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### **Acronyms**

DCAA	Defense Contract Audit Agency
GAS	Government Auditing Standards
LMI	Logistics Management Institute
OMB	Office of Management and Budget
PwC	PricewaterhouseCoopers, LLP



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MAR 19 2008

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SUBJECT: Report on Quality Control Review of FY 2006 Single Audit of Logistics Management Institute (Report No. D-2008-6-003)

We are providing this report for your information and use. As the cognizant Federal agency for Logistics Management Institute (LMI), we performed a review of the PricewaterhouseCoopers, LLP (PwC) single audit and supporting workpapers for the Fiscal Year ended September 30, 2006, to determine whether the audit was conducted in accordance with Government Auditing Standards (GAS) and the auditing and reporting requirements of Office of Management and Budget Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," (OMB Circular A-133). Appendix A contains additional background, scope and methodology for the review and Appendix B shows the applicable compliance requirements.

**Background.** Logistics Management Institute was established in October 1961 as a not-for-profit organization conducting fact-finding and research. Today, LMI has about 750 employees and offers strategic consulting services in acquisition, facilities and asset management, financial management, information and technology, logistics, and organizations and human capital. LMI expended \$101.6 million in Federal awards for the fiscal year ended September 30, 2006 under one Federal program, the Research and Development cluster. Of the \$101.6 million, \$61.1 million was expended for Department of Defense programs.

**Review Results.** PwC generally met GAS and OMB Circular A-133 requirements and no additional work is required for the FY 06 audit. However, we identified deficiencies related to the sampling methodology for contracts selected for testing (Finding A) and the review of the Subrecipient Monitoring and Special Tests and Provisions compliance requirements (Finding B) that need to be addressed in future audits. LMI generally met OMB Circular A-133 reporting requirements except that the Schedule of Expenditures of Federal Awards did not include the Federal awarding agency and pass-through entity assigned award identification numbers and fixed price contracts were not separately identified (Finding C).

**Management Comments and OIG DoD Response.** PwC management agreed to take corrective actions that satisfy the intent of the recommendations. Comments from the Controller, Logistics Management Institute, were responsive. Management comments and our response are discussed in the Findings and Recommendations sections and are included in their entirety at the end of this report.

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# Findings

**Finding A. Contracts Selected for the Compliance Audit of Federal Awards.** The PwC auditors' sample selection for compliance testing included fixed price contracts. Fixed price contracts are not identified as Federal awards under OMB Circular A-133, therefore, are not subject to the compliance audit. OMB Circular A-133 defines Federal awards as federal financial assistance and federal cost reimbursement contracts that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. Our review found that 8 of the 27 contracts selected by PwC for testing were fixed price contracts. More specifically, 17 of the 110 payroll and disbursement transactions selected for testing came from fixed price contracts. Because there were a sufficient number of transactions from cost-type contracts, we determined that there was no impact to the overall quality of the FY 06 single audit. However, it could potentially impact future single audits if PwC continues this audit approach particularly with clients that have a large number of fixed price contracts.

**Finding B. Review of Major Federal Program.** The PwC auditors did not perform adequate audit procedures for the Subrecipient Monitoring and Special Tests and Provisions compliance requirements for the FY 06 single audit.

**Subrecipient Monitoring Compliance Requirement.** The PwC auditors did not perform audit procedures related to internal controls and compliance because they inappropriately determined that the Subrecipient Monitoring compliance requirement was not applicable. The determination was based on their interpretation of the OMB A-133 characteristics for distinguishing between a vendor versus subrecipient relationship. Based on our discussions with LMI management and review of supporting documentation, we determined that LMI has subrecipients. According to the OMB Circular A-133, a subrecipient is a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program. For FY 06, we identified at least three non-profit organizations (Battelle Memorial Institute, Concurrent Technologies Corporation, and South Carolina Research Authority) that received pass-through funds from LMI to carry out research and development award objectives and should be considered subrecipients. The three non-profit organizations filed OMB Circular A-133 reports and reported the pass-through funds received from LMI on their Schedule of Expenditures of Federal Awards. Of the \$13 million in subcontract support for FY 06, the three non-profit organizations received \$207,278 from LMI. Therefore, we believe that noncompliance with the requirement would not have a material effect on the major program and not negatively impact the overall FY 06 audit. However, PwC needs to perform additional audit procedures to determine the applicability and materiality of the Subrecipient Monitoring compliance requirement and perform the appropriate audit procedures related to internal controls and compliance in future audits.

