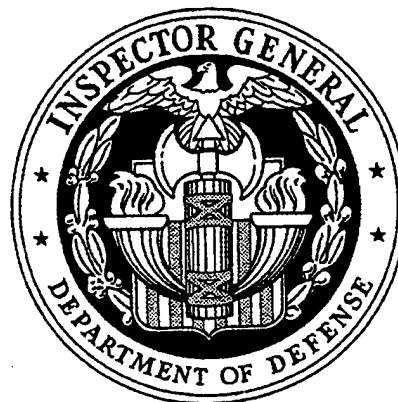


Policy and

Oversight



Financial and Performance Audit
Directorate

Quality Control Review

Leonard G. Birnbaum and Company, LLP
Kestrel Institute
Fiscal Year Ended December 31, 1995

Report Number PO 97-042

September 15, 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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September 15, 1997

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Leonard G. Birnbaum and Company, LLP
1773 Woodside Road, Suite 210
Redwood City, California 94061

SUBJECT: Quality Control Review of Leonard G. Birnbaum and Company, LLP
Kestrel Institute
Fiscal Year Ended December 31, 1995
Report No. PO97-042

Introduction

We are providing this report for your information and response. Your Redwood City, California, office performed the single audit for the Kestrel Institute (Kestrel), Palo Alto, California, a nonprofit organization providing scientific research and graduate education in the area of computer science. 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 the fiscal year ended December 31, 1995, Kestrel reported total Federal expenditures of \$3,264,430. Of the total Federal expenditures, \$3,214,430 is related to the Department of Defense and \$50,000 to other Federal agencies.

Leonard G. Birnbaum and Company, LLP, issued its audit report March 8, 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. The auditors issued positive and negative assurance

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 an 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 auditor's 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 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 generally met the applicable guidance and regulatory requirements in the Circular, its related Compliance Supplement, Government Auditing Standards (GAS), generally accepted auditing standards (GAAS), and the provisions of the Federal award agreements. See the "Discussion of Findings" section later in this report.

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 OMB Circular A-133. As the oversight agency for Kestrel, the Office of the Inspector General, DoD, 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 June 8, 1995, issued by Sorelle & Associates PC. The letter states that Leonard G. Birnbaum and Company, 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 December 31, 1994. However, Sorelle & Associates PC made recommendations for improvement in two areas noted in the previous review. Specifically, Sorelle & Associates PC recommended that Leonard G. Birnbaum and Company, LLP: revise its quality control policies and procedures to require an independent review of all audit engagements and selected reviews and compilations and reemphasize to staff the importance of documenting all significant auditing procedures and considerations.

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 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 May 5 through 9, 1997.

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 (R&D) program. The Federal R&D program expenditures totaled about \$3.3 million and accounted for 100 percent of Federal award expenditures for Kestrel.

Results of Prior Quality Control Reviews

We have not previously conducted a quality control review of Leonard G. Birnbaum and Company, LLP.

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 annual expenditures total \$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 funds 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 establishes the Federal audit and reporting requirements for nonprofit and educational institutions whose Federal awards total 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 Findings

During our quality control review, we reviewed and took exception to the following.

Auditor's Report on Compliance With Specific Requirements Applicable to Nonmajor Program Transaction. We found that Leonard G. Birnbaum and Company, LLP, issued a report on compliance with specific requirements applicable to nonmajor program transactions stating that the auditors tested certain transactions applicable to certain nonmajor Federal programs for compliance with specific requirements. However, there were no nonmajor programs and, therefore, no nonmajor program transactions. R&D program expenditures accounted for 100 percent of the Federal Award expenditures for Kestrel. Issuing a report on matters that do not exist indicates a lack of due care in conducting the audit.

Other Matters

Engagement Letter. We found that Leonard G. Birnbaum and Company, LLP, did not have a formal policy that discussed the OMB Circular A-133 requirements of allowing representatives of the cognizant agency to have access to the working papers and of maintaining the working papers for at least 3 years after the date of the report. The OMB Circular A-133, Attachment, paragraph 17, states that representatives of the cognizant agency, other Government audit staff, and GAO shall have access to the audit working papers upon request and that the working papers should be maintained for at least 3 years after the date of the audit report or longer if requested by the

cognizant agency, other Government audit staff, and GAO shall have access to the audit working papers upon request and that the working papers should be maintained for at least 3 years after the date of the audit report or longer if requested by the cognizant agency. Clarification of these requirements in the engagement letter minimizes confusion and helps to ensure a proper understanding of the responsibilities of each party. Leonard G. Birnbaum and Company, LLP, subsequently added the requirements to its engagement letter for the fiscal year ended December 31, 1996. Therefore, no further action is required.

