Policy and Oversight

Financial and Performance Audits Directorate
Quality Control Review

Defense Contract Audit Agency and KPMG Peat Marwick LLP
Battelle Memorial Institute
Fiscal Year Ended December 31, 1995

Report Number PO 97-059

September 30, 1997

Office of the Inspector General
Department of Defense

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Acronyms

<table>
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<tr>
<th>Acronym</th>
<th>Description</th>
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<tr>
<td>DCAA</td>
<td>Defense Contract Audit Agency</td>
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<td>DEAR</td>
<td>Department of Energy Acquisition Regulation</td>
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<td>DOE</td>
<td>Department of Energy</td>
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<td>FFRDC</td>
<td>Federally Funded Research and Development Center</td>
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<td>GAS</td>
<td>Government Auditing Standards</td>
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<td>GOCO</td>
<td>Government-Owned, Contractor-Operated</td>
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<td>OMB</td>
<td>Office of Management and Budget</td>
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<td>PNNL</td>
<td>Pacific Northwest National Laboratories</td>
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September 30, 1997

Board of Trustees
Battelle Memorial Institute
505 King Avenue
Columbus, Ohio 43201-2693

Director, Defense Contract Audit Agency
8725 John J. Kingman Road, Suite 2135
Fort Belvoir, Virginia 22060-6219

KPMG Peat Marwick LLP
1301 Avenue of the Americas
New York, New York 10019-6013

and KPMG Peat Marwick LLP
Battelle Memorial Institute
Fiscal Year Ended December 31, 1995
Report No. PO 97-059

Introduction

We are providing this report for your information and response. Your Columbus, Ohio, office, in coordination with the Defense Contract Audit Agency (DCAA), performed the single audit for the Battelle Memorial Institute (Battelle), Columbus, Ohio, a nonprofit corporation. 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." Battelle did not report total Federal expenditures for the fiscal year ended December 31, 1995.

KPMG Peat Marwick LLP issued its audit report March 1, 1996. The auditors questioned no costs and issued an unqualified opinion on the financial statements, a report on compliance at the financial statement level, and obtained an understanding of the internal controls related to the financial statements. The report states that the auditors' tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.
The DCAA issued reports on compliance with the requirements for the Federal research and development programs for the Columbus Operations (September 30, 1996); Battelle Centers of Public Health Research and Evaluation Group Home Office (January 28, 1997); Battelle Centers of Public Health Research and Evaluation (January 28, 1997); Office of the Chief Executive Officer (September 30, 1996); Battelle Technical Support Operations (January 28, 1996); Human Affairs Research Centers (January 28, 1997); and the Pacific Northwest National Laboratory’s Contract DE-AC06-76RL01831 (January 29, 1997). The DCAA reports do not identify the general and specific requirements tested, do not express an opinion on compliance with specific requirements for major Federal programs, and do not give positive and negative assurance statements on compliance with general requirements. Positive assurance states that, with respect to the items tested, the results of the auditors’ procedures disclosed no material instances of noncompliance. Negative assurance states that, with respect to the items not tested, nothing came to the auditors’ attention that caused them to believe that Battelle has not complied, in all material respects.

Battelle did not issue a report on internal controls related to Federal awards that describes the auditors’ scope of work in obtaining an understanding of internal controls; a statement of assessed control risk; and the significant internal controls or control structure, including the established controls that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations.

Quality Control Review Results

The OMB Circular A-133 audit did not meet the applicable guidance and regulatory requirements in the Circular, its related Compliance Supplement, Government Auditing Standards, generally accepted auditing standards, and the provisions of the Federal award agreements for the financial statements, internal controls, and compliance requirements. See a discussion of our findings below.
Material Findings

Audit of Pacific Northwest National Laboratory

Battelle did not obtain an audit of or submit a report on the Federal award expenditures under contract DE-AC06-76RL01830 at the Pacific Northwest National Laboratory (PNNL) in accordance with the provisions of OMB Circular A-133. The PNNL operations incurred approximately 60 percent of the total expenditures at Battelle during fiscal year 1995 (see Table 1), and about 98 percent of those expenditures was for Federal awards (see Table 2).

