

Oversight Report



QUALITY CONTROL REVIEW OF KPMG PEAT MARWICK LLP
AND THE DEFENSE CONTRACT AUDIT AGENCY
THE AEROSPACE CORPORATION
FISCAL YEAR ENDED SEPTEMBER 30, 1995

Report Number PO 98-6-007

March 6, 1998

Office of the Inspector General
Department of Defense

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Acronyms

DCAA	Defense Contract Audit Agency
DoD	Department of Defense
GAAS	Generally Accepted Auditing Standards
GAS	Government Auditing Standards
KPMG	KPMG Peat Marwick
OMB	Office of Management and Budget

March 6, 1998

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SUBJECT: Quality Control Review of KPMG Peat Marwick LLP
and the Defense Contract Audit Agency
The Aerospace Corporation
Fiscal Year Ended September 30, 1995
Report No. PO98-6-007

Introduction

We are providing this report for your information and response. The Long Beach, California, office of KPMG Peat Marwick LLP (KPMG), and the West Covina, California, office of the Defense Contract Audit Agency (DCAA), performed the single audit for The Aerospace Corporation (Aerospace), El Segundo, California, for the fiscal year ended September 30, 1995. The audit was required by Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions." For the fiscal year ended September 30, 1995, Aerospace reported total Federal expenditures of \$336,741,828, representing \$332,279,955 for the Department of Defense (DoD) and \$4,461,873 for other Federal agencies.

The KPMG audit report is dated November 22, 1995. The KPMG issued an unqualified opinion on the financial statements, Schedule of Federal Awards, and individual reports on internal controls, and compliance requirements. The DCAA

issued reports on internal controls and compliance requirements applicable to the Federal research and development program. The DCAA issued its audit reports on January 16, 1998. The DCAA issued a qualified opinion on common and specific requirements regarding the allowable costs/cost principles because of inadequate accumulation and reporting of costs under Federal awards at Aerospace.

KPMG issued positive and negative assurance statements on compliance with general requirements. Positive assurance means that, with respect to the items tested, the results of 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 Aerospace had not complied in all material respects.

KPMG also obtained an understanding of the internal controls related to the financial statements and Federal awards. The audit report describes the auditors' scope of work in obtaining that understanding and in assessing control risk. The report on internal controls further describes the significant internal controls and control structure, including reportable conditions, material weaknesses, and controls that provide reasonable assurance that Federal awards are being managed in accordance with applicable laws and regulations.

Quality Control Review Results

The OMB Circular A-133 audit performed by KPMG and DCAA does not meet the applicable guidance and regulatory requirements in OMB Circular A-133 and its related Compliance Supplement, which incorporate Government Auditing Standards (GAS) and generally accepted auditing standards (GAAS). Deficiencies identified during our review of the KPMG and DCAA working papers need management's attention. The deficiencies are discussed below.

Material Findings

Report Submissions

The DCAA did not issue its incurred costs audit report of Aerospace for the fiscal year ended September 30, 1995, until January 16, 1998. The OMB Circular A-133 requires that an auditee's audit report be issued within 13 months of the auditee's fiscal year end, unless the auditee obtains an extension from its cognizant Federal agency. Aerospace did not comply with this requirement. The DCAA did not issue its incurred costs audit report on time because of an outstanding audit issue related to claimed costs for retiree medical liability. However, the issue of those liability costs could have been included as a contingency in the audit report, and the report could have been issued on time. Failure to issue audit reports in a timely manner results in delays in the contract

and grant closeout process. OMB Circular A-133 identifies sanctions available for Federal agency use when an auditee does not submit a timely audit report. The sanctions include, but are not limited to, withholding of future Federal awards and payments related to unaudited award costs claimed.

Independent Auditors' Report on Compliance With Specific Requirements

The Aerospace OMB Circular A-133 single audit report did not include a report on compliance with specific requirements related to major programs because the required audit work related to that area had not been performed. The audit work was not performed because Aerospace did not properly coordinate its OMB Circular A-133 audit with the DCAA and KPMG. Had Aerospace properly coordinated the audit effort by identifying the responsibilities of each audit entity, Aerospace would have known that all areas requiring audit under the Circular had not been included. Consequently, there is no assurance that Aerospace expenditures of Federal awards are in compliance with the specific requirements of types of services allowed or unallowed, claims for advances or reimbursements, amounts claimed for matching, level of effort and/or earmarking, special reporting, and special tests and provisions.

Auditor Training

The DCAA auditors who performed the OMB Circular A-133 audit were not trained in conducting audits in accordance with OMB Circular A-133. The GAS, section 3.3, states, "the staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required." The DCAA auditors who participated in the audit did not receive training related to the Circular's requirements because DCAA headquarters and regional officials did not require the training for auditors performing OMB Circular A-133 audits. The lack of training resulted in the auditors not considering many of the requirements of the Circular, including the requirements to prepare a timely audit report and to coordinate their audit effort with the recipient and KPMG. After the completion of our field work and after finding the same condition during another quality control review, we discussed the condition with officials at DCAA headquarters. DCAA personnel told us that DCAA is issuing a memorandum explaining the importance of training specific to OMB Circular A-133 audits. Specifically, the memorandum states that DCAA will issue guidance to its field offices, reemphasizing the importance of OMB Circular A-133 audit training; update the DCAA Contract Audit Manual to include guidance on OMB Circular A-133 audit and reporting requirements; and update the DCAA course titled, "Audits at Educational Institutions," to place more emphasis on OMB Circular A-133 audits.

