Oversight Report

QUALITY CONTROL REVIEW OF KPMG PEAT MARWICK LLP
AND THE DEFENSE CONTRACT AUDIT AGENCY
MIDWEST RESEARCH INSTITUTE
FISCAL YEAR ENDED JANUARY 31, 1997

Report Number PO 98-6-018 September 26, 1998

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Department of Defense

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Acronyms

DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DLA	Defense Logistics Agency
GAGAS	Generally Accepted Government Auditing Standards
OMB	Office of Management and Budget

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September, 26, 1998

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SUBJECT: Quality Control Review of KPMG Peat Marwick LLP
and the Defense Contract Audit Agency
Midwest Research Institute
Fiscal Year Ended January 31, 1997
Report No. PO98-6-018 (Project No. 8OA-9008.06)

Introduction

We are providing this report for your information and response. The Kansas City, Missouri, office of KPMG Peat Marwick LLP (KPMG) and Independence (St.Louis Branch), Missouri, suboffice of the Defense Contract Audit Agency (DCAA) performed the coordinated single audit for the Midwest Research Institute (Institute), Kansas City, Missouri. The audit is required by the Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions." The Institute reported total Federal expenditures of $11,470,398 for the fiscal year ended January 31, 1997, representing $3,410,740 for the Department of Defense and $8,059,658 for other Federal agencies.

KPMG issued its audit report on April 25, 1997. The auditors identified no findings and questioned no costs. The KPMG auditors issued an unqualified opinion on the financial statements and Schedule of Federal Awards and issued positive and negative assurance statements on compliance with general requirements. Positive assurance means that, with respect to the items tested, the results of the auditors' procedures disclosed no material instances of noncompliance. Negative assurance means that, with respect to the items not

tested, nothing came to the auditors' attention that caused them to believe that the Institute has not complied in all material respects. The KPMG auditors also obtained an understanding of the internal controls related to the financial statements. The audit report describes the auditors' scope of work in obtaining that understanding and in assessing control risk.

DCAA issued its audit report on February 23, 1998. The DCAA auditors issued an unqualified opinion on compliance with specific requirements applicable to the research and development program. The DCAA auditors also obtained an understanding of the internal controls related to the Federal research and development awards. The audit report describes the auditors' scope of work in obtaining that understanding and in assessing control risk. The report on Federal awards further describes the significant internal controls or control structure including the controls that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations.

Quality Control Review Results

Some DCAA working papers supporting the OMB Circular A-133 audit do not meet the applicable guidance and regulatory requirements in the Circular, its related Compliance Supplement, Generally Accepted Government Auditing Standards (GAGAS), generally accepted auditing standards, and the provisions of the Federal award agreements. The KPMG working papers meet the applicable requirements.

Material Findings

Audit of Classified Contracts Not Verified

Approximately 25 percent ($3,000,000), of the Institute's fiscal year 1997 expenditures relate to classified contracts. However, the DCAA auditors did not verify that an audit had been performed on these expenditures by the auditors with the appropriate security clearances. The expenditures related to the classified contracts represent 85 percent of the total DoD expenditures at the Institute. Although the working papers state that DCAA did not audit these expenditures, no attempt was made to verify whether the DCAA Field Detachment, which has the audit responsibility for classified contracts, had audited the $3,000,000 of expenditures. The DCAA auditors did not verify that the classified contracts had been audited because they believed that it was the responsibility of the Field Detachment to notify them of any audit coverage. The Attachment, paragraph 13c of the OMB Circular A-133, states, in general,

that the auditor will select and test an adequate number of transactions from each major program to obtain sufficient evidence to support an opinion on compliance with laws and regulations that may have a direct and material effect on that major program. In addition to professional judgment, other factors affecting the transactions selected include ". . . prior experience with the program particularly as revealed in audits and other evaluations. . .[and] the level to which the program is already subject to program reviews or other forms of independent oversight . . ." Without verifying that an audit had been performed, the DCAA excluded 25 percent of the expenditures from transaction testing because they considered it as outside of their audit scope and failed to disclose that scope limitation in their compliance reports. As a result, the report reader would conclude that the internal control assurances and the compliance opinion relate to all of the expenditures identified in the Schedule of Federal Awards, including the classified contracts, and use the information to administer and close Federal awards.

