditors verified the 55 gross square feet criteria used by the private sector beyond the telephone calls to two child care providers.

Similar weaknesses existed in NAS's evaluation of the planning criteria for enlisted dining facilities. NAS selected two dining facilities to determine actual use by calculating the average meals served based on 3 meals a day, 30 days a month. NAVFAC, however, uses the average meals served for the noon meal. NAVFAC notes that the noon meal, the peak usage meal, must be used as a size criteria for various reasons NAS did not consider. For instance, local commanders have the authority to require service men and women to eat on base, and the dining facility must be able to serve the required number of meals in that event. NAS regional management has acknowledged that the method of determining enlisted dining hall use was invalid, that the audit work was limited, and that the dining facilities chosen for their survey may not have been typical.

NAS officials agreed that there was insufficient audit work and evidence to support the recommendations to reduce the size of child care facilities and enlisted dining facilities. NAS also agreed that a more realistic recommendation would have been for NAVFAC to study the size criteria for these two kinds of facilities. As a result of the NAVFAC studies, the size of child care and enlisted dining facilities could possibly be reduced.

Another instance of an unsupported finding occurred when NAS reported that maternity patients were being referred to civilian medical facilities because of a lack of sufficient professional staff at the Navy hospital, although sufficient capacity existed at the Navy hospital to accommodate these patients. The report concluded that \$1.25 million in unnecessary referral costs could be eliminated by negotiating contractual agreements with civilian doctors to use the Navy hospital facilities for maternity deliveries.

In reaching this conclusion and recommendation, NAS did not contact the Naval Medical Command to discuss the feasibility of implementing the recommendation. The auditor-in-charge told GAO that the audit team failed to adequately consider the number of support staff, such as

nurses, who would be required, as well as the associated costs to implement the recommendation. After the report was issued, NAS auditors returned at the request of the Navy hospital staff to do additional audit work. This work was proceeding at the time of our review.

NAS does not have an adequate internal control procedure which would prevent issuance of unsupported audit findings. One such control procedure is "report referencing," a process that checks the adequacy of evidence supporting an audit report. The NAS referencing policy requires "that someone independent of the audit team verify cross-references in draft reports to the work papers" but does not require the referencer to independently verify the accuracy of figures in the report, to verify that findings are adequately supported by working papers, or to verify that conclusions and recommendations logically flow from the support. In addition, not all of the draft reports in our sample were completely referenced. In fact, for one draft audit report that reportedly was referenced by NAS, the referencer review sheet noted that the draft report was not cross-indexed to the working papers.

Reporting unsupported findings may have a negative impact on an audit organization as well as on the auditee. Auditees and other users of audit reports may begin to question the usefulness of reports and the competence and degree of reliance that they should place on the audit organization and its future reports. In addition, unsupported findings and recommendations can mislead management into taking unnecessary or counterproductive actions to correct the findings. We believe the auditor general should issue a revised policy on report referencing to require independent verification of facts used in audit reports to include a review of the accuracy of data, the adequacy of support, and the logic of conclusions and recommendations. When draft reports differ from working papers or are not adequately supported by working papers, detailed notations should be made to show the disposition of the differences.

## Delays in Report Publication To Get Management Agreement

GAGAS state that audit reports shall include pertinent views of responsible agency officials on audit findings, conclusions, and recommendations. Management comments are a means of ensuring that the audit report is fair, complete, and objective. GAGAS require reports to be issued in a timely manner in order to maximize use of information. In addition, Office of Management and Budget circular A-50, "Audit Follow-Up," provides a process for resolving differences between management and auditors after report publication.



NAS efforts to get management agreement on audit recommendations goes beyond the requirement to get management comment on findings, conclusions, and recommendations. NAS provides Navy managers with drafts of individual findings and recommendations as they are developed, and management responds informally to this information. At the conclusion of the audit, management receives the draft audit report and by NAS policy is given 30 days to provide formal comment on the report findings and recommendations.

If management disagrees with any section of the draft report, regardless of how well-supported the findings may be, NAS provides the draft to progressively higher levels of Navy management in an attempt to resolve differences. This practice of obtaining management agreement has led to cases of prolonged discussions with management, from local to top command levels, and has caused inordinate delays in report issuance. Thus, NAS delayed publication of six reports in our sample from 6 to 15 months while trying to get management agreement on audit findings and recommendations. By contrast, Navy management agreed to all findings and recommendations in 6 of the 40 reports we reviewed, and NAS published the reports 2-1/4 to 5-1/2 months after presenting the draft report to management. Finally, NAS has deleted or changed some findings or recommendations to get management agreement on the draft report, without additional facts or support in working papers to justify the deletions or changes.

For example, following 10 months of audit work, NAS gave management a draft of the report eventually issued as Standard Accounting and Reporting System Controls (T30084, November 5, 1985). Management disagreed with all of the report's 6 findings and 16 recommendations; NAS, therefore, held a series of discussions with management, but auditors did not document the content of these discussions. NAS published the report 15 months after management received the initial draft report but did not report three of the findings and seven of the recommendations.

In another case, NAS drafted a report, eventually issued as Selected Aspects of Family Housing Maintenance, Plant Property, Accounting, Property Disposal, Budgeting, and Disbursing at Naval Weapons Center, China Lake, California (A10394, November 1, 1985), after 4 months of audit work. Management disagreed with one draft report finding and recommendation. NAS rewrote the finding and again presented it to management for comment. Navy management did not concur on the rewritten finding and recommendation. Although auditors noted that the

disputed finding was discussed with Navy management, they did not document the content of these discussions. NAS published the report 14 months after the initial draft report was given to management and did not report the disputed finding. Figure 3.1 provides a summary of the finding and recommendation deleted from the draft report.

**Figure 3.1: Summary of Finding and Recommendation Deleted From Draft Report After Management Disagreement**

NAS auditors found that the Naval Weapons Center, China Lake, California, had two budget offices, and that some functions within those offices were duplicative. Auditors drafted the finding and recommended that the two budget offices be integrated to promote continuity between budget formulation and execution.

Naval Weapons Center management disagreed with the finding and recommendation. Following normal policy for all findings and recommendations with which management disagrees, the regional office sent the draft finding and management response to NAS headquarters for review. The director of operations, NAS headquarters, believed the NAS finding and recommendation were valid and suggested that the finding be revised to include a potential recurring cost avoidance of \$116,000 obtainable through reduction of three or four personnel positions.

The NAS regional office revised the finding to include the potential cost avoidance and again submitted it to management for comment. Management disagreed with the finding stating that the two budget offices serve two different levels of Naval Weapons Center organizations.

The NAS regional deputy director made the decision to drop the finding and recommendation because he believed there was inadequate evidence to overcome Naval Weapons Center's disagreement. The regional assistant director who was responsible for this audit disagreed with the decision. The NAS director of operations who reviewed the draft at NAS headquarters also disagreed with the decision to drop the finding and was not aware that the finding was deleted from the report until his discussion with us. We also believe the finding was well-supported and should have been included in the final report.

When management in the audited organization disagrees with a specific finding or recommendation in a draft audit report but does not have additional data to disprove auditors' facts or conclusions, we believe NAS should report the finding and recommendation as an unresolved issue and include management's reasoning in the audit report. Circular A-50 provides for resolution of the issues by higher management. However,

NAS deletes or changes the finding or recommendation to get management agreement on the draft report.

In order to prevent delays in issuing future reports and to adequately address unresolved issues, we believe the auditor general should issue a revised NAS policy requiring responses only from management at the audited activity or others responsible for implementing audit recommendations. Management agreement or disagreement with findings should be included in audit reports. Getting management agreement on findings and recommendations should not be given precedence over the policy for getting management comments. The circular A-50 resolution process could then be effectively implemented.

## Inaccuracies and Other Problems in Audit Reports

GAGAS state that the need for accuracy in audit reports is based on “the need to be fair and impartial in reporting and to assure readers that what is reported is reliable.”

Seven of the 40 audit reports we reviewed contained inaccuracies and other problems, including factually incorrect data in 4 reports, material findings reported as nonmaterial in 1 report, and repeat findings not identified as such in 2 reports and therefore not reported to higher levels of management as required by NAS policy. The inaccuracies we found are attributable to the auditors-in-charge who conducted the work and/or the assistant directors involved in providing instructions and reviewing audit working papers and reports.

For example, NAS conducted audits at nine shipyards to determine whether the shipyards complied with Naval Sea Systems Command (NAVSEA) policies regarding overtime and borrowed labor. Individual audit reports were prepared for each site, including one we reviewed for the Portsmouth Naval Shipyard.

The draft report stated that “the direct overtime percentage (percentage of overtime hours to total direct hours) was 13.4 percent” at the shipyard while the NAVSEA goal was 7 percent. The auditor who calculated the 13.4 percent overtime rate used a formula included in NAVSEA policy. The NAS acting assistant director in the regional office calculated the percentage using an incorrect formula but one that was consistent with that used in a similar report being drafted for the Philadelphia shipyard. He therefore changed the rate in the draft report to 11.8 percent. Because NAS headquarters had not provided clear guidance on how the

overtime rate was to be calculated, the reports on the Portsmouth and Philadelphia shipyards contained understated overtime percentages.

Such inaccuracies may not only mislead and confuse management but also raise concerns as to the competency and abilities of the auditors and the usefulness of NAS products. Navy management may view reports as unreliable and may tend to resist implementing audit recommendations in the future.

In addition to needed improvements in supervision which we discuss later in this chapter, we believe that the auditor general should revise NAS policies and procedures on report referencing to require verification of reported facts. This should prevent inaccuracies in NAS audit reports.

## Deficiencies in Multilocation Audits

GAGAS specifically address the need for careful coordination of audit activities during multilocation audits to ensure that work is coordinated and review techniques are uniform.

Our sample of 40 audit reports included 2 types of reports issued by NAS as a result of multilocation audits—local and summary reports. Local reports are issued to managers at each of the audit sites included in the audit, detailing deficiencies and making recommendations specific to that site. Summary reports for an audit are written by NAS headquarters and summarize the content of local reports for top Navy management, but they do not include recommendations.

We found deficiencies unique to multilocation audits and their associated local reports.