**Special Tests and Provisions Compliance Requirement.** The PwC auditors did not obtain an understanding or test internal controls for the Special Tests and Provisions compliance requirement related to key personnel and the compliance testing was limited to verbal inquiries. Based on their verbal inquiries with the project managers of 4 contracts, the auditors documented

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1 contract where key personnel was replaced with Federal awarding agency approval. The auditors also documented that since LMI works closely with the Federal awarding agencies and that approvals are often made orally they determined that no further testing was deemed necessary. However, there was no evidence of audit procedures performed to verify the assertions made by the project manager. As a result, there is no assurance that LMI is in compliance with the Special Tests and Provisions compliance requirement related to key personnel. However, based on our analysis, we believe that noncompliance with the requirement would not have a material effect on the major program and, therefore, not negatively impact the overall FY 06 audit. Nevertheless, PwC needs to perform additional audit procedures to determine the applicability and materiality of the Special Tests and Provisions compliance requirement and perform the appropriate audit procedures related to internal controls and compliance in future audits.

## Recommendations, Management Comments, and OIG DoD Response

### **1. We recommend that the Audit Partner, PricewaterhouseCoopers, LLP:**

- a. Ensure that samples used for Federal program compliance testing are drawn from a universe of awards as defined in OMB Circular A-133 for future single audits.**

**PWC Comments.** PwC management believed that their sample for the FY 06 audit was representative of the universe of research and development awards and appropriate for the audit objectives. They used a dual purpose approach by using the same sample to test attributes from both a financial statement and OMB Circular A-133 compliance perspective. Furthermore, they stated that OMB Circular A-133, OMB Circular A-122, “Cost Principles for Non-Profit Organizations,” and the 2006 Compliance Supplement guidance for the treatment of fixed price contracts is not clearly defined. PwC management took corrective action to the recommendation by excluding fixed price contracts from their sample for testing under OMB Circular A-133 while continuing to perform some testing on fixed price contracts for financial statement purposes for the FY 2007 single audit. PwC management suggested that the DoD OIG work with OMB to provide clarification on the exclusion of fixed price contracts for the 2008 Compliance Supplement.

**OIG DoD Response.** The corrective actions taken by PwC are responsive to the intent of the recommendation. We have recognized the treatment of fixed price contracts to be a recurring issue in our quality control reviews and have proposed written changes to the Office of Management and Budget for the 2008 Compliance Supplement to provide further clarification on the types of Federal awards subject to compliance testing.

- b. Perform audit procedures to determine the applicability and materiality of the Subrecipient Monitoring and Special Tests and Provisions compliance**

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**requirements and perform the appropriate audit procedures related to internal controls and compliance for future single audits.**

**PwC Comments.** PwC management believed that based on their inquiry procedures performed none of the subcontractors met the criteria for subrecipient classification. For the FY 2007 audit, PwC is in the process of performing testing of the subcontractor agreements to ensure the proper classification of vendor versus subrecipient. If deemed to be subrecipients and the amount is material, PwC will test LMI's performance of subrecipient monitoring. PwC has also recommended in their Report to Management that LMI consider enhanced procedures to identify, monitor, and review their subrecipients.

PwC management plans to further enhance their documentation to clearly demonstrate the robustness of audit procedures performed for the Special Tests and Provisions compliance requirement in future audits.

**OIG DoD Response.** The corrective actions taken by PwC are responsive to the intent of the recommendation. We commend PwC management for making recommendations to LMI management to enhance their procedures to identify, monitor, and review their subrecipients.

- c. Provide the Department of Defense Office of Inspector General with the working paper documentation from the FY 2007 single audit that demonstrates corrective action taken to address the deficiencies related to sample selection and the Subrecipient Monitoring and Special Tests and Provisions compliance requirements.**

**PwC Comments.** PwC management will send the workpapers for the FY 2007 audit for the areas noted when the work is completed.