Reliance on the Work of Others

The DCAA direct cost working papers on equipment reference and include a copy of a property analysis review performed by the Defense Logistics Agency (DLA). However, we were unable to determine from the working paper documentation whether DCAA relied on the work of the DLA reviewers and if so, what procedures were performed to provide a basis for reliance. OMB Circular A-133, Attachment, paragraph 12a; GAGAS 6.14-6.16; and the DCAA Contract Audit Manual Section 4-1005, generally require that when reliance is placed on the work of others, the auditor must document the working papers to support the basis for that reliance. Specifically, the DCAA Contract Audit Manual states that when reliance is placed on the work of others, the extent of reliance: (1) should be documented; (2) must be based on specific knowledge of the actual work performed and the results obtained; and (3) should not be based only on the assumption or general knowledge that the work is performed by others. The DCAA auditor stated that the DLA property system analysis was not the sole basis for determining the existence of the items selected for review. However, since DCAA had not performed a review of the property control system, the auditor relied on the DLA review. The DCAA auditor was not aware of the requirement to provide documentation when reliance was placed on the work of others and did not consider the use of Defense Contract Management Command (DCMC) property system analysis as subject to special documentation. Therefore, a reviewer of the working papers cannot determine how much, if any, reliance was placed on the property system analysis and whether any reliance influenced the amount of testing performed on direct costs. Adhering to the requirements of GAGAS and the Contract Audit Manual will lead auditors to take steps to assure that they may rely on the work of others; otherwise, the auditors may erroneously reduce testing in an area.

Subrecipient Monitoring Audit Procedures Not in Accordance With OMB Circular A-133

The DCAA working papers do not support an audit of the subrecipient monitoring requirements conducted in accordance with the requirements of the Office of Management and Budget Circular A-133. Attachment, paragraph 13b(2)(b) of the Circular requires the auditor to review the recipient's system for monitoring subrecipients and obtaining and acting on the subrecipient audit reports. OMB Circular A-133, Attachment, paragraphs 13c(1) and (6) state that the auditor will obtain sufficient evidence to support an opinion on compliance with laws and regulations that may have a direct and material effect on its major programs. The OMB Circular A-133 Compliance Supplement contains suggested audit procedures to assist auditors in planning and performing tests of Federal programs. The auditor may elect to use the procedures identified in the Compliance Supplement to achieve the stated audit objectives or may choose alternative audit procedures. Regardless of procedures chosen, GAGAS 5.17 requires that the auditors report the scope of their testing of compliance with laws and regulations in the audit report. The DCAA compliance audit report states that the OMB Circular A-133 Compliance Supplement was used to evaluate general administrative requirements for subrecipient monitoring, although the DCAA used other procedures to audit subrecipient monitoring. The required audit objectives for subrecipient monitoring from OMB Circular A-133 were not achieved through the audit procedures described in the DCAA working papers. The DCAA Independence suboffice performs different types of audits at various contractors; however, the Institute is its only contractor subject to OMB Circular A-133, which limits DCAA exposure to the A-133 auditing requirements. Although it is acceptable to perform audit procedures other than those described in the Compliance Supplement for testing of subrecipient monitoring, those procedures must meet the audit requirements of the Circular and must be disclosed in the audit report. Users of the DCAA compliance report will incorrectly conclude that the procedures in the Compliance Supplement were the basis to test compliance for the Circular A-133 subrecipient monitoring requirements when alternative procedures were actually used that did not meet the objectives of the Circular. The users will also incorrectly conclude, lacking an audit finding to the contrary, that the subrecipient monitoring system met the requirements of the Circular.

Lack of Training

The DCAA audit staff did not possess the proficiency required by GAGAS to perform the OMB Circular A-133 audit. During the audit, two different supervisory auditors reviewed the work, but they did not meet the continuing professional education and training requirements and their documented training was not in subjects directly related to the Government environment and to Government auditing. In addition, the auditor that performed the A-133 audit

had no training specific to the Circular. GAGAS paragraphs 3.3 through 3.8 require that the staff assigned to conduct an audit in accordance with GAGAS collectively possess the knowledge and skills necessary for that audit. Although the requirements apply to the organization as a whole, those individuals responsible for planning, directing, conducting, or reporting substantial portions of an audit conducted in accordance with GAGAS are required to complete at least 24 of the 80 continuing professional education and training hours in subjects directly related to the Government environment and to Government auditing. Until recently, the DCAA did not require its auditors to acquire continuing education and training related to the conduct of an A-133 audit. Therefore, auditors at suboffices that do not perform OMB Circular A-133 audits regularly were likely not to seek the proper training. In a March 9, 1998, memorandum, the DCAA directed auditors and supervisors who need the A-133 related training to acquire it as soon as possible. In addition, the DCAA is revising its self-study course that applies to A-133 audits.