First, despite the need for coordination and uniform audit techniques, NAS headquarters did not provide consistent guidance to the various audit sites in each of the three multilocation audits we reviewed. We found differences in the scope of work, time periods covered, types of transactions to be audited, and methodology.

Second, NAS summary reports did not contain recommendations, although they summarize significant issues for top Navy management. GAGAS state that audit reports should contain recommendations whenever significant improvement in audited entities is possible. Recommendations should be made to effect compliance with laws or regulations when auditors report significant instances of noncompliance.

For example, a summary report on major procurement addressed to the commander of the Naval Supply Systems Command did not include recommendations despite its conclusion:

“Based on our study and evaluation of the internal control system in the major procurement and contract administration areas, controls were not sufficient, in our opinion, to prevent or promptly detect material errors or irregularities in operations.”

Instead of making a recommendation to correct this problem, the summary report states that “management responses (at each of the supply centers) indicated that satisfactory corrective action was taken or is planned on all recommendations” in the local reports. The report concludes: “Since the commands took or planned actions to correct the discrepancies noted, no further action is required.” However, we found that not all findings in summary reports were included in local audit reports. In these instances, the summary report’s assurance that satisfactory management actions were taken or planned is a false assurance.

As an example, the summary report on major procurement concluded that supply centers at Charleston, San Diego, Norfolk, and Puget Sound “excessively used negotiated procurements when other preferred procurement methods were available.” Although supported in the working papers we reviewed, this was not included in local reports to supply center commanders at San Diego, Norfolk, or Puget Sound with recommendations to improve operations. The auditor prepared the summary report based on his telephone conversations with auditors at each site. However, since findings were not reported to supply center management at San Diego, Norfolk, and Puget Sound, corrective actions would not be planned or taken.

Moreover, actions by local management may not correct deficiencies which are systemic in nature—the kinds of deficiencies one would expect to be reported in a summary report to top Navy management. The example of major procurement demonstrates that the command may have a systemwide problem since four of the six supply centers have excessively used negotiated procurements. NAS did not make recommendations to the command on how to improve supply center performance in this area.

Many of these problems with multilocation audits can be attributed to the NAS policy for issuing local and summary reports on these audits. The auditor-in-charge at NAS headquarters is responsible for writing the

summary report based on the content of local audit reports. However, the auditor-in-charge does not review working papers that support local reports and does not review draft local reports before they are issued. Consequently, auditors at each site may consider some issues as nonmaterial and not report them, but the headquarters auditor-in-charge may view the same issues as material and include the issues in the summary report. In the example of the major procurement audit we discussed earlier, the auditor-in-charge included some issues in the summary report that were not in the local report because he had discussed the issues with auditors at each site on the telephone. He had not reviewed their supporting working papers, and the local auditors did not consider the issues material for inclusion in the local report.

The accuracy of multilocation audit reports could be improved by strengthening quality control requirements, such as referencing, in NAS. The NAS policy on conducting and reporting on multilocation audits could be revised to require that the auditor-in-charge responsible for preparing the summary report review and approve all draft local audit reports before they are issued. This should ensure that the issues considered material for the summary report are included in local audit reports where appropriate. We believe the revised policy should also include the requirement that, when appropriate, summary reports should include recommendations to correct systemic deficiencies reported to top Navy management.

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## Deficiencies in Supervision

GAGAS state that the "most effective way to ensure the quality and expedite the progress of an assignment is by exercising proper supervision.... Supervision adds seasoned judgment to the work done by less experienced staff and provides necessary training for them." GAGAS further provide that supervisors review the work of staff to ensure conformance with audit standards, that working papers adequately support findings and conclusions, and that audit objectives are met. Supervisory reviews should be documented and retained.

Inadequate supervision at various levels of NAS contributed, in total or in part, to the problems that we found in audit conduct and reporting. Supervisory deficiencies included inadequate review and control of the work performed and conclusions reached by audit staff and poor judgment in changing reports or deleting findings from audit reports.

During our review of NAS audit reports and working papers, we found that supervisors had deleted 20 findings from 10 reports after discussing the written draft findings with management for comment. Among the reasons given for deleting findings were that evidence was insufficient, auditors used the wrong criteria in evaluating performance, and management was aware of the problem and taking action. We believe audit supervisors should review findings and supporting working papers and make these judgments before giving the findings to Navy management for comment. Management confidence in auditors' capabilities could be eroded by a series of unsupported and inaccurate conclusions given to them for comment.

We believe the auditor general should issue a policy specifically requiring supervisors to review all audit findings and recommendations before requesting management comment, to ensure that findings and conclusions are adequately supported.

In our discussion of unreported findings earlier in this chapter, we cited 15 audit reports with working papers which included findings which we believe were adequately supported and should have been included in the audit reports. NAS supervisors justified excluding these findings from the reports because the findings were outside the scope of the audit, the findings lacked sufficient support, and the recommendations were weak.

We were unable to determine why NAS supervisors made these decisions. However, the result is that NAS did not report a number of material findings and issued some inaccurate reports. In its November 1986 report on NAS,<sup>3</sup> the DOD Office of Inspector General concluded that supervisors were "lax in meeting their responsibilities or were not sufficiently knowledgeable in performing their duties." The DOD inspector general recommended that the auditor general provide supervisory training courses for regional supervisors and auditors-in-charge, concentrating on the supervisor's role in audit performance and reporting.

In responding to the recommendation of the DOD inspector general, the auditor general disagreed that supervisors and managers in NAS "categorically lack commitment and require supervisory training." The auditor general said this may be the case in a minority of instances and NAS would isolate those cases and provide necessary training. The auditor general added that NAS would take actions through other functions (such

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<sup>3</sup>Report on Quality Assurance Review of the Naval Audit Service (AP0-87-001, November 10, 1986).

as the performance appraisal process and disciplinary actions) when training is not the answer.

We believe that the results of our review and those of the DOD inspector general show that NAS supervisors could benefit from training in the supervisory function, and we believe that such training should be provided. We also believe that the auditor general's approach of identifying individual supervisors for specific training and using performance appraisals and disciplinary actions is a viable supplement to the general training of NAS supervisors.

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## Conclusions

An audit organization's credibility and effectiveness are directly related to the quality of its work and the accuracy and completeness of the resulting reports. At NAS, we found that serious deficiencies existed in 26 of 40 reports and in the related audit evidence. These deficiencies were in the areas of unreported material findings, unsupported findings and inaccuracies in audit reports, and the need for management concurrence on all findings and recommendations before report publication. We believe that revised policies and improved supervision could have eliminated many of these deficiencies.

We believe that the seriousness and frequency of noncompliance with GAGAS indicates that NAS professional staff should be trained on compliance with generally accepted government auditing standards.

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## Recommendations

To ensure that all material findings are reported by NAS auditors, we recommend that the auditor general

- clarify NAS policy on when findings and recommendations should be deleted from draft reports and
- issue NAS policy requiring all auditors to include in working papers a detailed explanation of why findings and recommendations are not in draft or final audit reports.

To ensure that audit reports are accurate and have adequate supporting evidence, we also recommend that the auditor general

- issue a policy requiring supervisors to review all audit findings and recommendations before requesting management comment, to ensure that findings and conclusions are adequately supported,



- strengthen quality controls over audit reports by developing and implementing a mechanism, such as effective referencing, and
- initiate a program of prepublication review of draft audit reports in NAS headquarters, at least for the more significant reports to be issued by NAS regional offices, to ensure that audit reports are complete and accurate. This review process should continue until a consistently high quality is achieved in audit reports.

To obtain management comments on draft findings and recommendations and to eliminate delays in issuing audit reports, we recommend that the auditor general revise NAS policy to

- require comments only from management of the audited organization or others directly responsible for implementing audit recommendations and
- state clearly that report issuance will not be delayed to get concurrence from Navy management on draft findings and recommendations. When management disagrees with audit findings and recommendations, NAS should evaluate its supporting evidence and change findings and recommendations only when additional information can be presented by management to invalidate audit conclusions and recommendations as presented in draft reports.

To improve the consistency between local and summary reports issued after multilocation audits, we recommend that the auditor general issue NAS policy to require

- audit guidelines on multilocation audits providing identical audit scope and methodology for the individual audit sites,
- review of draft local audit reports by the auditor-in-charge who will be preparing the summary report for issuance to top Navy management, and
- recommendations to top Navy management on actions to be taken to correct or eliminate the systemic deficiencies reported in summary reports.

To improve overall compliance with generally accepted government auditing standards, we recommend that the auditor general require that all auditors, supervisors, and managers in both regional offices and headquarters attend training that emphasizes generally accepted government auditing standards and, in particular, the standards for supervision, evidence, reporting, and due professional care.

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## Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD concurred with all findings and recommendations in this chapter. Many of the recommendations have been implemented, based on our briefing of the auditor general and his staff on the results of our review. NAS has revised its handbook to require (1) proper documentation of decisions not to report audit findings and (2) documentation of the supervisory role in these decisions. In addition, NAS has instituted an improved report referencing procedure and has increased the number of regional office and headquarters reports selected for prepublication reviews. If properly implemented, these changes should adequately address our concerns.

We also recommended that the auditor general revise NAS policy to state clearly that report issuance will not be delayed to obtain concurrence from Navy management on draft findings and recommendations. Although the DOD response indicates actions that may improve the timeliness of issuing reports, such as simultaneous distribution of draft reports to all recommendation addressees, it does not state that the policy of obtaining management agreement on draft reports will be clarified to require management comment. Our report makes a clear distinction between the need to get management comment and the practice of getting management agreement on findings and recommendations. We believe NAS should issue a clear policy statement that reports will be issued with management comments, even if those comments disagree with the findings and recommendations.

# Audit Independence

Generally accepted government auditing standards require that audit organizations and individual auditors “be free from personal or external impairments to independence, must be organizationally independent, and shall maintain an independent attitude and appearance.” Independence is necessary to ensure that “opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties.” GAGAS emphasize that auditors should consider “whether there is anything about their situation that might lead others to question their independence.” The perception of a lack of independence can be as harmful to the effective operation of an audit organization as situations where a lack of independence has been established.

Three conditions exist at NAS that could cause a perception of impaired independence:

- the relationship between NAS and the Office of the Assistant Secretary of the Navy for Financial Management,
- the rotational appointment of military officers as deputy auditor general and NAS regional office directors, and
- efforts to get management concurrence on audit findings and recommendations before report publication.