Management Representations. We found that the management representation letter did not contain certain representations that should ordinarily be obtained in an organization-wide audit. Specifically, the management representation letter did not contain the following representations.

- Management has monitored subrecipients to determine that they have expended financial assistance in accordance with applicable laws and regulations and have met the requirements of Circular A-133 or other applicable Federal audit requirements.
- Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with Federal laws and regulations.
- Management has considered the results of the subrecipient's audit and made the necessary adjustments to the entity's books and records.

Statement on Auditing Standard No. 19, "Client Representations," paragraph .04, and Statement of Position 92-9, "Audits of Not-for-Profit Organizations Receiving Federal Awards," paragraph 6.84, requires the 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. Lack of the required written representations constitute a limitation on the scope of the audit potentially sufficient to require a qualified opinion or disclaimer of opinion on an institution's compliance with Circular A-133 requirements.

Selection of the Audit Firm. We found that Kestrel did not procure its Single Audit in accordance with OMB Circular A-133 requirements. Specifically, in the competition for selection of the audit firm, Kestrel did not issue a request for proposals to solicit potentially interested public accounting firms, or provide adequate justification for the selection of the audit firm. The OMB Circular A-133, Attachment, paragraph 10, requires institutions to follow the procurement standards prescribed by Circular A-110, paragraph 43, "Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-profit Organization." Solicitations should clearly set forth all requirements that the accounting firm shall fulfill in order for the proposal to be evaluated by Kestrel. The selected accounting firm's proposal should be responsive to the solicitation. Kestrel's evaluation of

proposals should be documented and include consideration of factors such as the integrity of the accounting firm, record of past performance, and, financial and technical resources as well as price. Because Kestrel did not establish full and open competition to the maximum extent practical in the selection of the audit firm, Kestrel had no assurance of a fair and reasonable price for the audit and did not comply with Federal requirements for procurement of single audits.

Recommendations for Corrective Actions

1. We recommend that Leonard G. Birnbaum and Company, LLP, purge the "Auditor's Report on Compliance With Specific Requirements Applicable to Nonmajor Program Transaction," and resubmit the single audit report to our office at no additional cost to the Government .
2. We recommend that Kestrel Institute include in its representation letter matters concerning a system for monitoring subrecipients, taking corrective action on the subrecipient's auditor's report, and consider the results of subrecipients' audits to make necessary adjustments to the entity's books and records.
3. We recommend that Kestrel Institute follow the requirements of Office of Management and Budget Circular A-133, Attachment, paragraph 10, in obtaining goods and services, particularly in procuring audit services.

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 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 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.

Auditor's Report on the Internal Control Structure. 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.

The auditor is also required to obtain an understanding of the internal control structure and to 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, to review the system for monitoring subrecipients and for 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 test of controls performed.

Auditor's 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 the 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.

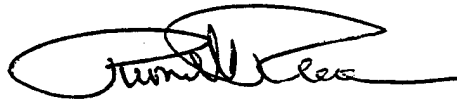
Auditor's Report on Compliance With the General Requirements Applicable to Federal Awards Programs. The auditor is required to determine whether the recipient has complied with the laws and regulations that may have a direct and material effect on any of its major Federal programs. General requirements 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. 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.

Auditor's 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, 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.

Comments

Because, 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, please contact Ms. Barbara Smolenyak, Program Director, at (703) 604-8761 or Mr. Sunil R. Kadam at (703) 604-8735. See the Enclosure for the report distribution.

A handwritten signature in black ink, appearing to read "Russell A. Rau", with a large, sweeping loop at the end.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Enclosure

Kestrel Institute
Fiscal Year Ended December 31, 1995

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Enclosure

Evaluation Team Members

This report was prepared by the Financial and Performance Audit Directorate,
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