**Finding C. Schedule of Expenditures of Federal Awards.** LMI included internal project numbers rather than the Federal awarding agency and pass-through entity assigned award identification numbers and did not separately disclose fixed price contracts for the FY 06 Schedule of Expenditures of Federal Awards. OMB Circular A-133 requires that for Federal awards expended for each individual Federal program or received from a pass-through entity, that the identification number be included on the Schedule of Expenditures of Federal Awards. LMI should have included the assigned award identification numbers instead of their internal project tracking numbers so that Federal awarding agencies and pass-through entities can use the Schedule of Expenditures of Federal Awards to monitor their awards. In addition, LMI should separately disclose the fixed price contracts from the Federal awards since fixed price contracts are not identified as Federal awards as previously defined. This will enable the auditors to correctly identify their sampling universe when performing the compliance audit of the Federal program.

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# Recommendations, Management Comments, and OIG DoD Response

1. We recommend that the Vice President of Finance, Logistics Management Institute:
  - a. Prepare the Schedule of Expenditures of Federal Awards according to the Office of Management and Budget A-133 requirements for future single audits. Specifically, the Schedule of Expenditures of Federal Awards should include the Federal awarding agency and pass-through entity assigned award identification numbers and separately identify fixed price contracts from Federal awards as defined in OMB Circular A-133.

**LMI Comments.** LMI concurred with the finding and recommendation and incorporated the recommendation in the preparation of the FY 2007 Schedule of Expenditures of Federal Awards.

**Other Matters.** The PwC auditors did not coordinate with the Defense Contract Audit Agency (DCAA) when planning the FY 2006 audit. While the auditors reviewed 3 DCAA audit reports obtained from LMI, DCAA issued 7 additional reports on floor checks, incurred costs, contract audit closing statements, and quick closeout procedures relevant to the FY 2006 audit period. Although the DCAA reports did not disclose any noncompliances, the PwC auditors should coordinate all future OMB Circular A-133 audits with DCAA to identify any issues that may impact audit planning to achieve a more efficient and effective audit.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Ms. Janet Stern at (703) 604-8750 (DSN 664-8750) or Ms. Sharon Vasquez at (703) 604-5007 (DSN 664-5007). See Appendix C for the report distribution.

  
Carolyn R. Davis  
Acting Assistant Inspector General  
for Audit Policy and Oversight

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# Appendix A. Quality Control Review Process

## Background, Scope and Methodology

The Single Audit Act, Public Law 98-502, as amended, was enacted to improve the financial management of State and Local Governments and nonprofit organizations by establishing one uniform set of auditing and reporting requirements for all Federal award recipients required to obtain a single audit. OMB Circular A-133 establishes policies that guide implementation of the Single Audit Act and provides an administrative foundation for uniform audit requirements of non-Federal entities administering Federal awards. Entities that expend \$500,000 (for fiscal years ending after December 31, 2003) are subject to the Single Audit Act and the audit requirements in OMB Circular A-133 and therefore must have an annual single or program-specific audit performed under Government Auditing Standards and submit a complete reporting package to the Federal Audit Clearinghouse.

We reviewed the PwC, LLP audit of Logistics Management Institute FY 2006 and the reporting package that was submitted to the Federal Audit Clearinghouse dated June 26, 2007 using the 1999 edition of the “Uniform Quality Control Guide for the A-133 Audits” (the Guide). The Guide applies to any single audit that is subject to the requirements of OMB Circular A-133 and is the approved President’s Council on Integrity and Efficiency checklist used for performing the quality control reviews. We performed the review from September 2007 through January 2008. The review focused on the following qualitative aspects of the single audit:

- Qualification of Auditors,
- Independence,
- Due Professional Care,
- Planning and Supervision,
- Internal Control and Compliance testing,
- Schedule of Expenditures of Federal Awards, and
- Data Collection Form.

## Appendix B. Compliance Requirements

The PwC auditors determined that the following requirements are applicable to the single audit of the Logistics Management Institute for the fiscal year ended September 30, 2006.