## Relationship With the Office of the Assistant Secretary

GAGAS state that auditors’ independence “can be affected by their place within the structure of the government entity to which they are assigned.” To ensure maximum independence, GAGAS state that the audit organization should be “located outside the staff or line management function of the unit under audit.”

Although the auditor general reports to the Under Secretary of the Navy, NAS has maintained ties with the Office of the Assistant Secretary of the Navy for Financial Management (the assistant secretary also serves as the comptroller), a relationship which could be perceived as an impairment to NAS independence. Specifically,

- NAS receives technical advice from the office of the assistant secretary,
- a member of the assistant secretary’s staff, who had no prior audit experience, was named auditor general of the Navy, and
- the NAS legal counsel reports to and is rated by the legal counsel for the assistant secretary.

Arthur Andersen and Co. issued a report in 1983 following an evaluation of NAS's ability to perform its mission effectively and efficiently. The Arthur Andersen report notes that the auditor general received technical advice from the then-Deputy Under Secretary (Financial Management). The report further states that the auditor general's seeking technical advice from the under secretary could create "an unwarranted image of inadequate technical auditing competence within NAS. Further, it could be viewed by those outside the NAS as impairing NAS' independence." The report recommended that the relationship between the two organizations be discontinued.

We found that NAS continues to receive technical advice from the current Office of the Assistant Secretary for Financial Management, which includes advice related to findings involving financial matters. We believe this creates the perception of a lack of independence in reaching audit opinions, conclusions, judgments, and recommendations.

One of the reports in our sample illustrates this potential problem.

Auditors at NAS issued a report stating that the Space and Naval Warfare Systems Command improperly issued project orders<sup>4</sup> to its field activities in fiscal years 1982 and 1983. These project orders obligated Operation and Maintenance, Navy, funds, which are annual appropriations, but the funds provided through the project orders were not spent until the following fiscal years. The report concluded that the command improperly extended the availability of \$56.8 million in expired fiscal year 1982 and 1983 Operation and Maintenance, Navy, funds.

In response to the report, the Office of the Comptroller of the Navy said the Navy comptroller's manual would be changed to clearly authorize the use of project orders to fund field activities, a practice which NAS had previously reported as improper. The NAS legal counsel wrote to the auditor general that the proposed change to the comptroller's manual constituted a deviation from accepted DOD accounting procedures and therefore needed to be approved by the Assistant Secretary of Defense (who also serves as the comptroller). Following discussions with staff from the Navy Office of the Comptroller, NAS did not raise the issue to the DOD level for review and the comptroller's manual was changed to

<sup>4</sup>Project orders are appropriately used to obligate funds between different organizational entities and appropriation accounts, but they are not appropriate for obligating funds between entities in the same organization that are funded by the same appropriator.

authorize this funding procedure. We were unable to determine why NAS did not elevate this issue to the DOD level.

In preparing this same audit report, auditors drafted a finding that "on 28 September 1983 there was an apparent \$4.5 million Section 3679 (31 USC 1341) (Anti-Deficiency Act) violation that must be reported." The apparent violation resulted from the improper extension of funds beyond the fiscal year. We were told that NAS discussed this issue with the Office of the Comptroller staff, but the content of this conversation was not documented. We could not identify why NAS did not report this apparent Anti-Deficiency Act violation.

We believe the technical advice received from the assistant secretary's office was not only incorrect but also creates the perception of impairing audit independence. NAS should have included the possible Anti-Deficiency Act violation in the audit report with a recommendation that the Office of the Comptroller determine if such a violation did occur and, if so, report the violation as required by law.

A second tie to the assistant secretary's office was created in January 1986 when the Deputy Secretary of the Navy appointed a member of the comptroller's staff as the Navy auditor general. This appointment could create the perception of a lack of independence since, as GAGAS state, a personal impairment to independence could exist if an auditor has had "previous involvement in a decisionmaking or management capacity that would affect current operations of the entity or program being audited." Many NAS audits involve budget, accounting, and financial management issues which are governed by the Office of the Assistant Secretary and the comptroller.

In addition, the NAS legal counsel is selected by, reports to, and is rated by the counsel for the Navy comptroller, within the Office of the Assistant Secretary for Financial Management. In its 1986 report, the DOD inspector general cited this reporting structure as an impairment to NAS independence since the NAS counsel "is actually under the control" of the counsel of the Navy comptroller while NAS "audits fiscal functions under the policy direction and oversight of the Comptroller of the Navy."

By contrast, the auditor general of the Air Force receives legal counsel from the Office of the Secretary of the Air Force. The Army Audit Agency, the most independent structure of the three military audit services, has its own legal counsel who is hired by and reports solely to the auditor general.

Additionally, GAGAS take note of the unique position of internal auditors, such as NAS, stating that to ensure independence, auditors should be "sufficiently removed from political pressures" and, when feasible, "should be under a personnel system where compensation, training, job tenure, and advancement are based solely on merit." Since these auditing standards pertain to the audit organization as a whole, the standards also apply to the NAS legal counsel. We believe the reporting structure for the NAS legal counsel creates the appearance of impairing NAS's independence.

## Use of Military Officers

In our 1977 report, we recommended that the Secretary of Defense strengthen the internal audit function within the Navy by directing the Secretary of the Navy to redesignate the positions of auditor general, deputy auditor general, and directors of regional offices as civilian positions. In response, the Secretary of the Navy converted the auditor general position to a civilian position in 1980; however, the other positions remain designated for military officers. We made similar recommendations for the audit organizations in the Army<sup>5</sup> and Air Force.<sup>6</sup> The Army Audit Agency has designated the positions of auditor general, deputy auditor general and regional directors as civilian. Air Force Audit Agency has established a career field for military auditors who do not serve on a rotational basis but whose careers are primarily in the audit agency.

The possible impairment to independence of the audit organization is based on the fact that military officers fill audit management positions on a temporary basis and later return to line positions in the military. Consequently, it is possible for officers to be responsible for audit reports on those military units from which they were recently assigned or to which they will be assigned. It is further possible that a superior officer whose unit is being audited could subsequently sit on the promotion board for officers responsible for the audits.

Arthur Andersen and Co. notes in its report that the regional directors and deputy directors "should have a strong knowledge and in-depth experience in auditing and accounting principles and practices. Continuity in these positions is important, and both should be filled by individuals with a career path in financially related activities." Knowledge

<sup>5</sup>Why the Army Should Strengthen Its Internal Audit Function (FGMSD-77-49, July 26, 1977).

<sup>6</sup>The Air Force Audit Agency Can Be Made More Effective (FGMSD-78-4, November 11, 1977).

and experience in auditing and accounting principles and practices has not been a requirement for filling the regional director positions.

The DOD inspector general report took exception to the Navy's practice of filling the deputy auditor general and regional director positions in NAS with Supply Corps and line officers, and Marine Corps officers. The report concluded that these officers are "not usually trained and proficient in auditing standards, techniques and procedures."

We agree with these comments from the Arthur Andersen and Co. and DOD inspector general reports. The Navy could strengthen its internal audit function by establishing permanent managerial positions within NAS to be filled by individuals who are trained and experienced in auditing and accounting principles and practices. We also believe the perception of impairment to NAS independence remains as long as military officers rotate into management positions within the audit organization, unless steps are taken to ensure that they (1) have knowledge and experience in auditing and accounting, (2) will not be responsible for audits of those units from which they were recently assigned, and (3) are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit.

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## Management Agreement on Audit Findings and Recommendations

GAGAS state that an audit is adversely affected and the auditor will not have complete freedom to make an independent and objective judgment if there is external "authority to overrule or to influence the auditor's judgment as to the appropriate content of an audit report or selection of what is to be audited." However, audit reports are to include management comments on findings, conclusions, and recommendations to ensure that audit reports are fair, complete, and objective.

The NAS emphasis on getting management agreement on audit reports is given precedence over its policy for getting management comments on draft reports. The priority given to getting management agreement on findings and recommendations increases the potential for impairing independence of auditors and the audit organization.

As discussed in chapter 3, NAS delayed issuing reports while auditors met repeatedly with local management or with different levels of Navy management to get agreement on findings and recommendations. Also, NAS deleted findings and recommendations from some reports after management disagreement or changed recommendations in others to get management concurrence. In these latter cases, the decisions not to

report findings or to make changes to recommendations were not based on additional facts that countered the original judgment or conclusions of the auditors.

We believe the practice of getting management agreement on audit findings and recommendations should not receive undue emphasis in NAS. Our recommendations in chapter 3 address this issue and will improve the appearance of independence at NAS.

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## Conclusions

Audit independence is an important audit standard to ensure a more effective audit organization. Even if an audit organization's reports are clear, concise, and convincing and all information contained in them is supported by sufficient, competent, and relevant evidence, the credibility of the organization can be impaired if knowledgeable third parties perceive a lack of independence at the organization. This perception may exist at NAS because of the relationship between NAS and the Navy Office of the Assistant Secretary for Financial Management, the use of military officers on a rotating basis as deputy auditor general and directors of regional offices, and the use of legal counsel that is selected by and reports to the Navy Office of the Comptroller, an organization that could be directly affected by audit findings, conclusions, and recommendations. This perception is enhanced by the NAS emphasis on getting management agreement on audit findings and recommendations before they are included in the final audit report.

No hard evidence came to light during our review that showed that NAS was conducting its activities in less than a fully independent and impartial manner. However, the perception of a lack of independence can be as harmful to the effective operation of an audit organization as situations where a lack of independence has been established.

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## Recommendations

To reduce the possibility of perceived or actual impairments to NAS's independence, the Secretary of the Navy should

- direct the auditor general and the Assistant Secretary for Financial Management to limit the nature and extent of technical advice provided to NAS so as not to impact the reporting of findings relating to financial matters; advice in these instances can be obtained from other organizations such as the DOD Office of the Comptroller;



- create a legal counsel for NAS that is completely independent of any activity subject to audit by NAS and that legal counsel should report directly to the auditor general;
- address the perception of impaired independence created by having military officers rotate into the positions of deputy auditor general and regional directors, either by designating these positions as civilian positions, or at least, by ensuring that the military personnel (1) have knowledge and experience in auditing and accounting, (2) will not be responsible for audits of those units from which they were recently assigned, and (3) are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit; and
- commit the Navy to an internal audit service which operates free of any impairments to its independence and foster this commitment among all levels of Navy management.

## Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD concurred with the findings and recommendations in this chapter and has acted in a number of ways to strengthen the organizational alignment and authority of the auditor general. NAS has revised its handbook to require audit staff to refer all questions concerning financial matters to NAS headquarters for research and clarification rather than going directly to the Office of the Comptroller for such information. In addition, the general counsel assigned to the auditor general's staff is being reassigned to report directly to the Navy General Counsel, as recommended.

We also recommended that the deputy auditor general and regional director positions be designated as civilian positions, or alternatively ensure that three conditions be met for any military officers assigned to those positions. The DOD response states that civilians will be selected to fill these positions if the auditor general is unable to obtain qualified military officers.

Regarding the first condition, we recommended that if military officers are used to fill the deputy auditor general and regional director positions, those officers should have knowledge and experience in auditing and accounting. DOD responded that the position of deputy auditor general will be filled by a military officer with knowledge and experience in auditing. The regional office director positions will be filled by officers with knowledge and experience in either auditing, logistics, or finance.

Further, the DOD response indicated that measures would be taken to ensure that military officers serving in NAS will not be responsible for

audits of those units from which they were recently assigned. This meets the intent of the second condition to retaining military officers in NAS.

The third condition included in our recommendation is that NAS ensure that officers are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit. In reply to the draft report, DOD has stated that this requirement can not be met since a future assignment will generally not be known until near the end of an individual's NAS tour of duty.

Overall, we believe that the actions taken or proposed by DOD and the Navy will free NAS from several impairments to its independence. While these actions are not precisely as we recommended regarding the use of military officers, the actions that are discussed will help foster the needed commitment to a strengthened internal audit function. The NAS has committed to certain further actions, including civilianization of the positions of deputy auditor general and regional director, if the actions taken do not resolve the issues raised, including the issue of qualified leadership in the deputy auditor general and regional director positions. Further, as discussed in the next chapter, the DOD inspector general has agreed to review NAS in fiscal year 1989 to determine if the actions taken have been effective in correcting the deficiencies identified in this report.

# Response to Previously Reported Deficiencies

Since 1977, GAO, the DOD Office of Inspector General, and the public accounting firm of Arthur Andersen and Co. have evaluated NAS. Each of these organizations reported deficiencies similar to those we have identified in this evaluation of NAS. In addition to having these problems identified by outside organizations, NAS auditors voiced concerns over these same deficiencies in response to an NAS questionnaire in 1985. The House Committee on Armed Services has become aware of the Navy's inaction in improving its internal audit function and has deleted \$100 million from the Navy's Operation and Maintenance budget request for fiscal year 1988 to emphasize its concern.

Table 5.1 summarizes the common findings reported by the GAO in 1977, by Arthur Andersen and Co. in 1983, by the DOD Office of Inspector General in 1986, and by this report.

**Table 5.1: Comparison of the GAO, DOD Inspector General, and Arthur Andersen Reviews of the Naval Audit Service**

<b>Issues Reported</b>	<b>GAO 1988</b>	<b>DOD 1986</b>	<b>Arthur Andersen 1983</b>	<b>GAO 1977</b>
Unreported Material Findings	X	X		
Unsupported Findings	X		X	
Delays in Issuing Reports	X	X	X	
Inaccuracies in Audit Reports	X	X		
Inadequate Supervision	X	X	X	
Impairments to Independence	X	X	X	X

Note: The DOD inspector general report was issued while we were conducting our review. Therefore, the impact of NAS reactions to DOD recommendations would not be reflected in the audit work we reviewed.

In addition to the findings of these organizations, NAS performed Technical Standard Reviews in each of its regional offices to assess performance in areas such as supervision, training, and planning. Auditors were also asked to comment on what needed to be done to improve audit operations and to make comments on areas not covered by the questionnaire. The acting deputy auditor general wrote to the regional directors that the statistical data "displays both a need for increased supervisory involvement and for addressing indicated problems in training." The acting deputy auditor general also included a summary of the comments from questionnaire responses. Those comments included:

- "Reports are watered down because audit service is unwilling to approach controversy.... We conform."
- "Get rid of the military—a conflict of interest."

- “More LOE (level of effort, the estimated staff-hours for each audit established by NAS when an audit begins) to allow for additional audit work, developing findings with savings...”

These and other comments made by the auditors indicate their awareness of the deficiencies in audit quality and supervision and their concerns over the types of audits being done and the independence of NAS.

## Navy's Actions Have Been Ineffective

Since 1977, the Secretary of the Navy and the auditor general have taken some actions to improve NAS operations, such as converting the auditor general position from military to civilian and improving the annual audit planning process. However, the insufficient nature of these actions is reflected in the fact that we are again reporting many of the deficiencies included in earlier evaluations of NAS.

GAO's 1977 report, The Naval Audit Service Should Be Strengthened (FGMSD-78-5), concluded that the Navy could obtain greater benefits from NAS by placing the audit service at a higher organizational level and by filling all military positions within NAS with civilians. The Secretary responded by having the auditor general report directly to the under secretary rather than the Assistant Secretary of the Navy for Financial Management. However, only the auditor general position was converted from military to civilian, the first civilian being appointed to this position in June 1980. The deputy auditor general and regional director positions remain military.

Initiatives to improve the effectiveness of NAS were undertaken following the 1983 report of Arthur Andersen and Co. Among those efforts were improvements to the annual planning process, including obtaining management suggestions for audits and performing risk evaluations to support the annual audit plan.

The previous auditor general also instituted a system of quality assurance reviews on audit performance. However, the current auditor general expressed concern that these reviews are not identifying the types of problems with audit reports and working papers that we identified.

The current auditor general has reallocated audit resources to types of audits which he believes will lead to more systemic findings and recommendations and increase the reporting of potential monetary benefits. In addition, the auditor general told us that he has initiated efforts to (1) structure training requirements for auditors at each grade-level,

(2) revise the NAS audit handbook to clarify certain segments of NAS policy, and (3) improve NAS capabilities to audit computer-based systems. He has also asked his staff to develop a quality assurance program to improve NAS audits and audit reports. Since these initiatives were just beginning, we could not evaluate their impact on NAS operations or on the deficiencies we found.

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## Conclusions

The Navy and the auditor general have taken some actions which have improved selected aspects of NAS operations. However, none of these actions, as yet, has had a discernible impact on the continuing deficiencies in conducting, reporting, or supervising audits. Other actions, such as those to improve the independence of NAS, also need to be expanded.

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## Recommendations

Because of the severity of the deficiencies noted during our review and because they have been reported in the past, we recommend that the Secretary of the Navy report to the Secretary of Defense on actions to resolve the issues identified in this report.

We also recommend that one year after receiving the report from Secretary of the Navy, the Secretary of Defense conduct, or have conducted, a review to evaluate the effectiveness of actions taken to correct the reporting, evidence, supervision, and independence deficiencies cited in this report. This review should provide the Congress and the Secretary of Defense assurance that actions have been taken to improve the effectiveness of Navy's internal audit function.

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## Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD agreed with the findings and recommendations in this chapter. The DOD Office of Inspector General has agreed to undertake a review in fiscal year 1989 to determine whether the Navy actions in response to the recommendations in this report have improved the effectiveness of the Navy's internal audit function.

However, DOD stated that the response to our report would serve to inform the Secretary of Defense on actions to resolve the issues identified. Since effective implementation and compliance with new procedures are necessary to fully implement all of our recommendations, further reporting to the Secretary of Defense is necessary. The Secretary of the Navy should inform the Secretary of Defense of additional actions taken to fully implement our recommendations.

# Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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

8 DEC 1987

Mr. Frank C. Conahan  
Assistant Comptroller General  
National Security and  
International Affairs Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "NAVAL AUDIT SERVICE: Effectiveness of Navy's Internal Audit Organization Is Limited," dated 5 November 1987 (GAO Code 911062/OSD Case 7456). The DoD concurs with the report findings and recommendations. The GAO report confirms similar findings and recommendations contained in a prior Inspector General, DoD, report covering the same period (APO-87-01, "Report on Quality Assurance Review of the Naval Audit Service," dated November 10, 1986.)

The report reflects the result of the GAO review of FY 1985 audit report documentation. The GAO concludes that the Naval Audit Service (NAS) did not appear to be reporting on significant issues, and that the potential monetary benefits resulting from NAS audit recommendations were far below those of the other DoD internal audit organizations. The GAO recommends needed improvements--many of which have been implemented within the NAS since the GAO audit was conducted. New procedures strengthening the audit process have been incorporated in the Naval Audit Service Handbook. In addition, the increased emphasis on program results and economy and efficiency audits is resulting in increased monetary benefits being identified in the NAS audit reports. For the 6 months ended September 30, 1987, \$341 million in potential monetary benefits have been reported.

The DoD shares the GAO concern that the NAS be an important element of the Department of the Navy managerial control system, providing independent and objective evaluation of the overall performance of the Navy. The current efforts to improve the effectiveness of the NAS will afford the Navy more efficient use of allocated resources.

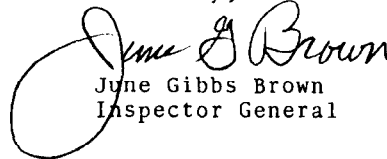
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The Department is committed to effective Service internal audit organizations and continually monitors them through various quality assurance reviews. As a part of that process, the Office of the Inspector General, DoD, will monitor the implementation of agreed-upon actions in response to the recommendations contained in the GAO draft report.

The detailed DoD comments on the GAO findings and recommendations are provided in the enclosure.