Immaterial Findings

Statement in KPMG Report Relating to Type of Indirect Rates at Aerospace

The KPMG audit report states that the DCAA intends to issue an Advisory Report on Predetermined Overhead Rates for the period October 1, 1994, through September 30, 1995. This statement is not accurate. Indirect rates at Aerospace are not predetermined overhead rates, but rather are procurement-determined overhead rates. Predetermined rates are not subject to adjustment except for unallowable costs. Procurement-determined overhead rates are subject to adjustment based on an audit of incurred costs and subsequent negotiations by the Administrative Contracting Officer.

Management Representation Letter

Paragraph 91, Statement on Auditing Standard No. 68, Client Representations--Audits Performed Under OMB Circular A-133, requires an auditor to obtain certain written representations from management as part of an audit conducted to express an opinion on compliance with requirements that have a material effect on a Federal award program. The representations allow the auditor to apply procedures specifically designed to obtain corroborating information concerning matters that are the subject of the written representations. The management representation letter furnished to KPMG by Aerospace did not include specific representations related to an audit conducted in accordance with OMB Circular A-133. Specifically, the management representation letter did not include the representations from management that it is responsible for the entity's compliance with the requirements of OMB Circular A-133 and that 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. Without the representations, the auditor will have difficulty in developing specific audit objectives directly related to that particular engagement and in expressing an opinion on the institution's compliance with OMB Circular A-133.

Independent Auditors' Report on Compliance With General Requirements

KPMG erroneously stated in its Independent Auditors' Report on Compliance With General Requirements that it had applied procedures to test compliance with the allowable costs and cost principles applicable to Aerospace's Federal awards programs. The procedures are required by the OMB Circular A-133 Compliance Supplement. KPMG representatives agreed that testing procedures were not performed, because the DCAA was performing the testing of allowable costs and cost principles related to Federal awards. The effect of KPMG not performing required testing, is that the audit report is misleading and provides false assurance to users of the report with respect to audit of allowable costs and cost principles.

Recommendations for Corrective Action

1. We recommend that KPMG Peat Marwick LLP reissue its audit report for The Aerospace Corporation for the fiscal year ended September 30, 1995; qualify the report on compliance with general requirements for allowable costs and cost principles related to the audit of Federal awards; and eliminate the reference to "Predetermined Overhead Rates" in the introduction section.

2. We recommend that The Aerospace Corporation:

a. Obtain an audit of the specific requirements related to major programs consisting of types of services allowed or unallowed, claims for advances or reimbursements, amounts claimed for matching, level of effort and/or earmarking, special reporting, and special tests and provisions. Thereafter, issue an audit report on specific requirements related to major programs for the fiscal year ended September 30, 1995.

b. Coordinate all future Office of Management and Budget Circular A-133 audits with the auditors. The coordination should include the preparation of a matrix that identifies the responsibilities each audit entity will assume.

c. Provide future audit reports timely, in accordance with the reporting requirements of Office of Management and Budget Circular A-133.

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 OMB Circular A-133. As a Federal oversight agency for Aerospace, we conducted a quality control review of the KPMG and DCAA audit working papers for their audit of Aerospace. 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 most recent peer review letter issued by Price Waterhouse LLP for KPMG on November 8, 1996. The peer review letter found that KPMG 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. The Guide is further divided into the substantive audit work performed during the audit of 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 review was conducted from October 2 through 6, and from October 9 through 10, 1997.

Our quality control review of the audit working papers covered areas related to the financial statements, major programs, and nonmajor programs. The auditors considered two large Air Force contracts as separate major programs. The expenditures against the two major programs totaled about \$332 million and accounted for 99 percent of total Federal award expenditures at Aerospace.

Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at two of the eight KPMG locations we visited at various times between January 1, 1995, through July 31, 1997. The affected offices were notified, and no further action is necessary.

Background

The Inspector General Act of 1978, Public Law 95-452, as amended, 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 in Federal financial assistance 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 in the OMB Circular A-133, under the Single Audit Act.

The 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 implement 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 on 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.

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 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 to 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 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 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 Auditors' Report.

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 to assess control risk to determine whether 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, to review the system for monitoring subrecipients and obtaining and acting on subrecipient audit reports, and to determine whether controls are effective to ensure that direct and indirect costs are calculated 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 results of the testing of controls.

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 auditors' procedures were limited to those prescribed in the OMB Circular A-133 Compliance Supplement. 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.

Schedule of Current Year Findings and Recommendations. The auditor is not required to, but may report immaterial findings in the audit report or report them to the recipient in writing in a separate communication. The recipient is responsible for forwarding the findings to the Federal grantor agencies. We traced the findings in the working papers to the audit report to make sure that it includes all findings identified in the working papers and that the findings are properly supported. We noted that there were no repeat audit findings that remain unresolved from the prior year's audit. A complete list of all audit findings is in Enclosure 1.

Comments

Because this report contains findings and recommendations, written comments are required. Please provide your comments by April 27, 1998. If you have questions on this report, please contact Ms. Barbara Smolenyak, Program Director, at (703) 604-8761. The report distribution is in Enclosure 2.

A handwritten signature in black ink, reading "Robert J. Lieberman". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosures

**The Aerospace Corporation
Fiscal Year Ended September 30, 1995
Summary of Current Year Findings and Recommendations**

KPMG Peat Marwick LLP

<u>Page no.</u>	<u>Description</u>	<u>Questioned Costs</u>	<u>Resolution Agency</u>
24	Reconciliations	n/a	DoD

Defense Contract Audit Agency

<u>Page no.</u>	<u>Description</u>	<u>Questioned Costs</u>	<u>Resolution Agency</u>
4	Indirect Costs	\$26,578,460	DoD

Acronym and Abbreviation

DoD	Department of Defense
n/a	Not Applicable

Enclosure 1

**The Aerospace Corporation
Fiscal Year Ended September 30, 1995**

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Enclosure 2

Evaluation Team Members

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

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