Immaterial Finding

Direct Cost Testing Attributes Not Documented

The DCAA working papers do not document all of the compliance criteria that were tested to determine the allowability of direct costs. The DCAA review of direct costs was categorized into equipment, subcontracts, and all other direct costs. DCAA determined whether the costs were authorized, charged to the correct project number, and properly inventoried; however, we could not determine whether they tested any other attributes. OMB Circular A-133, Attachment, paragraph 12a; Government Auditing Standards 4.35 - 4.37.b; and Codification of Statements on Auditing Standards, AU Section 339.05 contain documentation requirements for working papers. Generally, the auditor must document the working papers so that an experienced auditor having no previous connection with the audit could ascertain from them the evidence that supports the auditors' significant conclusions and judgments. Without discussions with the DCAA auditor, it was unclear whether all the applicable compliance criteria had been tested for direct costs. Because the DCAA performs the audit annually and is familiar with the Institute's disclosed practices, the auditor did not document the working papers to indicate the specific compliance criteria that had been tested for direct costs. Instead, the auditor stated that the criteria were implied in the working paper documentation and thus would lead a reviewer to conclude that all criteria had been tested. However, an independent reviewer

cannot discern from the working papers alone the compliance attributes that were tested to support the DCAA opinion on compliance that is stated in the audit report.

Recommendations for Corrective Action

We recommend that the Director, Defense Contract Audit Agency:

1. Ensure that the Fiscal Year 1997 classified expenditures for Midwest Institute have been audited by the appropriate auditors and furnish verification to our office.

2. Document the Fiscal Year 1997 working papers for the reliance placed on the work of others in accordance with Office of Management and Budget Circular A-133, Generally Accepted Government Auditing Standards, and the Defense Contract Audit Agency Contract Audit Manual.

3. Ensure that the recipient's system for monitoring subrecipients meets the requirements of the Office of Management and Budget Circular A-133 for future years.

4. Reemphasize to the field offices that:

a. The report on compliance should accurately reflect the audit scope in all instances, especially when procedures others than those contained in the Compliance Supplement are used, and

b. Alternative audit procedures must meet the audit objectives of the Office of Management and Budget Circular A-133.

5. Provide training to the auditors at the Independence Suboffice in subjects directly related to the Government environment and to Government auditing as required by Generally Accepted Government Auditing Standards before the Defense Contract Audit Agency's 2-year continuing professional education cycle ends in September 1998.

Quality Control Review Objective

The objective of a quality control review is to ensure that the audit was conducted in accordance with applicable standards and meets the auditing

requirements of the OMB Circular A-133. As a Federal funding agency for the Institute, we conducted a quality control review of the audit working papers. We focused our review on the following qualitative aspects of the audit: due professional care, planning, supervision, independence, quality control, internal controls, substantive testing, general and specific compliance testing, and the Schedule of Federal Awards.

We reviewed the report on the most recent peer review dated November 8, 1996, performed by Price Waterhouse LLP, which found that KPMG Peat Marwick LLP met the objectives of the quality control review standards established by the American Institute of Certified Public Accountants and that the standards were being complied with during the fiscal year ended March 31, 1996.

Scope and Methodology

We used the 1991 edition of the Uniform Quality Control Guide for Single Audits (the Guide) that was approved by the President's Council on Integrity and Efficiency as guidance for performing the quality control review procedures. The Guide is organized by the general and field work audit standards and the required elements of a single audit. It is further divided into the substantive work performed during the audit of the financial statements and the specific program compliance testing for major programs. We conducted our review March 30 through April 3, 1998.

Results of Prior Quality Control Reviews

We identified several material findings at one of the four DCAA locations we visited at various times between February 1, 1997, and January 31, 1998. The affected office was notified, and no further action is necessary.

We identified material quality control review findings at one of the three KPMG locations we visited at various times between February 1, 1997, and January 31, 1998. The affected office was notified, and we are awaiting a response.

Background

The Inspector General Act of 1978, Public Law 95-452, prescribes the duties and responsibilities of that office. In implementing the responsibilities, the

Inspector General is required to "take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General."

The Single Audit Act of 1984 (the Act) (Public Law 98-502) was intended to improve the financial management of state and local governments whose total annual expenditures are $100,000 or more with respect to Federal financial assistance programs; establish uniform requirements for audits of Federal financial assistance; promote efficient and effective use of audit resources; and ensure that Federal departments and agencies rely on and use the audit work done under the Act, to the maximum extent practicable.

The Single Audit Act Amendments of 1996 (the Amendments), based on 12 years of experience under the 1984 Act, are intended to strengthen the usefulness of single audits by increasing the audit threshold from $100,000 to $300,000 with respect to Federal financial assistance programs before an audit is required under the Act; by selecting programs to be audited on the basis of risk assessment rather than the amount of funds involved; and by improving the contents and timeliness of single audits. The Amendments also bring nonprofit organizations, previously covered by similar requirements under the OMB Circular A-133, under the Single Audit Act.