Sincerely,



June Gibbs Brown  
Inspector General

Enclosure

GAO DRAFT REPORT - DATED NOVEMBER 5, 1987  
(GAO CODE 911602) OSD CASE 7456

"NAVAL AUDIT SERVICE: EFFECTIVENESS OF NAVY'S INTERNAL  
AUDIT ORGANIZATION IS LIMITED"

DEPARTMENT OF DEFENSE COMMENTS

\* \* \* \* \*

FINDINGS

- **FINDING A: Audit Resource Allocation.** The GAO reported that the Naval Audit Service (NAS) was established in 1966 and is the Department of the Navy internal audit organization. The NAS is headed by the Auditor General of the Navy, who reports directly to the Under Secretary of the Navy. The GAO observed that, in FY 1986, the previous Auditor General dedicated 29 percent of available audit hours to single-activity audits, which determine compliance with laws and regulations and which evaluate internal controls at a single Navy activity. The GAO explained that activity audits are generally short-term audits, providing broad coverage of the activity, but lacking depth in audit scope. The GAO further observed that the present Auditor General, who assumed his position in January 1986, revised the allocation of audit resources, reducing the level of resources dedicated to activity audits in the FY 1987 Annual Audit Plan to 6.8 percent. According to the GAO, those resources have been shifted predominantly to functional audits. The GAO noted that the NAS believes the functional audits should identify more Navy-wide deficiencies and potential monetary benefits, leading to systemic recommendations. The GAO found that the FY 1986 NAS audits, other than single activity audits, covered a variety of issues. Although the issues could be productive audit topics, the GAO found that the NAS reported a very limited number of significant findings and potential monetary benefits. The GAO concluded that the shift to more functional audits should lead to the identification of more systemic recommendations which, in turn, may lead to an increase in potential monetary benefits to be derived from NAS audit recommendations. The GAO further concluded, however, that other noted deficiencies must be corrected before additional functional audits will lead to improved NAS effectiveness.

ENCLOSURE



See comment 1.

**DOD RESPONSE:** Concur. With the development of the FY 1987 annual audit plan, the NAS has placed substantially more emphasis on important and productive audits that focus on economy and efficiency and program results issues. The planning efforts and other initiatives resulted in potential monetary benefits of \$341 million being reported in NAS audit reports issued during the 6 months ended September 30, 1987. Actions completed and on-going to implement the GAO recommendations should eliminate the other deficiencies noted in the report and will lead to further improvement of the NAS effectiveness.

- **FINDING B: Adherence To Standard Audit Programs And Time Constraints.** The GAO reported that the NAS has developed a series of standardized audit programs for auditors to use as guides in conducting audits, especially for those audits conducted on a recurring basis. The GAO found, however, that auditors and regional managers have interpreted guidance from the prior auditor general as requiring completion of all audit steps in standardized programs, regardless of their utility. The GAO observed that time spent doing the audit steps prevents auditors from pursuing unanticipated audit findings or from fully developing other findings. The GAO noted that a summary of discussions at a May 1985 meeting between regional management and auditors-in-charge in one region stated, as follows:

"As a general consensus, it was concluded that a considerable amount of resources were being expended to complete audit guides and prepare workpapers for areas which contained little or no audit potential."

The GAO reported that standard audit programs were used in 19 of the 40 audits reviewed, and auditors did not deviate from the standard program in 12 of the 19 audits. The GAO concluded the Auditor General should:

- clarify the NAS policy on the use of standardized audit programs as general guides--i.e., that they should be supplemented with additional audit steps as appropriate; and
- emphasize only applicable audit steps should be completed when standardized program are used.

The GAO also found that the problem posed by strict adherence to standard audit programs has been compounded by auditor perception that the estimated number of staff hours to complete each standardized audit is an inflexible guideline. Specifically, in a sample of 40 NAS audit reports and working papers, the GAO found references to time constraints placed on completing seven audits and to the fact that auditors reduced the audit scope as they neared the limit of authorized staff-hours. While recognizing the necessity of establishing estimated staff-hours or staff-days to complete audit assignments as a management tool, the GAO concluded that those estimates should be used as guidelines and should not limit the ability of the auditor to fully develop findings or complete the scope of work assigned.

See comment 1.

**DoD RESPONSE:** Concur. The use of standardized audit programs has been discontinued by the NAS. In addition, in FY 1987, internal policies were changed to allow auditors to expand the scope of auditing when warranted.

- **FINDING C: Impact On Potential Monetary Benefits.** The GAO reported that the House Armed Services Committee has expressed concern over the "extremely low" potential monetary benefits reported by the NAS, when compared to the internal audit organizations in other Military Services. The GAO found that the NAS potential monetary benefits have been comparatively low in recent years for several reasons, including a deemphasis by the NAS headquarters on reporting monetary benefits. The GAO noted that, according to NAS auditors and managers, the current Auditor General has more interest in reporting potential monetary benefits. The GAO also noted that, in FY 1986, the NAS reported monetary benefits totaling \$983 million, the highest in the five DoD semiannual reports to the Congress, between March 31, 1985, and March 31, 1987. While noting it did not validate the total monetary benefits reported by the NAS (or by the other military audit organizations), based on a sample of NAS audit reports and working papers, the GAO raised questions as to the reliability of some of the monetary benefits reported by the NAS for the 6-month period ended March 31, 1986. The GAO observed that, when NAS identifies monetary benefits in audit reports, it is NAS policy to indicate the applicable appropriations. The GAO found that, according to the Navy Comptroller staff, however, compliance with the requirement is inconsistent. In addition to the potential monetary benefits quantified in audit reports, the GAO

reported that budget analysts read audit reports and identify monetary benefits beyond those claimed by auditors and agreed-to by Navy management. The GAO concluded that indicates a potential for NAS auditors to quantify monetary benefits more frequently than is currently being done. The GAO further concluded that monetary benefits identified in audit reports should increase if the NAS allocates its resources to significant issues and eliminates time constraints and strict adherence to standard audit programs.

**DoD RESPONSE:** Concur. As stated above, the NAS has placed substantially more emphasis on important and productive audits that focus on economy, efficiency and program results issues. Also, the use of standardized audit programs has been discontinued and internal policies have been changed to allow auditors to expand the scope of auditing when warranted.

- **FINDING D: Unreported Material Findings.** The GAO reported that the NAS "Naval Audit Handbook" states, in part:

"Normally, all material audit findings will be reported in single formal reports. An exception to this rule would be a material finding unrelated to the audit objective(s), which the auditor just happens to find and which is directed to a command other than the primary auditee. In this instance, the material finding will be reported separately in a formal report after consultation with Naval Audit Service Headquarters."

According to the GAO, the Handbook details 15 criteria for judging the materiality of a finding, and findings involving one or more of the conditions are usually considered material and, therefore, are included in the formal audit reports. The GAO found that in 15 of the audits reviewed, the NAS omitted at least one material finding from the final audit report and, in addition, the reasons why the material findings were not reported were not documented in the working papers. The GAO observed that, while the decision not to report findings was made at various levels within the NAS, based on its analysis, valid reasons for the decisions not to report material findings could not be identified. One noteworthy reason for omitting a finding was given by an auditor who justified deleting a finding by referring to

See comment 1.

Section 602 of the Naval Audit Handbook, which states, in part, "...the issue itself must also be sufficiently significant to warrant action by higher management levels after report publication." The GAO concluded that, if management disagrees with the auditors, the language in the Naval Audit Handbook could be used as a basis for deleting any audit finding of a local nature. The GAO concluded the working papers for 15 reports reviewed contained material audit findings that were not included in the final audit report. The GAO further concluded that these omitted findings were well supported and should have been reported.

See comment 2.

**DoD RESPONSE:** Concur. Inadequate supervisory actions contributed to the condition, i.e., failing to document adequately the reasons for including findings in, or deleting findings from, draft reports. To correct the condition, renewed emphasis has been placed on effective supervision and oversight. Furthermore, the NAS policies and procedures have been revised to require an explanation in the audit working papers as to why omitted findings and recommendations are not in draft or final reports. Details on specific actions taken to correct the condition are provided in the DoD responses to the applicable GAO recommendations.

- **FINDING E: Unsupported Material Findings.** The GAO explained that generally accepted Government auditing standards (GAGAS) require that auditors obtain sufficient, competent, and relevant evidence to afford a reasonable basis for their judgments and conclusions. The GAO found, however, two of the reports reviewed contained findings and conclusions that were not adequately supported in the working papers. The GAO further observed that, because the auditors had not gathered sufficient and competent evidence, they may have reach incorrect conclusions and, therefore, the report recommendations also may have been inappropriate. As an example, the GAO cited the NAS evaluation of the planning criteria for enlisted dining facilities. The GAO noted that NAS regional management acknowledged (1) the method of determining enlisted dining hall use was invalid, (2) the audit work was limited, and (3) the dining facilities chosen for survey may not have an adequate internal control procedure (which would prevent issuance of unsupported audit findings). The GAO further observed that one such control procedure is "report referencing," a process that checks the adequacy of evidence supporting an audit finding.

The GAO reported, however, that NAS referencing policy does not require the referencer to:

- verify independently the accuracy of figures in the report;
- verify that findings are adequately supported by workpapers; or
- verify that conclusions and recommendations logically flow from the support.

The GAO also found that not all the draft reports sampled were completely referenced. The GAO concluded that reporting unsupported findings may have a negative impact on an audit organization as well as on the auditee, because auditees and other users of audit reports may begin to question the usefulness of reports and the competence and degree of reliance they should place on the audit organization and its future reports. The GAO further concluded that unsupported findings and recommendations can mislead management into taking unnecessary or counterproductive actions to correct the findings.

**DoD RESPONSE:** Concur. The NAS is committed to performing audits and reporting audit results in keeping with the letter and spirit of the GAGAS. As part of its renewed emphasis on audit quality, the NAS has instituted additional management controls, including the following:

- establishing an independent referencing system to ensure the accuracy of information in audit reports;
- increasing the number of audit reports subject to pre-publication reviews; and
- enforcing audit policies through training programs, performance reviews, and quality control reviews.

- **FINDING F: Delays In Report Publication To Get Management Agreement.** While the GAGAS states audit reports shall include pertinent views of responsible agency officials on audit findings, conclusions and recommendations, the GAO found that the NAS efforts to obtain management

See comment 2.

agreement on audit recommendations goes significantly beyond the requirement. The GAO explained the NAS comment procedure, as follows:

- the NAS provides Navy managers with drafts of individual findings and recommendations as they are developed, and management responds informally to the information;
- at the conclusion of the audit, management receives the draft audit report and, under NAS policy, is given 30 days to provide formal comments on the report findings and recommendations; and
- if management disagrees with any section of the draft report, regardless of how well supported the findings may be, the NAS provides the draft to progressively higher levels of Navy management in an attempt to resolve the differences.