Table 1. Total FY 1995 Battelle Memorial Institute Expenditures

<table>
<thead>
<tr>
<th>Battelle Segments</th>
<th>Expenditures*</th>
<th>% of Total</th>
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<tr>
<td>Pacific Northwest National Laboratory</td>
<td>$575,859,555</td>
<td>60.43</td>
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<td>Other Battelle Memorial Institute segments</td>
<td>376,951,445</td>
<td>39.57</td>
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<tr>
<td>Total Battelle Expenditures</td>
<td>$952,911,000</td>
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*Based on the Cost of Operations from the Consolidated Statement of Earnings in the FY 1995 financial statements.

Table 2. Total FY 1995 PNNL Federal Expenditures

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>PNNL Funding Sources</th>
<th>FY 1995</th>
<th>% of Total</th>
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<td>1830 Contract</td>
<td>Department of Energy</td>
<td>$476,184,948</td>
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<td>Work for Other Federal Agencies:</td>
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<td>Department of Defense</td>
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<td>Other Federal Agencies</td>
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<td>Total 1830 Contract</td>
<td>$545,121,233</td>
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<td>1831 Contract</td>
<td>Government Business Volume</td>
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<td></td>
<td>Total PNNL Expenditures</td>
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<td>100.00</td>
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1Department of Energy contract DE-AC06-76RL01830
2Department of Energy contract DE-AC06-76RL01831
3Based on the KPMG Peat Marwick LLP working paper A-3, PNNL binder.

Paragraph 2.a.(1) of the Attachment to OMB Circular A-133 states that nonprofit institutions receiving $100,000 or more annually will have an organization-wide audit
made in accordance with the provisions of the Circular. The PNNL is a federally
funded research and development center (FFRDC) in Richland, Washington, under the
cognizance of the Department of Energy (DOE). The PNNL includes a DOE
Government-owned, contractor-operated (GOCO) facility used by Battelle under the
terms of the maintenance and operations contract and Battelle’s own facility, which
uses the GOCO for commercial and other Government work under a use permit.
PNNL status as an FFRDC was confirmed in the July 8, and July 12, 1994, letters
from the DOE and in document NSF 95-64 published by the National Science
Foundation.

The DOE awarded maintenance and operation contract DE-AC06-76RL01830 (1830) to
Battelle in the 1960’s. DOE awards are governed by the DOE Acquisition Regulation
(DEAR). DEAR section 970.5204-9(h) states that the contractor (Battelle) agrees to
conduct an internal audit and examination of the records, operations, expenses, and
transactions related to costs claimed to be allowable annually under the contract (1830).
The audit and examination will include internal controls and the internal audit function.
The DEAR also states that the Office of the Inspector General, DOE, will conduct a
peer review of the internal auditor’s work and organizational position. OMB Circular
A-133 became effective for fiscal years beginning on or after January 1, 1990. Battelle
was required to obtain an audit and submit a report in accordance with the provisions of
the Circular for the fiscal year ended December 31, 1990 and thereafter.

Battelle is listed in Attachment C to OMB Circular A-122, “Cost Principles for
Nonprofit Organizations,” as exempt because Battelle follows the cost principles
identified in Federal Acquisition Regulation, Part 31. Because of this specific
exemption, Battelle management did not consider that the organization was subject to
the provisions of OMB Circular A-133 and asked OMB for an exemption; Battelle was
denied in 1993. The December 10, 1993, OMB letter to Battelle stated that the
external audit firm (KPMG Peat Marwick LLP) in general, would perform the financial
statement audit and issue the related reports, while the on-site DCAA auditors would
perform the audit work for Federal awards and issue the related reports. However,
neither Battelle management nor the Office of the Inspector General, DOE, considered
PNNL subject to the auditing and reporting requirements in paragraph 2b(4) of the
Attachment to OMB Circular A-133 and the specific auditing requirements of the
DEAR. Therefore, DOE required and received under the DEAR an internal audit of
the allowable costs for fiscal year 1995 at PNNL. The referenced paragraph in the
attachment to the Circular specifies when OMB will assign cognizance to GOCOs, if
necessary. The Circular does not exempt GOCOs from the requirements of the
Circular.