OMB Circular A-133 establishes the Federal audit and reporting requirements for nonprofit and educational institutions whose Federal awards are or exceed $100,000. The Circular provides that an audit made in accordance with the Circular shall be in lieu of any financial audit required under individual Federal awards. An agency must rely on the audit to the extent that it provides the information and assurances that an agency needs to carry out its overall responsibilities. The coordinated audit approach provides for the independent public accountant, Federal auditor, and other non-Federal auditors to consider each other's work in determining the nature, timing, and extent of their respective audit procedures. The Circular also requires that the cognizant agency obtain or conduct quality control reviews of selected audits made by non-Federal auditors and provide the results, when appropriate, to other interested organizations. The revised Circular was issued June 30, 1997, to incorporate the changes in the Single Audit Act Amendments of 1996. Its provisions apply to audits of fiscal years beginning after June 30, 1996.

Discussion of Results

During our quality control review, we reviewed and took exception to the working papers supporting the following report (see findings detailed above).

Report on OMB Circular A-133 Review of Fiscal Year 1997 Compliance With Requirements Applicable to the Federal Research and Development Program. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. The specific requirements applicable to research and development programs include types of services allowed or unallowed; eligibility; matching, level of effort, and/or earmarking requirements; special reporting requirements; and special tests and provisions. General requirements are national policies that could have a material effect on the recipient's financial statements including those prepared for Federal programs. In accordance with the coordinated audit agreement, KPMG audited compliance for the cash management, Federal financial reports, allowable costs/cost principles, and the administrative requirements. The auditors' procedures were limited to those prescribed in the OMB Compliance Supplement for "Audits of Institutions of Higher Learning and Other Non-Profit Institutions." We reviewed the audit program for the appropriate procedures, compared the audit program steps to those in the Compliance Supplement to make sure that all areas were audited, reviewed the working paper documentation and its support, and reviewed the compliance tests performed.

During our quality control review, we reviewed and took no exception to the working papers supporting the following reports and schedules.

Independent Auditors' Report. The auditor is required to obtain reasonable assurance about whether the financial statements are free of material misstatement. We reviewed the audit programs and the testing of evidence to determine whether testing was sufficient based on assessment of control risk to warrant the conclusion reached and whether the working papers supported the conclusion.

Independent Auditors' Report on Schedule of Federal Awards. The auditor is required to subject the Schedule of Federal Financial Assistance to the auditing procedures applicable to the audit of the financial statements and to ensure that the amounts are fairly stated in relation to the basic financial statements. Our review was included in the steps of evaluation of the audit working papers related to the "Independent Auditors' Report."

Schedule of Federal Awards. The recipient is responsible for creating the Schedule of Federal Awards. The auditor is required to audit the information in the Schedule and to ensure that it identifies major programs, as defined by OMB Circular A-133, and total expenditures for each program. We reviewed the audit programs for the appropriate procedures, reviewed a selected number of footings/cross-footings, and traced some of the amounts to the Subsidiary Ledger and/or Trial Balance.

Report on the Internal Control Structure Based on an Audit of Consolidated Financial Statements Performed in Accordance with Government Auditing Standards. The auditor is required to obtain an understanding of the internal controls that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements. We reviewed the audit programs for the appropriate procedures, the working paper documentation, and the substantive testing performed.

Report on Compliance with Laws, Regulations, Contracts, and Grants Based on an Audit of Consolidated Financial Statements Performed in Accordance with Government Auditing Standards. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect in determining financial statement amounts. We reviewed the audit program for the appropriate procedures, the working paper documentation, its support, and the compliance tests performed.

Report on Compliance with General Requirements - No Material Noncompliance Identified. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. General requirements are national policies that could have a material effect on the recipient's financial statements including those prepared for Federal programs. In accordance with the coordinated audit agreement, KPMG audited compliance for the political activity, civil rights, and the Drug-Free Workplace Act requirements. The auditors' procedures were limited to those prescribed in the OMB Compliance Supplement for "Audits of Institutions of Higher Learning and Other Non-Profit Institutions." We reviewed the audit program for the appropriate procedures, compared the audit program steps to those in the Compliance Supplement to make sure that all areas were audited, reviewed the working paper documentation and its support, and reviewed the compliance tests performed.

Report on OMB Circular A-133 Review of Fiscal Year 1997 Internal Control Used in Administering the Research and Development Program. The auditor is required to obtain an understanding of the internal controls and to assess control risk to determine whether the auditor intends to rely on the internal controls. The auditor must perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing and detecting material noncompliance, review the system for monitoring subrecipients and obtaining and acting on subrecipient audit reports, and determine whether controls are effective to ensure that direct and indirect costs are computed and billed in accordance with requirements in the compliance supplement. We reviewed the audit programs for the appropriate procedures, the working paper documentation, and the test of controls performed, and the substantive testing performed.

Comments

Because this report contains findings and recommendations to the DCAA, written comments are required from DCAA by October 15, 1998. We appreciate the courtesies extended during the review. If you have questions on this report, please contact Mrs. Barbara Smolenyak at (703) 604-8760. See the Enclosure for the report distribution.

Donald E. Davis
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Enclosure

Midwest Research Institute
Fiscal Year Ended January 31, 1997

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