The GAO observed that the practice of always trying to obtain management agreement has led to cases of prolonged discussions with management and has caused inordinate delays in report issuance. The GAO further found that, in order to obtain management agreement on the draft report, the NAS had deleted or changed some findings or recommendations without additional facts or support in working papers to justify the deletions or changes. The GAO concluded that, when management and the audited organization disagree with a specific finding or recommendation in a draft report, but do not have additional data to disprove auditor facts or conclusions, the NAS should report the findings and recommendations as unresolved issues and include management positions in the audit report. The GAO further concluded that obtaining management agreement on findings and recommendations should not be given precedence over the policy for obtaining management comments.

See comment 2.

**DoD RESPONSE:** Concur. The previous NAS draft report utilization policies inordinately delayed final report publication dates. To minimize or eliminate the delays, the current NAS policy requires the following:

- simultaneous distribution of draft reports to multiple Department of the Navy command levels, but requesting comments only from recommendation addressees only; and

- publishing final reports without management comments if unreasonable delays are experienced.

- **FINDING G: Inaccuracies And Other Problems In Audit Reports.** The GAO reported that the GAGAS states that the need for accuracy in audit reports is based on "...the need to be fair and impartial in reporting and to assure readers that what is reported is reliable." The GAO found, however, that seven of the 40 audit reports reviewed contained inaccuracies and other problems, including:

- factually incorrect data in four reports;
- material findings reported as nonmaterial in one report; and
- repeat findings, not identified as such, in two reports and, therefore, not reported to higher levels of management, as required by the NAS policy.

The GAO noted that the inaccuracies found were attributable to the auditors-in-charge, who conducted the work, and/or the assistant directors involved in providing instruction and reviewing audit working papers and reports. The GAO concluded that such inaccuracies could not only mislead and confuse management, but could also raise concerns as to the competency and abilities of the auditors, as well as the usefulness of the NAS products. The GAO further concluded that, as a result of such inaccuracies, Navy management may view reports as unrealistic and tend to resist implementing audit recommendations in the future.

**DoD RESPONSE:** Concur. As stated above, the NAS has initiated a number of actions to improve the effectiveness of audit supervision and the quality of audit reports. Implementation of those and other actions identified in the responses to the GAO recommendations will correct the conditions and improve the accuracy and usefulness of audit reports.

See comment 1.

- **FINDING H: Deficiencies In Multilocation Audits.** The GAO reported that the GAGAS specifically addresses the need for careful coordination of audit activities during multilocation audits, in order to ensure the work is coordinated and review techniques are uniform. The GAO explained that two types of reports are issued by the NAS as a result of multilocation audits:

- **Local Reports**--issued to managers at each of the audit sites included in the audit, detailing deficiencies and making recommendations specific to that site; and
- **Summary Reports**--written by NAS headquarters, which summarize the content of local reports for top Navy management, but do not include recommendations.

The GAO found deficiencies unique to multilocation audits and their associated local reports. First, the NAS headquarters did not provide consistent guidance to the various audit sites in each of the three multilocation audits reviewed. Second, the NAS summary reports did not contain recommendations, although they summarized significant issues for top Navy management. The GAO further found that actions by local management may not be able to correct systemic deficiencies--the kinds of deficiencies one would expect to be reported in a summary report to top management. As an example, the GAO cited that a report on major procurement concluded that supply centers at Charleston, San Diego, Norfolk, and Puget Sound, "...excessively used negotiated procurement when other preferred procurement methods were available." Nevertheless, the NAS did not make recommendations to the Command on how to improve supply center performance in that area, even though the Command appeared to have system-wide problems. The GAO found that many of the problems with multilocation audits can be attributed to the NAS policy for issuing local and summary reports on these audits. The GAO concluded that the accuracy of multilocation audit reports could be improved by strengthening quality control requirements. The GAO further concluded that the NAS policy on conducting and reporting on multilocation audits should be revised to require the auditor-in-charge, responsible for preparing the summary report, to review and approve all draft local audit reports before they are issued.

**DoD RESPONSE:** Concur. During the period covered by the GAO review, the NAS performed two types of multilocation audits.

See comment 1.



One type, which is the subject of the GAO finding, was referred to as a concurrent audit (i.e., an audit of a single function, performed concurrently by NAS staff located at similar types of naval installations). While the audits had a common objective, they used locally prepared audit programs, which resulted in a series of local audit reports with a summary report issued by NAS headquarters. The NAS has discontinued that type of audit. All multilocation audits are now based on a single audit program, with one common set of objectives, scope and methodology for all participating audit sites.

- **FINDING I: Deficiencies In Supervision.** The GAO found that inadequate supervision at various levels of the NAS contributed, in total or in part, to the problems found in audit conduct and reporting. The GAO noted that supervisory deficiencies included inadequate review and control of the work performed and conclusions reached by audit staff, and poor judgment in changing reports or deleting findings from audit reports. As an example, the GAO reported that supervisors had deleted 20 findings from ten reports, after discussing the written draft findings with management. Among the reasons for deleting the findings were:

- evidence was insufficient;
- auditors used the wrong criteria in evaluating performance; and
- management was aware of the problem and taking action.

The GAO concluded that the audit supervisor should review findings and supporting working papers and make those judgments before giving the findings to Navy management for comment. The GAO observed that management confidence in auditor capabilities could be eroded by a series of unsupported and inaccurate conclusions given to them for comment. The GAO also observed that 15 audit report working papers included findings that should have been included in the audit reports. The GAO reported that NAS supervisors justified excluding the findings from the reports because:

- the findings were outside the scope of the audit;
- the findings lacked sufficient support; or
- the recommendations were weak.

The GAO emphasized, however, that it was unable to determine from the audit documentation why NAS supervisors made those decisions. The GAO noted that in a November 1986 report on NAS<sup>1/</sup>, the DoD Inspector General concluded that supervisors were "...lax in meeting their responsibilities or were not sufficiently knowledgeable in performing their duties." The Inspector General, DoD, recommended that the Navy Auditor General provide supervisory training courses for regional supervisors and auditors-in-charge, concentrating on the supervisor role in audit performance and reporting. The GAO reported, however, that the Auditor General disagreed, stating in part that laxness or lack of knowledge may be the case in a minority of instances and the NAS would isolate those cases and provide necessary training. The GAO concluded that the results of its review and those of the Inspector General, DoD, both show that, generally, NAS supervisors could, in fact, benefit from supervisory training and, therefore, such training should be provided. The GAO also concluded that the approach of the Navy Auditor General--i.e., identifying individual supervisors for specific training and using performance appraisals and disciplinary actions--is a viable supplement to the general training of the NAS supervisors.

See comment 1.

**DoD RESPONSE:** Concur. The NAS is currently emphasizing to its audit staff the need to comply with the GAGAS. The results of quality assurance reviews conducted by the Office of the Inspector General, DoD, and the GAO are being provided to the NAS auditors so that they may benefit from the reviews. During meetings of audit supervisors and regional office staffs, compliance with the GAGAS is a continuing agenda item. The Navy Auditor General Staff Notes, published quarterly, is also used to promote more effective auditing, in accordance with the GAGAS. The NAS quality control program also emphasizes compliance with the GAGAS and a course is being developed on the requirements of the NAS Handbook, which incorporates the GAGAS (as set forth in the current draft of the GAO Yellow Book). The course will be given to all regional GS-12 and GM-13 auditors.

<sup>1/</sup> DoD IG Report APO-87-001, "Report on Quality Assurance Review of the Naval Audit Service," November 10, 1986

- **FINDING J: Relationship With the Office of the Assistant Secretary (Financial Management).** The GAO noted that, to ensure maximum independence, the GAGAS states the audit organization should be "...located outside the staff or line management function of the unit under audit." The GAO found, however, that although the Auditor General reports to the Under Secretary of the Navy, the NAS has maintained ties with the Office of the Assistant Secretary of the Navy (Financial Management), a relationship that could be perceived as an impairment to the NAS independence (the Assistant Secretary also serves as the Navy Comptroller). Specifically, the GAO found that the NAS continues to receive technical advice from the Office of the Assistant Secretary of the Navy (Financial Management), which includes advice related to findings involving financial matters. The GAO concluded that this creates the perception of a lack of independence in reaching audit opinions, conclusions, judgments, and recommendations. As an example, the GAO cited that a NAS report concluded that the Space and Naval Warfare Systems Command improperly extended the availability of \$56.8 million in expired FY 1982 and FY 1983 Operation and Maintenance, Navy funds. In response to the report, the Office of the Comptroller of the Navy said the Navy Comptroller Manual would be changed to authorize clearly the use of project orders to fund field activities, a practice the NAS had previously reported as improper. This same audit report also identified an apparent \$4.5 million Anti-deficiency Act violation; however, the NAS did not report the apparent violation and discussions with Office of the Navy Comptroller staff were not documented. The GAO further reported that a second tie to the Office of the Assistant Secretary (Financial Management) was created in January 1986, when the Deputy Secretary of the Navy appointed a member of the Comptroller staff as the Navy Auditor General. The GAO concluded that the appointment could also create the perception of a lack of independence, since a personal impairment to independence could exist if an auditor has had "previous involvement" in a decisionmaking or management capacity that would affect current operation of the entity or program being audited. The GAO also found that the NAS legal counsel is selected by, reports to, and is rated by the Counsel for the Navy Comptroller, within the Office of the Assistant Secretary (Financial Management). The GAO concluded that the reporting structure for the NAS Legal Counsel also creates the appearance of impairing NAS independence.

See comment 1.

**DoD RESPONSE:** Concur. To eliminate the perception of a lack of independence noted by the GAO, the following actions have been taken:

- the NAS Handbook has been revised to require its audit staff to direct all inquiries regarding financial matters to the NAS headquarters;
- the headquarters staff will research the questions and obtained any technical opinions required;
- the nature of information requested from the Assistant Secretary of the Navy (Financial Management) will be clarification rather than guidance; and
- the same procedure will be used in obtaining technical advice from other functional areas, such as logistics, research and development, personnel, etc.

With respect to the legal counsel reporting structure, effective March 31, 1988, the Counsel assigned to the Naval Audit Service will begin reporting directly to the Office of the Navy General Counsel.