The Federal expenditures under Contract 1830 were audited by the Battelle internal
audit staff, who do not meet the OMB Circular A-133 definition of independent
auditors. Although the Office of the Inspector General, DOE, auditors reviewed the
internal audit work, there is no written assurance, such as a quality control review, that
the DOE accepted the audit work.
Schedule of Federal Awards

Battelle did not prepare, obtain an audit of, or submit a Schedule of Federal Awards in accordance with the requirements of OMB Circular A-133. Paragraph 12.a. of the Attachment to OMB Circular A-133 states that an audit made in accordance with the Circular will be organization-wide. Paragraph 15.c. of the Attachment requires that the Federal award recipient include a Schedule of Federal Awards as part of the reporting requirements. The Schedule must identify major programs and total expenditures for each program. Question 29 of the President's Council on Integrity and Efficiency Position Statement No. 6 also provides guidelines for preparing the Schedule. Specifically, the Schedule should identify Federal funds passed through from other recipients and include enough information to be useful to its readers. Therefore, the Battelle Schedule of Federal Awards should consolidate the Federal awards from all Battelle segments in such a way as to be useful to Federal awarding agencies.

The Schedule represents the Federal programs and related expenditures for which the reports on internal controls and compliance apply. Federal agencies can choose whether to rely on the report, knowing that the internal control and general requirements assurances and the opinion on specific compliance included in the reports relate to their programs as shown in the Schedule of Federal Awards. Without a consolidated list of awards, Federal agencies do not know whether their programs have been audited, allowing them to exercise their rights under the provisions of the Circular to conduct individual program audits. The overall effect is that the intent of the Circular, to conduct one audit of the institution for the benefit of all, will not be achieved because Battelle and the DCAA did not comply with the reporting requirements of the Circular.

The noncompliance was caused, in part, because the DCAA auditors did not have training specifically related to Circular A-133. Government Auditing Standards (GAS) section 3.10.a on staff qualifications states that the staff members conducting the audit should have "... knowledge of the methods and techniques applicable to government auditing and the education, skills, and experience to apply such knowledge to the audit being conducted." [emphasis added] The DCAA auditors met the continuing professional education requirements of sections 3.6 and 3.7 to the GAS. They had sufficient training hours in governmental auditing; however, they did not have training specific to conducting an audit in accordance with the provisions of OMB Circular A-133. Most of the audits performed at Battelle relate to the requirements of the Circular, and the DCAA is responsible for performing the necessary audits to satisfy the requirements for an audit of Federal awards.

Subsequent to the completion of our field work, the DCAA issued an audited Schedule of Federal Awards on August 29, 1997, that satisfies the requirements of this finding.
The PNNL expenditures were not audited as described above in "Audit of Pacific Northwest National Laboratory."

**Opinion on Schedule of Federal Awards**

The OMB Circular A-133 audit report does not include an opinion on the Schedule of Federal Awards. Question 30 of the President's Council on Integrity and Efficiency Position Statement No. 6 states that an auditor's opinion on the Schedule of Federal Awards in relation to the financial statements is a requirement of a Circular A-133 audit. The opinion should state that the auditor applied procedures to determine whether the information in the Schedule of Federal Awards is fairly stated in relation to the financial statements. In most cases, the independent, non-Federal auditors apply auditing procedures to annually express and publicly report an opinion on the financial position of a company. The financial statements can be and are used to determine information, such as financial stability and investment opportunities. The opinion on the Schedule of Federal Awards provides assurance that the information presented therein is not materially different from the same information regarding Federal expenditures that is presented in the financial statements. Therefore, without the opinion on the Schedule of Federal Awards, there is no assurance that the information therein is reliable. Battelle did not prepare a Schedule of Federal Awards; therefore, no auditing procedures were applied and no opinion was given.

Subsequent to completion of our field work, the DCAA issued an opinion on the audited Schedule of Federal Awards on August 29, 1997, that satisfies the requirements of this finding.

**Report on Internal Controls Over Federal Awards**

Battelle submitted its OMB Circular A-133 audit report without a report on internal controls over Federal awards. The DCAA issued Audit Report No. 01651-95A17700006, "Audit of Contractor's Control Environment and Overall Accounting Controls," dated September 30, 1996, and submitted a copy to Battelle. However, neither Battelle nor the DCAA complied with the reporting requirements of the Circular because they did not include the internal control report in the Circular A-133 report submission. Paragraph 15.c.(2) of the Attachment to Circular A-133 requires that a written report of the independent auditor's understanding of the internal control structure and the assessment of control risk be submitted as part of the reporting requirements. The auditor is required to test the internal control structure over Federal awards to determine whether they plan to place reliance on the internal control structure. The report must identify the internal controls tested for Federal awards as well as identified reportable conditions and material weaknesses. Without the internal controls report, Federal agencies that receive the Circular A-133 audit report do not know which internal controls were tested and relied on to express an opinion on the specific compliance requirements and to provide assurance on the general requirements over the expenditures identified in the Schedule of Federal Awards. More important,
the Federal funding agencies do not know whether the internal control structure is acceptable to administer the funds awarded by their agency.