<b>Compliance Requirements</b>	<b>Applicable</b>	<b>Not Applicable</b>
Activities Allowed/Unallowed	X	
Allowable Costs/Cost Principles	X	
Cash Management	X	
Davis-Bacon Act		X
Eligibility		X
Equipment and Real Property Management	X	
Matching, Level of Effort, Earmarking		X
Period of Availability of Federal Funds	X	
Procurement, Suspension, and Debarment	X	
Program Income		X
Real Property Acquisition and Relocation Assistance		X
Reporting	X	
Subrecipient Monitoring*		X
Special Tests and Provisions	X	

\* Based on our analysis, we determined that the Subrecipient Monitoring compliance requirement is applicable to Logistics Management Institute for FY 06.

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## **Appendix C. Report Distribution**

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House Committee on Armed Services  
House Committee on Oversight and Government Reform  
House Subcommittee on Government Management Organization, and Procurement,  
Committee on Oversight and Government Reform  
House Subcommittee on National Security and Foreign Affairs  
Committee on Oversight and Government Reform



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# Logistics Management Institute Management Comments



February 5, 2008

Sharon Vasquez  
Single Audit Technical Specialist  
Department of Defense Inspector General  
Audit Policy and Oversight

Reference: Project No. D2007-DIP0AC-0235 – Finding C and Recommendations.

Sharon Vasquez,

LMI concurs with the findings and recommendations included in the referenced audit report and will incorporate the recommendations in the FY07 Schedule of Expenditures of Federal Awards. Preliminary versions of the FY2007 SEFA have been forwarded to the DOD IG office for compliance feedback.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Michael P. Dutchak".

Michael P. Dutchak

**Michael P. Dutchak**  
**Controller**

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# PricewaterhouseCoopers, LLP Management Comments



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February 29, 2008

Wayne C. Berry  
Acting Assistant Inspector General for  
Audit Policy and Oversight  
Office of Inspector General  
Department of Defense  
400 Army Navy Drive (Room 1016)  
Arlington, VA 22202-4704

Dear Mr. Berry

Thank you for your draft of a proposed report Project No. D2007-DIP0AC-0235 related to our audit of Logistics Management Institute for the fiscal year ended 2006. We have reviewed your draft recommendations based on the quality control review you performed while onsite at our McLean office during the weeks of September 3 and 10, 2007. We appreciate the opportunity to provide additional information and clarification on your potential findings.

Fixed Price Contracts (Finding A)

The DoD Office of Inspector General (OIG) indicated that PwC inappropriately included fixed price contracts in the sample selection for compliance testing. However, there were a sufficient number of transactions from cost-type contracts such that there was no impact to the overall quality of the FY 06 single audit.

*Response*

Our sample selection for testing expenditures did include both cost-type contracts and fixed price contracts. Our planned testing for the sample included a dual purpose approach, utilizing, to the extent practical, the same sample to test attributes from both a financial statement and OMB Circular A-133 (A-133) compliance perspective. The A-133 compliance testing additionally incorporated the dual purpose approach incorporating an understanding and testing of internal controls coupled with the substantive testing, where allowed, under the compliance supplement.

Through our current year testing and updated understanding of LMI's control environment, we have determined that the controls related to contract oversight and maintenance are the same for both fixed price and cost -type contracts. Contract accounting entries are processed by the same general ledger accounting system and the majority of the overall monitoring controls apply to all contracts such that audit assurance is gained over both cost-type and fixed price contracts.

In addition, the overall guidance over the treatment of fixed price contracts contained in OMB Circulars A-133 and A-122 is not clearly defined. We noted the 2006 OMB Compliance Supplement, OMB Circulars A-133 and OMB Circular A-122 do not specifically instruct the auditor to exclude fixed price contracts from the sample of awards selected for testing. The 2006 Compliance Supplement on page 3-B-39 under "Introduction" states:

"These principles are used by all Federal agencies in determining the costs of work performed by non-profit organizations under grants, cooperative agreements, and cost reimbursement contracts, and



other contracts in which costs are used in pricing, administration, or settlement. All of these instruments are hereafter referred to as awards".

The 2006 Compliance Supplement further states on page 5-2-2, which is the section concerning audit procedures for the R&D Cluster:

"When selecting a sample for testing of compliance requirements, the auditor should choose a representative sample from the universe of R&D awards appropriate to the audit objective being tested".

We believe our audit sample in fact was representative of the universe of R&D awards and was in fact appropriate for the audit objectives, given our knowledge of LMI, including LMI's financial and compliance systems.