- **FINDING K: Use of Military Officers.** The GAO noted that, in a 1977 report<sup>Z/</sup>, it recommended that the Secretary of Defense strengthen the internal audit function within the Navy by directing the Secretary of the Navy to redesignate the positions of auditor general, deputy auditor general, and the directors of regional offices as civilian positions. The GAO reported that, in response to the recommendations, in 1980, the Secretary of the Navy converted the auditor general position to a civilian position; however, the other positions remain designated for military officers. The GAO found that the possible impairment to independence of the audit organization is based on the fact that military officers fill audit management positions on a temporary basis and later return to line positions in the military. The GAO observed, therefore, that it is possible for officers to be responsible for audit reports on those military units from which they were recently assigned or to

<sup>Z/</sup> GAO Final Report FGMSD 78-5, "The Naval Audit Service Should Be Strengthened." November 11, 1977 (OSD Case 4573-B)

which they will be assigned. The GAO further observed that a superior officer, whose unit is being audited, could subsequently sit on the promotion board for officers responsible for the audits. The GAO also noted that an Arthur Anderson and Company report stressed the importance of filling regional director and deputy director positions with individuals with a career path in financially related activities. The Inspector General, DoD report also took exception to the Navy practice of filling the deputy auditor general and regional director positions in the NAS with Navy supply corps and line officers, and Marine Corps officers. The GAO concluded that the Navy could strengthen its internal audit function by establishing permanent managerial positions within the NAS to be filled by individuals trained and experienced in auditing and accounting principles and practices. The GAO further concluded that the perception of impairment to NAS independence remains as long as military officers rotate into management positions within the audit organizations, unless steps are taken to ensure that:

- they have knowledge and experience in auditing and accounting;
- they will not be responsible for audit of those units from which they were recently assigned; and
- are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit.

**DoD RESPONSE:** Concur. In the future, Military officers selected by the NAS to fill regional director positions will have knowledge and experience in either auditing, logistics or finance. Also, military officers selected for the Deputy Auditor General position will have knowledge and experience in auditing. To the extent that the Navy Auditor General is unable to obtain qualified military officers for assignment to such positions, he will civilianize the positions.

Further, regional directors will be required to exclude themselves from audits that involve programs or activities in which they were recently directly involved. Also, when a military officer's next assignment is known, he or she will not participate in an audit of that command/function. It would be very unlikely, however that this information would be available until near the end of his/her NAS tour of duty.

See comment 3.

Internal controls will be established to preclude the removal of audit findings or recommendations from a report or the cancellation of a scheduled audit, without the written approval of both the regional director and deputy regional director. Disputes on such matters will be referred to the Navy Auditor General for resolution. (These requirements are contained in the NAS Audit Handbook and the NAS Management Handbook.)

The new policies concerning the selection and utilization of military officers will be included in SECNAVINST 7510.6.

- **FINDING L: Management Agreement On Audit Findings and Recommendations.** The GAO found that the NAS emphasis on obtaining management agreement on audit reports is given precedence over its policy for obtaining management comments on draft reports. The GAO concluded that the priority given to obtaining management agreement on findings and recommendations increases the potential for impairing independence of auditors and the audit organization (also see Finding F).

**DoD RESPONSE L:** Concur. As stated above, previous NAS draft report utilization policies inordinately delayed final report publication dates. To minimize or eliminate the delays, the current NAS policy requires the following:

- simultaneous utilization of draft reports to multiple Department of the Navy command levels requesting comments from recommendation addressees; and
- publishing final reports without management comments, if unreasonable delays are experienced.

- **FINDING M: Response to Previously Reported Deficiencies.** The GAO reported that, since 1977, the Office of the Inspector General, DoD, the Arthur Anderson and Company, and the General Accounting Office have evaluated the NAS. According to the GAO, each has reported deficiencies similar to those identified in the current audit. The GAO also found that, in addition to having the problems identified by outside organizations, in 1985, in response to a NAS questionnaire, the NAS auditors voiced concerns over the same deficiencies. The GAO observed that the House Committee on Armed Services has become aware of the Navy inaction in improving its internal audit function and, to emphasize its concern, deleted \$100 million from the Navy FY 1988 Operation and Maintenance budget request. The GAO concluded the congressional message is that an effective Navy audit organization would have identified at least \$100 million in potential monetary benefits from its recommendations.

See comment 3.

**DoD RESPONSE:** Concur. The DoD shares the GAO concern with respect to the effectiveness of the NAS and will continue to monitor the NAS through periodic quality assurance reviews. As part of the process, the Office of the Inspector General, DoD, will evaluate the implementation of agreed-to actions on the GAO recommendations.

- **FINDING N: Navy Actions Have Been Ineffective.** The GAO reported that, since 1977, the Secretary of the Navy and the Navy Auditor General have taken some actions to improve NAS operations, such as converting the Auditor General position from military to civilian, and improving the annual audit planning process. The GAO further found that the previous Auditor General also instituted a system of quality assurance reviews on audit performance; however, the current Auditor General expressed concern that these reviews are not identifying the types of problems with audit report working papers identified by the GAO. As the GAO previously noted, the current Navy Auditor General has reallocated audit resources to functional audits, which he believes will lead to more systemic findings and recommendations and increase the reporting of potential monetary benefits. The GAO also noted that, according to the Navy Auditor General, the following efforts have been initiated:

- structuring training requirements for auditors at each grade-level;
- revising the NAS audit handbook to clarify certain segments of NAS policy; and
- improving NAS capabilities to audit computer-based systems.

The GAO concluded that, while the Department of the Navy and the Navy Auditor General have taken some actions (which have improved selected aspects of the NAS operations), none of the actions has, as yet, had a discernible impact on the continuing deficiencies in conducting, reporting, or supervising Navy audits.

**DoD RESPONSE:** Concur. A renewed and concerted effort by the current Navy Auditor General and the Department of the Navy have been made to enhance the quality of audit work and to increase the effectiveness of audit resources. The DoD

See comment 4.

responses to the GAO recommendations expand on a number of substantial changes that have been instituted or are planned. Certain organizational changes will take time to institutionalize and require continuous management attention. The Department of Defense, like the GAO, is not satisfied with the progress to date and will monitor NAS operations to ensure noted deficiencies are corrected.

**RECOMMENDATIONS**

- **RECOMMENDATION 1:** The GAO recommended that the Navy Auditor General issue clarifications on the use of the standardized audit program for certain types of audits and for segments of other audits, so that auditors are able to pursue potentially significant issues identified during audit, even though these issues are not included in standardized audit programs.

**DoD RESPONSE:** Concur. The use of standardized audit programs has been discontinued in the NAS. In addition, internal policies have been changed to allow auditors to expand the scope of auditing when warranted. The changes were implemented during FY 1987.

- **RECOMMENDATION 2:** The GAO recommended that the Navy Auditor General issue policy clarifications to ensure that authorized staff-hours for completing audits are viewed as flexible milestones, which can be extended to allow for developing audit issues.

**DoD RESPONSE:** Concur. The GAO recognized the efforts of the current Navy Auditor General in redirecting limited audit resources to those types of audits designed to identify systemic problems. For resource utilization purposes, an estimate of the time needed to perform those audits is developed. However, recognizing that these estimates can change as the audits progress, NAS policy provides that additional time will be made available when the need is demonstrated. The NAS Handbook requires audit management to reevaluate audit resource requirements on a continuing basis, as the audit progresses. In the event additional resource requirements are identified, they may be, and should be, requested. If justified, the request will be approved. The GAO points out that despite the

See comment 5.

See comment 6.



Handbook procedures for requesting additional resources, many NAS auditors perceived that such requests reflect negatively in their performance. Execution of the audit process in the last year should have changed this perception.

- **RECOMMENDATION 3:** The GAO recommended that the Navy Auditor General clarify NAS policy on when findings and recommendations should be deleted from draft reports.

**DoD RESPONSE:** Concur. In keeping with the renewed emphasis on effective supervision, NAS supervisors are required to maintain continuous oversight on all audits for which they are responsible, including the following:

- attending significant conferences;
- making periodic supervisory visits to ongoing audits and documenting results of such visits;
- reviewing the adequacy of audit coverage and the quality of work papers, and document these reviews; and
- ensuring that all supported audit findings are reported.

In addition, the audit working paper file is required to contain sufficient documentation to confirm that the above described supervisory oversight actually occurred. Selected on-site quality control reviews conducted by NAS headquarters personnel are planned each year to confirm implementation of the policy.

- **RECOMMENDATION 4:** The GAO recommended that the Navy Auditor General issue NAS policy requiring all auditors to include, in their working papers, a detailed explanation of why findings and recommendations are not in draft or final audit reports.

**DoD RESPONSE:** Concur. The NAS Handbook has been revised to require the following:

- explanation by the appropriate auditor of why findings and recommendations are not in draft or final reports; and
- documentation of a decision to delete or not report an audit finding.

See comment 7.

See comment 7.

The documentation must fully explain the basis for such a decision, as well as evidence of concurrence by a regional assistant director, to avoid any perception of erosion of independence. Such decisions must be made by a qualified civilian auditor.

- **RECOMMENDATION 5:** The GAO recommended that the Navy Auditor General issue a policy requiring supervisors to review all audit findings and recommendations before requesting management comments, to ensure that findings and conclusions are adequately supported.

See comment 5.

**DoD RESPONSE:** Concur. The NAS supervisors are required to maintain continuous oversight on all audits for which they are responsible. Current NAS policy requires supervisors to review all audit findings and recommendations, before requesting management comments, to ensure findings and conclusions are adequately supported. Enforcement of the policy will be emphasized during internal quality control reviews. (Also see DoD Response to Recommendation 3.)

- **RECOMMENDATION 6:** The GAO recommended that the Navy Auditor General strengthen quality controls over audit reports by developing and implementing a mechanism such as effective referencing.

- and -

- **RECOMMENDATION 7:** The GAO recommended that the Navy Auditor General initiate a program of pre-publication review of draft audit reports in NAS headquarters, at least for the more significant reports to be issued by NAS regional offices, to ensure that audit reports are complete and accurate.

**DoD RESPONSE:** Concur. As part of the NAS renewed emphasis on quality audit work:

See comment 5

- an independent referencing system has been established to ensure the accuracy of information in audit reports and to ensure all reportable findings have been included;

See comment 2.

- the number of audits subject to pre-publication review has been increased; and

- a Quality Index Review program has been implemented, as a subset of the NAS productivity program, which will evaluate and measure the overall quality of a representative sample of NAS products.