Identification of Specific Requirements Tested

The DCAA audit reports on compliance with specific requirements do not identify the requirements tested. Paragraph 12a of the Attachment to OMB Circular A-133 states that the audit will be made in accordance GAS. GAS incorporates the reporting standards for the American Institute of Certified Public Accountants, including Statement of Position 92-9, "Audits of Not-for-Profit Organizations Receiving Federal Awards," a guide to assist the independent auditor's examination under the requirements of OMB Circular A-133. Exhibit D of Statement of Position 92-9 is an example of a report on compliance with specific requirements. Exhibit D states that the specific requirements tested are to be identified. Under the reporting requirements of OMB Circular A-133, the independent auditor is required to express an opinion on compliance with specific requirements, stating that Battelle complied or did not comply in all material respects with the specific requirements tested. It is necessary to state the specific requirements in the audit report to identify the scope of the opinion on compliance. However, that information was omitted because Battelle and the DCAA did not comply with the reporting requirements of the Circular. Therefore, training on the specific auditing and reporting requirements of OMB Circular A-133 is especially important when participating in coordinated audits.

Subsequent to completion of our field work, the DCAA issued a June 13, 1997, memorandum to our office that identified the general and specific requirements that were tested and reported on for the research and development program. The memorandum satisfies the requirements of this finding.

Management Representation Letters

The management representation letter furnished to KPMG Peat Maverick LLP did not include representations related to a financial statement audit conducted in accordance with GAS. Specifically, the management representation letter did not include the representations that management is responsible for the entity's compliance with laws and regulations, and management has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts. In addition, certain representations that should have been obtained from management as part of an audit conducted to express an opinion on compliance with the requirements that have a material effect on a Federal award program were not obtained. For example, the representation that states that management has identified in the Schedule of Federal Awards all awards provided by Federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations was not obtained from management. The representations related to Federal award programs may be added to the representation letter obtained in connection with an audit of financial statements instead of obtaining a
separate letter. The American Institute of Certified Public Accountants issued Statements on Auditing Standards to assist the auditor in conducting financial audits. Statements on Auditing Standards No. 19, Client Representations, requires the auditor to obtain written representations from management as part of evidential matter. The representations allow the auditor to apply procedures specifically designed to obtain corroborating information concerning matters that are also the subject of the written representations. Without the representations, the auditor will find it difficult to develop specific audit objectives directly related to that particular engagement. In the case of the audit of Federal awards, had the representations related to the Schedule of Federal Awards been obtained the auditors would have been aware that Battelle had not prepared the Schedule.

Recommendations for Corrective Action

1. We recommend that Battelle Memorial Institute:

   a. Obtain an audit of the Pacific Northwest National Laboratories as required by and in accordance with the provisions of Office of Management and Budget Circular A-133, and include the audit results in an organization-wide report that meets the requirements of the Circular.

   b. Issue an internal control report over Federal awards that meets the requirements of Office of Management and Budget Circular A-133.

   c. Reissue the Office of Management and Budget Circular A-133 reports for fiscal year 1995 after an organization-wide audit of all Battelle Memorial Institute segments that meets OMB Circular A-133 reporting requirements.

   d. Take action to ensure that auditors conducting Office of Management and Budget Circular A-133 audits are furnished the required management representations including those related to an audit of Federal award programs.

2. We recommend that the Director, Defense Contract Audit Agency provide auditors assigned to Office of Management and Budget Circular A-133 audits with training specific to Circular A-133 reporting and auditing requirements.

