

Policy and

Oversight



Financial and Performance Audits
Directorate

Quality Control Review

KPMG Peat Marwick LLP
Applied Physics Laboratory of Johns Hopkins University
Fiscal Year Ended June 30, 1995

Report Number PO 97-022

June 18, 1997

Office of the Inspector General
Department of Defense

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Acronyms

GAAS	Generally Accepted Auditing Standards
GAS	Government Auditing Standards
OMB	Office of Management and Budget
R&D	Research and Development



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June 18, 1997

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

SUBJECT: Quality Control Review of KPMG Peat Marwick LLP
Applied Physics Laboratory of Johns Hopkins University
Fiscal Year Ended June 30, 1995
Report No. PO97-022

Introduction

We are providing this report for your information and response. Your Baltimore, Maryland, office performed the single audit for the Applied Physics Laboratory of Johns Hopkins University (the Laboratory), Laurel, Maryland, a nonprofit organization. The audit is required by Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions." For fiscal year ended June 30, 1995, the Laboratory reported total Federal and Non-Federal expenditures of \$429,293,173 and \$4,114,730, respectively. Of the total Federal expenditures of \$429,293,173, \$427,230,508 are related to the Department of Defense and \$2,062,665 to other Federal Agencies.

The audit was performed under the coordinated audit approach, with KPMG Peat Marwick LLP (KPMG), the principal auditor, taking full responsibility for audit work performed by the Defense Contract Audit Agency. KPMG issued its audit report September 26, 1995. 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 report describes the auditors' scope of work in obtaining that understanding and assessing control risk. The report on Federal awards further describes the 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 met 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), and the provisions of the Federal award agreements. We found, however, that five of the eight auditors assigned to the OMB Circular A-133 audit did not have the required 24 hours of continuing education in subjects directly related to the Government environment and Government auditing as required by the GAS, General Standard One.

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 Laboratory, 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 most recent peer review letter dated November 3, 1993, performed by Price Waterhouse LLP that found that KPMG met the objectives of the quality control review 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. Price Waterhouse LLP found, however, improvements could be made to strengthen the KPMG system of quality control. Price Waterhouse LLP recommended that KPMG emphasize its requirements in communications and training programs for managerial staff, develop sample memorandum or other practice aids to address or illustrate the nature and extent of expected documentation, and devise an appropriate training program for partners and other members of engagement management to stress the importance of representation letters. KPMG responded to Price Waterhouse LLP and advised actions would be taken to correct the deficiencies.

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 review was conducted from September 16 through 20, 1996.

We limited the scope of our quality control review to the KPMG audit working papers covering areas related to the Department of Defense expenditures, the financial statements, and the research and development (R&D) program. The Federal R&D program expenditures were approximately \$429 million and accounted for 99 percent of Federal award expenditures of the Laboratory.

Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at two of the six KPMG 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 based on risk rather than the amount

of dollars involved, and 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.

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 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. 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 the most funds. The DoD has assumed the oversight responsibilities for the Laboratory. The Circular is currently being revised to incorporate the changes in the Single Audit Act Amendments of 1996.

Discussion of Findings

General Standards. The general standards in the GAS, Chapter 3, Paragraph 3, 1994 Revision, promulgated by the Comptroller General of the United States require that "The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required." To meet this standard, GAS requires that KPMG should have a program to ensure its staff maintains professional proficiency through continuing education and training. Specifically, each auditor responsible for planning, directing, conducting, or reporting on audits covered by GAS should complete every 2 years at least 80 hours of continuing education that contributes to the auditor's professional proficiency. At least 20 hours should be completed in any 1 year of the 2-year period. According to GAS, Chapter 3, Paragraph 6, auditors responsible for planning or directing an audit, conducting substantial portions of the field work, or reporting on the audit should complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the Government environment and to Government auditing.

Auditors Assigned to Single Audit. We found that five of eight auditors assigned to the Laboratory single audit did not have the required 24 hours of continuing education and training in subjects directly related to the Government environment and to Government auditing. In performing an audit in accordance with OMB Circular A-133, the auditor assumes certain testing and reporting responsibilities beyond those

of an audit performed in accordance with GAAS and GAS. These responsibilities focus on compliance with laws and regulations applicable to Federal awards and on the internal control structure. Therefore, when an auditor undertakes an audit of Government grants or recipient of Government monies, he must be knowledgeable of Government audit standards, guides, procedures, statutes, rules, and regulations to conduct the necessary tests and procedures to afford a reasonable basis for his opinion.