The NAS is committed to performing audits and reporting audit results in keeping with the letter and spirit of the GAGAS. The NAS management at all levels is committed to closely monitor the effort. Enforcement will be maintained through training programs and performance reviews.

- **RECOMMENDATION 8:** The GAO recommended that the Navy Auditor General revise NAS policy to require comments only from management of the audited organization or other directly responsible for implementing audit recommendations.

- and -

- **RECOMMENDATION 9:** The GAO recommended that the Navy Auditor General revise NAS policy to state clearly that report issuance will not be delayed to obtain concurrence from Navy management on draft findings and recommendations. (The GAO observed that, when management disagrees with audit finding and recommendations, the NAS should evaluate its supporting evidence and change findings and recommendations only when additional information can be presented by management to invalidate audit conclusions and recommendations as presented in draft reports.)

**DoD RESPONSE:** Concur. Previous NAS utilization policies delayed publication dates. The previous Navy Auditor General policy to resolve management disagreement with findings, recommendations, and/or monetary benefits, before issuing an audit report, is one of the more prevalent reasons for the delays. Management failure to respond in a timely manner, coupled with the NAS practice of not publishing a report without management comments, is another significant reason. To minimize or eliminate the delays, the current NAS policy requires the following:

- simultaneous distribution of draft reports to all Department of the Navy commands, who are recommendation addressees, with an information copy sent two command echelons above those addressees;

See comment 5.

See comment 2.

- comments are solicited only from the recommendation addressees; and
- management comments will be required by the NAS regional office within a reasonable time (generally 30 calendar days for noncomplex audits) with regional offices having the authority to grant only one extension of not more than 15 calendar days; and
- if responses are not received by the requested response date or extended deadline (after consulting with NAS headquarters), the final audit report will be published without management comments.

- **RECOMMENDATION 10:** The GAO recommended that the Navy Auditor General issue NAS policy to require audit guidelines on multilocation audits, providing identical audit scope and methodology for the individual audit sites.

- and -

- **RECOMMENDATION 11:** The GAO recommended that the Navy Auditor General issue NAS policy to require review of draft local audit reports by the auditor-in-charge who will be preparing the summary report for issuance to top Navy management.

- and -

- **RECOMMENDATION 12:** The GAO recommended that the Navy Auditor General issue policy to require recommendations to top Navy management on actions to be taken to correct or eliminate the systemic deficiencies reported in summary reports.

**DOD RESPONSE:** Concur. During the period covered by the GAO review, the NAS performed two types of multilocation audits. One type, which is the subject of the GAO finding, was referred to as a concurrent audit (an audit of a single function, performed concurrently by Navy Audit Service staff located at similar types of naval installations). While those audits had a common objective, they used locally prepared audit programs and resulted in a series of local audit reports, with a summary report was issued by NAS headquarters. The NAS has discontinued that type of audit.

See comment 6.

All multilocation audits are now based on a single audit program, with one common set of objectives, scope and methodology for all participating audit sites. A designated lead region is responsible for ensuring a common coordinated approach and preparation of a single report, including all audit results and recommendations to correct all material deficiencies found. In addition to the responsible action addressee(s), copies of all multilocation reports are sent to the Chief of Naval Operations or the Commandant of the Marine Corps, as appropriate. The Secretary and Under Secretary of the Navy are briefed on significant audits.

- **RECOMMENDATION 13:** The GAO recommended that the Navy Auditor General require that all auditors, supervisors, and managers in both regional offices and headquarters attend training that emphasizes generally accepted auditing standards and, in particular, the standards for supervision, evidence, reporting and due professional care.

**DoD RESPONSE:** Concur. The NAS is currently emphasizing to its audit staff the need to comply with GAGAS. During meetings of audit supervisors and regional office staffs, compliance with GAGAS is an ongoing agenda item. The Auditor General Staff Notes, published quarterly, is also used to promote more effective auditing, in accordance with the GAGAS. The NAS quality control program also emphasizes compliance with the GAGAS and the annual performance appraisal system is used to evaluate compliance with those standards.

The NAS is also developing a course on the requirements of the NAS Handbook, which incorporates the GAGAS (as set forth in the current draft revision of the GAO Yellow Book). The course will commence during FY 1988, and will be given to all regional GS-12 and GM-13 auditors.

- **RECOMMENDATION 14:** The GAO recommended that the Secretary of the Navy direct the Navy Auditor General and the Assistant Secretary of the Navy (Financial Management) to limit the nature and extent of technical advice provided to the NAS, so as not to impact the reporting of findings relating to financial matters. (The GAO observed that advice in these instances can be obtained from other organizations such as the Office of the Assistant Secretary of Defense (Comptroller).)

See comment 5.

See comment 5.

**DoD RESPONSE:** Concur. The current organizational placement of the Navy Auditor General fully complies with the Comptroller General's auditing standard on independence. The Navy Auditor General reports directly to the Under Secretary of the Navy. In recent years, two actions were taken to further strengthen the organizational independence of the position.

- As a result of the recommendations of Arthur Andersen and Company, the Secretary of the Navy terminated the authority of the Assistant Secretary (Financial Management) to provide technical advice to the Navy Auditor General on audit matters; and
- In implementing the Goldwater-Nichols DoD Reorganization Act of 1986, the Navy Auditor General was made a member of the Office of the Secretary of the Navy and given sole responsibility for all audit policy matters within the Navy.

The Navy Auditor General and his staff should be, and are, free to contact any senior manager in the Department of Defense to obtain technical advice or interpretation of operational and policy matters within the purview of those managers. The Navy Auditor General, however, retains the sole right to accept or reject such advice, based on his consideration and evaluation of all available information. Nevertheless, to preclude any perceptions of impairments to independence, the Navy Auditor General has revised the NAS Handbook to require that the audit staff direct all inquiries regarding financial matters to NAS headquarters. The NAS headquarters will research the questions and obtain any technical opinions required in a manner that does not present the perception or contribute to any lack of independence for the NAS.

- **RECOMMENDATION 15:** The GAO recommended that the Secretary of the Navy create a legal counsel for the NAS, who is completely independent of any activity subject to audit by the NAS and who reports directly to the Navy Auditor General.

See comment 5.

**DoD RESPONSE:** Concur. With respect to the legal counsel reporting structure, effective March 31, 1988, the Counsel assigned to the Naval Audit Service will begin reporting directly to the Office of the Navy General Counsel.

- **RECOMMENDATION 16:** The GAO recommended that the Secretary of the Navy address the perception of impaired independence created by having military officers rotate into the positions of deputy auditor general and regional directors either by designating the positions as civilian positions, or, at least, ensuring that the military personnel:
  - have knowledge and experience in auditing and accounting;
  - will not be responsible for audits of those units from which they were recently assigned; and
  - are not likely to be subsequently assigned to work for a superior officer whose unit is subject to audit.
  
- **DoD RESPONSE:** Concur. In the future, military officers selected by the NAS to fill regional director positions will have knowledge and experience in either auditing, logistics or finance. Also, military officers selected for the Deputy Auditor General position will have knowledge and experience in auditing. To the extent that the Navy Auditor General is unable to obtain qualified military officers for assignment to the position, he will civilianize the positions. Further, regional directors will be required to exclude themselves from audits that involve programs or activities in which they were recently directly involved. Also, when a military officer's next assignment is known, he or she will not participate in an audit of the command/function. It would be very unlikely, however, that this information would be available until near the end of his/her NAS tour of duty. Internal controls will be established to preclude the removal of audit findings or recommendations from a report or the cancellation of a scheduled audit, without the written approval of both the regional director and deputy regional director. Disputes on such matters will be referred to the Navy Auditor General for resolution. (These requirements are contained in the NAS Audit Handbook and the NAS Management Handbook.)

The new policies concerning the selection and utilization of the military will be included in SECNAVINST 7510.6, which will be revised and reissued within the next 180 days.

- **RECOMMENDATION 17:** The GAO recommended that the Secretary of the Navy commit the Navy to an internal audit service that operates free of any impairments to its independence and foster the commitment among all levels of Navy management.

See comment 3.

See comment 3.

**DoD RESPONSE:** Concur. The actions taken by the Secretary of the Navy to strengthen the organizational alignment and authority of the Navy Auditor General, and the agreed-to actions in response to the General Accounting Office recommendations, clearly demonstrate that the Navy is seriously committed to an independent and effective internal audit service.

- **RECOMMENDATION 18:** The GAO recommended that the Secretary of the Navy report to the Secretary of Defense on actions to resolve the issues identified in this report. (p. 80/GAO Draft Report)

See comment 4

**DoD RESPONSE:** Concur. This response constitutes the recommended reporting by the Secretary of the Navy to the Secretary of Defense on actions to resolve the issues identified in this report.

- **RECOMMENDATION 19:** The GAO recommended that one year after receiving the report from the Secretary of the Navy, the Secretary of Defense conduct, or have conducted, a review to evaluate the effectiveness of actions taken to correct the reporting, evidence, supervision, and independence deficiencies cited in this report. (The GAO noted that the review should provide the Congress and the Secretary of Defense assurance that actions have been taken to improve the effectiveness of the Navy internal audit function.) (p. 81/GAO Draft Report)

See comment 5.

**DoD RESPONSE:** Concur. In FY 1989, the Inspector General, DoD, will undertake a review to determine whether the Navy actions in response to the recommendations in this report and a prior quality assurance review by the Office of the Inspector General, DoD, have improved the effectiveness of the Naval Audit Service. The results of the FY 1989 review, with any recommendations for further actions, will be made available to the Secretary of Defense and appropriate committees of the Congress.



The following are GAO's comments on the Department of Defense's letter dated December 8, 1987.

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## GAO Comments

1. No change to the report is necessary.
2. The DOD response is discussed under Agency Comments and Our Evaluation at the end of chapter 3.
3. The DOD response is discussed under Agency Comments and Our Evaluation at the end of chapter 4.
4. The DOD response is discussed under Agency Comments and Our Evaluation at the end of chapter 5.
5. Actions taken are responsive to our concerns.
6. The DOD response is discussed under Agency Comments and Our Evaluation at the end of chapter 2.
7. The DOD response to recommendations three and four adequately addresses our concerns.



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