Subsequent to completion of our field work, the DCAA agreed to provide training and issue a policy memorandum emphasizing the importance of training specific to OMB Circular A-133. Upon issuance of the memorandum this recommendation will be satisfied.
Quality Control Review Objective

The objective of a quality control review is to assure that the audit was conducted in accordance with applicable standards and meets the auditing requirements of the OMB Circular A-133. As the oversight agency for Battelle, 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 September 23, 1994, performed by Ernst and Young 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, 1994.

Scope and Methodology

We used the 1991 edition of the Uniform Quality Control Guide for Single Audits (the Guide), which 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. The Guide is further divided into the substantive work performed during the audit of the financial statements and the specific program compliance testing for major programs. In addition, we supplemented the Guide to include additional review of transaction testing.

We conducted our review from June 2 through 12, 1997. We limited the scope of our quality control review to the audit working papers covering areas related to Department of Defense expenditures: the financial statements and the research and development programs.

Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at three of the nine KPMG Peat Marwick LLP locations we visited from January 1, 1995, through December 31, 1996. The affected offices were notified, and no further action is necessary.
Background

The Inspector General Act of 1978, Public Law 95-452, prescribes the duties and responsibilities of that office. In implementing those 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 (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, 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 24, 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 no exception to the working papers supporting the following reports and schedules. Because Battelle decided not to
obtain an audit of PNNL contract DE-AC06-76RL01830, the DCAA reports on compliance over Federal awards does not represent an organization-wide audit of Battelle (see the “Material Findings” section of this report).

**Independent Auditor’s Report.** The auditor is required to obtain reasonable assurance about whether the financial statements are free of material misstatement. We reviewed the audit program and the testing of evidential matter 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 Auditor’s Report on Internal Controls at the Financial Statement Level.** The auditor is required to obtain an understanding of the internal control structure that is sufficient to plan the audit and assess control risk for the assertions embodied in the financial statements. We reviewed the audit program for the appropriate procedures, the working paper documentation, and the substantive testing performed.

**Independent Auditor’s Report on Compliance at the Financial Statement Level.** The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on the determination of financial statement amounts. We reviewed the audit program for the appropriate procedures, the working paper documentation, its support, and the compliance tests performed.

**Reports on Compliance With Specific Requirements Applicable to Major Programs and General Requirements.** 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 those that, if not observed, could have a material effect on the recipient’s financial statements including those prepared for Federal programs. These requirements are political activity, Davis-Bacon Act, civil rights, cash management, Federal financial reports, allowable costs/cost principles, Drug-Free Workplace Act, and administrative requirements. The auditor’s 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, reviewed the compliance tests performed, and reevaluated selected compliance items.
The DCAA issued audit reports that satisfied the general and specific auditing and reporting requirements for fiscal year 1995 (see Enclosure 1).

Material Instances of Noncompliance. The auditor is required to report all instances of material noncompliance in the audit report. The various DCAA reports include questioned costs related to noncompliances. We traced the findings in the working papers to the audit report to make sure that the report includes all findings identified in the working papers and that the findings are properly supported. A complete listing of all the material instances of noncompliance are in Enclosure 2 of this report.

Comments

Because this report contains findings and recommendations, written comments are required by November 30, 1997. We appreciate the courtesies extended during the review. If you have questions on this report, please contact Mrs. Barbara Smolenyak, Program Director, at (703) 604-8761. See Enclosure 3 for the report distribution.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Enclosures
Battelle Memorial Institute
Fiscal Year Ended December 31, 1995

DCAA Audit Reports Issued to Satisfy the OMB Circular A-133
General and Specific Requirements

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Enclosure 1
Schedule Of Findings and Questioned Costs

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<td>Unrecorded Employee</td>
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<td></td>
<td>Cost Accounting Standard 418 Noncompliance</td>
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<td>Cost Accounting Standard 420 Noncompliance</td>
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</tr>
<tr>
<td></td>
<td>Incomplete Value Added General and Administrative Base</td>
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* Includes the Department of Health and Human Services questioned costs.

**Acronyms**

- **DoD-DLA**: Department of Defense, Defense Logistics Agency
- **N/A**: Not Applicable

Enclosure 2
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Dayton, Ohio 45444-5300

Enclosure 3
Evaluation Team Members

This report was prepared by the Financial and Performance Audits Directorate, Office of the Assistant Inspector General for Policy and Oversight, DoD.

Barbara E. Smolenyak
Vera J. Garrant
Nancy C. Cipolla
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Arlington, VA  22202-2884

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