Recommendation for Corrective Action

We recommend that KPMG Peat Marwick LLP management take action to ensure that auditors responsible for planning or directing an audit, conducting substantial portions of field work, or reporting on the audits covered by Government Auditing Standards complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the Government environment and to Government auditing.

Discussion of Results

During our quality control review, we found the audit work performed, including substantive testing, was adequate. We reviewed and took no exception to the working papers supporting the following reports and schedules:

Independent Auditors' Report on Financial Statements and Supplementary Schedule of Federal Awards. 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 conclusions reached and whether the working papers supported the conclusions.

The auditor is also required to subject the Schedule of Federal Awards to the auditing procedures applicable to the audit of the financial statement and to ensure that 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 auditors' report on the financial statements.

The recipient is responsible for creating the Schedule of Federal Award Expenditures. 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 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 the 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 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 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 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 are 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 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 its major Federal programs, including 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, checked the audit program steps to those in the Compliance Supplement to make sure all areas are 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 Specific Requirements Applicable to Nonmajor Program Transactions. The auditor is required to issue a report on nonmajor programs that provides "a statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested." If the auditor has not selected any nonmajor program transactions or if the entity has no nonmajor programs, no report is required. If the auditor has selected such transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions. We did not review the auditors' work on nonmajor program transactions because major program transactions represented 99 percent of the Laboratory's Federal award expenditures.

Independent Auditors' Comments on Status of Previously Reported Audit Findings and Subrecipient Audit Findings. The auditor is required to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Federal Agencies are required to track the status of management's action on significant or material findings and recommendations from prior audits. We reviewed the auditors' comments and found that none of the findings presented resulted in significant questioned costs or adjustments to Federal award expenditures by the Laboratory. We traced the auditors' follow-up on prior year findings from the working papers to the audit report.

Schedule of Findings. The auditor is required to report findings in the audit report; however, immaterial findings are not required to be in the audit report but should be provided to the recipient in writing in a separate communication. The immaterial findings were provided to the recipient as a "Memorandum Relating to Accounting Procedures and Internal Controls," dated November 29, 1995 (see enclosure). The recipient is responsible for forwarding the immaterial findings to the Federal grantor agencies. We traced the immaterial 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. In its December 5, 1996, results of desk review, the Department of Health and Human Services, Cognizant Agency for the University, assigned resolution responsibility to the appropriate Federal Agency.

Comments

This report contains a finding and recommendation; therefore, 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

Enclosure

cc: Mr. Philip Tahey, Partner, KPMG Peat Marwick LLP
Board of Trustees, Applied Physics Laboratory of Johns Hopkins
Resident Representative, Office of Naval Research
Director, Defense Contract Audit Agency
Commander, Defense Contract Management Command
Director, Defense Procurement

APPLIED PHYSICS LABORATORY OF
JOHNS HOPKINS UNIVERSITY

SCHEDULE OF FINDINGS¹

<u>FINDING</u>	<u>TITLE</u>	<u>AGENCY</u>
Section H	Financial Reporting	2
Section I-1-2	Subrecipient Reports	AID
1	Departmental Administrative Costs	HHS
2	Clinical Services Matters	2
3	Closing and Financial Reporting Process	2
4	Accounting, Reporting, and Control Procedures	2
5	Development of Information Systems	2
6	Purchasing Matters	2
7	Monitoring of Departmental Performance	2

AID Agency for International Development
HHS Department of Health and Human Services

¹Includes immaterial findings identified in "Memorandum Relating to Accounting Procedures and Internal Controls," November 29, 1995.

²Findings and related recommendations not identified for formal Federal resolution. Appropriate corrective action recommended by the auditors should be taken. This action would involve necessary financial adjustments to Federal programs, accounts, and records. In the subsequent audit report, the auditors should address corrective actions not taken under "Status of Prior Year's Recommendations."

Enclosure

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