We would also like to point out that we are not aware of the Fixed Price contracts included in our sample being audited by a federal agency prior to, during or at the conclusion of the work, to date.

Overall, as you also have concluded, we do not believe that our inclusion of fixed price contracts resulted in any deficiencies in our testing, as the testing performed over of non-fixed price contracts was sufficient to support our overall audit opinions provided over the research and development cluster.

*Update:*

As requested by the DOD OIG office, the total amount of funds expended relating to fixed price contracts was excluded by LMI from its SEFA for the year ended September 30, 2007. The footnotes that accompany the fiscal 2007 SEFA include a reconciliation of the SEFA to the LMI audited Statement of Activities for the year then ended. One of the reconciliation items is the total fixed price contract amount. In addition, as requested, we have excluded fixed price contracts from our selection of contracts for testing under OMB Circular A-133. However, some testing was performed on fixed price contracts for financial statement purposes from both a controls and substantive testing perspective.

We would like to suggest that the DOD OIG office work with OMB to include in the 2008 Compliance Supplement which we understand is currently in draft form, clarification of the exclusion of fixed price contracts from the SEFA and therefore from the auditor's selection of R&D contracts to audit. Such clarification, we believe, will promote consistency of the preparation of the SEFA by auditees and therefore, help to ensure auditors are not auditing fixed price contracts. It will also help to ensure all Federal agencies are in agreement over this matter.

Review of Subrecipient Monitoring (Finding B)

The OIG indicated that PwC inappropriately determined that subrecipient monitoring was not applicable.

*Response*

As per the AICPA Audit Guide "Government Auditing Standards and Circular A-133 Audits" as of May 1, 2006, section 11.22 states that the "auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a



matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of federal funds passed through to a subrecipient is material in relation to the major program being audited, then need is greater for the auditor to test the subrecipient monitoring requirements".

We performed inquiry procedures over monitoring of subcontract expenses performed by management, and performed testing in this area. In the opinion of management, none of the subcontracts in question met the criteria for subrecipient classification. This evaluation and understanding was documented in our workpapers.

For the fiscal year ended September 30, 2006, the amount of funds passed through to subcontractors who received OMB circular A-133 reports, and identified LMI as a pass-through, as identified by the OIG, was \$207,278. The fact that these subcontractors identified LMI as a pass-through does not mean LMI's conclusion on vendor versus subrecipient determination is incorrect. In addition, this amount represents approximately 0.20% of the research and development cluster and is deemed to be clearly immaterial to the R&D Cluster. As such, in our judgment, we were not required to perform testing over LMI's monitoring of these subawards. However, we do believe we could have documented our view of the materiality of this matter more clearly and performed further procedures.

*Update:*

For 2007, we again documented audit procedures over vendor versus subrecipient evaluation by management. We are also in the process of performing testing of the subcontractors' agreements directly to ensure proper classification. If deemed to be subrecipients, and the amount passed through to subrecipients is deemed material, we will test management's performance of subrecipient monitoring. Further, we have recommended in our Report to Management that LMI consider enhanced procedures to identify, monitor, and review their subrecipients.

Special Tests and Provisions (Finding B)

The OIG indicated that PwC did not obtain an understanding or test internal controls for Special Tests and Provisions and the compliance testing was limited to verbal inquiries.

*Response*

For the 2006 audit, we obtained the contracts selected for testing and reviewed them in detail for any specific special provisions. We inquired of management as to changes in personnel. Going forward, we will plan to further enhance our documentation of procedures performed to clearly demonstrate the robustness of our audit procedures.

*Update:*

For the 2007 audit, we obtained and reviewed contracts selected for testing and noted special provisions relating to key personnel requirements. We initially discussed with management regarding changes, noting no significant changes, and then corroborated this understanding by reviewing project summary reports for the year reviewing for appropriateness of staff assigned to the contracts.

Thanks again for your consideration of our responses as shown above. We will send to you at your request our 2007 workpapers which support our work in the three areas noted, when our work is concluded.

We would be pleased to discuss this response to you at your convenience.

(3)



Sandra Aresti  
Engagement Partner

(4)



# Inspector General Department of Defense

