# Policy and Oversight

## Financial and Performance Audits Directorate

# Quality Control Review

KPMG Peat Marwick LLP
GreatLakes Composites Consortium, Inc.
Fiscal Year Ended December 31, 1995

Report Number PO 97-029 June 25, 1997

Office of the Inspector General
Department of Defense

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**Acronyms**

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| CPSR | Contractor Purchasing System Review |
| DLA | Defense Logistics Agency |
| FAR | Federal Acquisition Regulation |
| OMB | Office of Management and Budget |

**INSPECTOR GENERAL**
**DEPARTMENT OF DEFENSE**
**400 ARMY NAVY DRIVE**
**ARLINGTON, VIRGINIA 22202-2884**

June 25, 1997

KPMG Peat Marwick LLP
345 Park Avenue
New York, New York 10154-0004

SUBJECT: Quality Control Review of KPMG Peat Marwick LLP
GreatLakes Composites Consortium, Inc.
Fiscal Year Ended December 31, 1995
Report No. PO97-029

## Introduction

We are providing this report for your information and response. Your Greenville, South Carolina, office performed the single audit for the GreatLakes Composites Consortium, Inc. (Consortium), West Columbia, South Carolina, a nonprofit institution. The audit is required by 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 $8,292,836 for the fiscal year ended December 31, 1995, representing $7,433,858* for the Department of Defense and $858,978 for other Federal agencies.

KPMG Peat Marwick LLP issued its audit report August 23, 1996. The auditors questioned no costs and issued an unqualified opinion on the financial statements, Schedule of Federal Awards, and compliance with specific requirements applicable to major programs. They issued 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 the institution has not complied, in all material respects. The auditors also obtained an understanding of the internal controls related to the financial statements and Federal awards. The audit reports describe the auditors' scope of work in obtaining that understanding and assessing control risk. The auditors' report on Federal awards also describes the

* Erroneously subtotaled in the Schedule of Federal Awards.

significant internal controls and control structure including the controls established that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations.

## Quality Control Review Results

The working papers supporting the OMB Circular A-133 audit did not meet the applicable guidance and regulatory requirements in the OMB Circular A-133, its related compliance supplement, Government Auditing Standards (GAS), Generally Accepted Auditing Standards (GAAS), or the provisions of the Federal award agreements. Specifically, the institution's system for monitoring sub-recipients was not reviewed and internal control deficiencies related to timekeeping were not detected and, therefore, not reported. As a result, the audit cannot be relied upon by Federal agencies for negotiation of overhead rates or close out of contracts and grants.

## 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 cognizant agency for the Institute, we conducted a quality control review of the audit working papers. We focused our review on the 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 most recent peer review letter dated November 3, 1993, performed by Price Waterhouse that found that KPMG Peat Marwick LLP met the objectives of the quality control review and standards established by the American Institute of Certified Public Accountants and the standards were being complied with during the fiscal year ended March 31, 1993.

## 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. In addition, we supplemented the Guide to include additional review of transaction testing. Our on-site review was conducted in December 1996.

We limited the scope of our quality control review to the audit working papers covering areas related to the Department of Defense expenditures: the financial statements and the research and development program. The research and development program expenditures accounted for 100 percent of total Federal award expenditures.

## Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at two of the six KPMG Peat Marwick LLP locations we visited between January 1, 1995, and 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 these 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 in Federal Financial Assistance before an audit is required under the Act; selecting programs to be audited based on risk rather than the amount of dollars involved; and improving the contents and timeliness of single audit reports. The Amendments also bring nonprofit organizations, previously covered by similar requirements under the OMB Circular A-133, under the Single Audit Act provisions.

The OMB Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," establishes the Federal audit and reporting requirements for nonprofit and educational institutions whose Federal awards are or exceed $100,000. It 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. It 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. According to the Circular, smaller institutions that are not assigned a cognizant agency are under the general oversight of the Federal agency that provides them with the most funds. The Department of Defense is the oversight agency for the Consortium. The Circular is currently being revised to incorporate the changes in the Single Audit Act Amendments of 1996.

## Discussion of Findings

During our quality control review, we reviewed and took exception to the working papers supporting the following report.

**Report of Independent Accountants on the Internal Control Structure Used in Administering Federal Awards.** The auditor is required to obtain an understanding of the internal control structure and assess control risk to determine whether the auditor intends to place reliance on the internal control structure. The auditor must perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material non-compliance, review the system for monitoring subrecipients and obtaining and acting on subrecipient audit reports, and determine whether controls are effective to ensure direct and indirect costs are computed and billed in accordance with the general requirements in the compliance supplement.

We reviewed the audit program, the working paper documentation, and the test of controls and found that the auditors did not review the recipient's system for monitoring sub-recipients and obtaining and acting on sub-recipient audit reports, as required by OMB Circular A-133. The OMB Circular A-133, Attachment, Paragraph 13b(2)(b), requires the auditor to review the recipient's system for monitoring sub-recipients and obtaining and acting on sub-recipient audit reports. The GAS, Chapter 4, Paragraph 21, and GAAS, Statement on Auditing Standards number 55, Section 319, require auditors to obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed. As part of this process the auditor should perform procedures to provide sufficient understanding of the design of internal control structure policies and procedures and whether those policies and procedures have been placed in operation. During fiscal year ended December 31, 1995, the recipient had approximately 26 nonprofit sub-recipients. Four of the 26 nonprofit subrecipients received funding of greater than $25,000, which made them subject to the A-133 audit requirements. The total Federal sub-recipient expenditures associated with those four nonprofits for fiscal year ended December 31, 1995, was approximately $1,124,000 or 14 percent of the Consortium's total Federal

expenditures. The audit review of the recipient's system for monitoring sub-recipients is necessary to ensure that the recipient has procedures in place for determining that the sub-recipients expend awards in accordance with applicable laws and regulations. The auditors' tests of controls may include inquiry, observation, and inspection of documentation. Also, the auditors' tests may include performance of some or all monitoring procedures that are the primary recipient's responsibility.

**Recommendation 1: We recommend that KPMG Peat Marwick LLP review the recipient's system for monitoring sub-recipients and obtaining and acting on sub-recipient audit reports and advise our office of the results of that review.**

We re-tested the three timesheets that the auditors tested for compliance with internal controls and found that none had sequential numbers and employee numbers, two of the three timesheets were not signed or approved by the proper official, and one timesheet was not dated. The auditors did not find these errors on the employee timesheets; therefore, these errors were not reported to management. The OMB Circular A-133, Attachment, Paragraph 13 (c), states "the auditor shall determine whether controls are in effect to ensure direct and indirect costs were computed and billed in accordance with the guidance provided in the general requirements section of the compliance supplement to this circular." GAS, Chapter 4, Paragraph 21, and GAAS, Statement on Auditing Standard 55, Section 319, require auditors to obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed. In an audit of governmental financial statements this understanding includes knowledge about the design of the internal control structure policies and procedures relevant to financial statement assertions affected by compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts and whether those policies and procedures have been placed in operation. For proper computation and billing of direct and indirect labor costs, effective timekeeping controls are important. The auditor must perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures related to timekeeping and report the deficiencies to management.

**Recommendation 2: We recommend that KPMG Peat Marwick LLP re-test the timekeeping controls to evaluate the effectiveness of the design and operation of the timekeeping policies and procedures and report any deficiencies to management.**

## Discussion of Results

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 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 Auditors' Report on Schedule of Federal Awards.** The auditor is required to subject the schedule 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 Auditor's Report."

**Schedule of Federal Awards.** The recipient is responsible for creating the schedule. 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 program 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.

**Independent Auditors' Report on the Internal Control Structure Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards.** 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 Auditors' Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of 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 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.

**Independent Auditors' Report on the Internal Control Structure Used in Administering Federal Awards.** The auditor is required to obtain an understanding of the internal control structure and assess control risk to determine whether the auditor intends to place reliance on the internal control structure. The auditor must perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or 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 direct and indirect costs are computed and billed in accordance with the general requirements in the compliance

supplement. We reviewed the audit program for the appropriate procedures, the working paper documentation, and the test of controls performed.

**Independent Auditors' Report on Compliance With Specific Requirements Applicable to Major Programs.** 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. They include Types of Services Allowed or Unallowed; Eligibility; Matching, Level of Effort, and/or Earmarking Requirements; Special Reporting Requirements; and Special Tests and Provisions. We reviewed the audit program for the appropriate procedures, compared the audit program steps to those in the Compliance Supplement to make sure all areas were audited, reviewed the working paper documentation and its support, reviewed the compliance tests performed, and re-evaluated selected compliance items.

**Independent Auditors' Report on Compliance With 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. General requirements are those that could have a material effect on the recipient's financial statements including those prepared for Federal programs. 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 all areas were audited, reviewed the working paper documentation and its support, reviewed the compliance tests performed, and re-evaluated selected compliance items.

**Schedule of Findings and Questioned Costs.** For the 2 fiscal years ended December 31, 1995, KPMG Peat Marwick LLP auditors did not have any findings or questioned costs. However, the auditors noted in their report that the Defense Contract Audit Agency questioned costs of $168,500 for fiscal year ended December 31, 1994. We did not review the Defense Contract Audit Agency's working papers.

## Comments

Since this report contains findings and recommendations, written comments are required within 60 days of the date of this report. We appreciate the courtesies

extended during the review. If you have questions on this report, please contact Mr. Donald Steele, Project Manager, at (703) 604-8705 or Mr. Sunil R. Kadam at (703) 604-8735.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

cc: Mr. Kenneth Deon, Partner, KPMG Peat Marwick LLP
The Board of Directors, GreatLakes Composites Consortium, Inc.
Director, Defense Research & Engineering
Director, Defense Procurement
Director, Defense Contract Audit Agency
Commander, Defense Contract Management Command
Resident Representative, Office of Naval Research

# Audit Team Members

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

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