February 10, 2003

Audit Oversight

Quality Control Review of Grant Thornton, LLP Office of Management and Budget Circular A-133 Audit Report of the Center for Naval Analyses Corporation, Fiscal Year Ended September 30, 2001
(D-2003-6-004)

Office of the Inspector General
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Acronyms

CNA	Center for Naval Analyses
CNAC	CNA Corporation
DCAA	Defense Contract Audit Agency
FAR	Federal Acquisition Regulation
FFRDC	Federally Funded Research and Development Center
GAS	Government Auditing Standards
OIG	Office of the Inspector General
OMB	Office of Management and Budget
R&D	Research and Development

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February 10, 2003

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SUBJECT: Report on Quality Control Review of Grant Thornton, LLP Office of Management and Budget Circular A-133 Audit Report of the Center for Naval Analyses Corporation, Fiscal Year Ended September 30, 2001 (Report No. D-2003-6-004)

We are providing this report for your information and use. The audit firm of Grant Thornton, LLP (Grant Thornton) performed the FY 2001 single audit for the Center for Naval Analyses Corporation (CNAC), located in Alexandria, Virginia. Office of Management and Budget Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations,"(OMB Circular A-133) requires the audit. CNAC expended $66.6 million in Federal awards under the Research and Development (R&D) cluster during the fiscal year that ended September 30, 2001. Of the $66.6 million, $62.6 million was expended for DoD research and development programs.

Background. CNAC maintains two operating divisions, the Center for Naval Analyses (CNA) and the Institute for Public Research. CNA is a federally funded research and development center (FFRDC) whose primary focus is to provide assistance to the Navy in operations and systems analysis. CNA has conducted research for the Navy and other government entities since 1942 under affiliations with various universities and institutes. Effective October 1, 1990, CNA was granted FFRDC status as an independent entity. The Institute for Public Research division provides resources for studies and analyses for non-DoD agencies. CNAC is subject to the Cost Accounting Standards and Disclosure Statement requirements in 48 Code of Federal Regulation Chapter 99. Grant Thornton has provided OMB Circular A-133 audit services to CNAC since FY 1991. The Grant Thornton offices in the Washington, D.C., area have performed 24 OMB Circular A-133 audits in the last year.

Quality Control Review Objective. As the cognizant Federal agency for CNAC, the Office of the Inspector General of the Department of Defense (OIG DoD) performed a quality control review of the single audit report and supporting working papers for the FY 2001 CNAC single audit. The objectives of the review were to determine whether the audit was conducted according to Government Auditing Standards (GAS) and the auditing and reporting requirements of OMB Circular A-133.

Review Results. The Grant Thornton auditors did not meet the requirements of OMB Circular A-133 and GAS that related to the audit of Federal programs because the FY 2001 single audit was not adequately planned, executed, and documented (finding A and finding B). CNAC generally complied with OMB Circular A-133 reporting

requirements, except that the Schedule of Expenditures of Federal Awards did not clearly identify expenditures received as pass-through awards or provide the identifying number assigned by the pass-through entities. In addition, the reporting package did not contain a Summary Schedule of Prior Audit Findings (finding C).

Finding A. Audit Planning and Performance of Single Audit. The Grant Thornton auditors did not adequately plan and perform the single audit of CNAC major program Federal awards according to OMB Circular A-133 requirements. The auditors failed to exercise due professional care because they did not perform sufficient procedures to support their opinion statements on compliance with major program requirements and on the fair representation of the Schedule of Expenditures of Federal Awards. This condition occurred because the auditors did not:

- Develop and use a representative sample of awards from the R&D cluster to test internal control over compliance as well as compliance with major program requirements;
- Review and consider the work of others;
- Identify all of the applicable compliance requirements;
- Perform adequate tests of internal control over compliance and compliance with major program requirements; and
- Perform adequate audit followup procedures.

As a result of the inadequate planning and performance of the single audit, Federal awarding agencies cannot rely on Grant Thornton audit reports for assurance that CNAC is managing Federal awards in compliance with laws, regulations, and award provisions.

Audit Coverage and Sampling Methodology. The Grant Thornton auditors did not plan for adequate audit coverage to achieve the objectives of OMB Circular A-133 audit of Federal programs. The auditors selected transactions from only three awards covering two Federal agencies, resulting in a sample selection that was not representative of the R&D cluster as a whole. In addition, one of the three awards selected should not have been included in the sample selection because it was a fixed-price contract and not subject to the single audit requirements.

The American Institute of Certified Public Accountants Statements on Auditing Standards AU §350.17 states that when planning a particular sample, the auditor should consider the specific audit objective to be achieved and determine the audit procedure, or combination of procedures, applied to achieve that objective. The auditor should determine that the population from which the sample is drawn is appropriate for the specific audit objective. For the three awards reviewed, the auditors selected sample items from expense and time sheet reports. The working papers did not demonstrate how the sample items and audit procedures achieved the objectives for the review of internal control and compliance for each applicable compliance requirement. OMB Circular A-133 requires assessment of the level of control risk. The working papers did not contain a basis for how the selected sample would achieve a low level of assessed control risk.

During our review, Grant Thornton management advised us that the firm's practice was to use a sample of 30 transactions. The Grant Thornton auditors originally selected 30 direct cost transactions and 30 indirect cost transactions for testing purposes. The sample size was then revised to test 50 direct cost transactions and 10 indirect cost transactions. To test for the allowability of costs, the auditors inappropriately reduced the sample size for indirect costs from the original 30 to 10 transactions. Specifically, the working papers indicate that the auditors depended on the Defense Contract Audit Agency (DCAA) to perform an incurred cost audit of CNAC indirect costs as the rationale for reducing the sample size. When making the decision, however, the auditors did not coordinate with the DCAA. At the time the auditors were performing the FY 2001 single audit, the DCAA had not planned or performed the FY 2001 incurred cost audit for CNAC. As a result, the auditor's conclusion that $30 million of indirect cost expenditures was allowable was based on a sample of 10 transactions with an approximate value of $100,000.

Unless all awards from the R&D cluster are represented in the sampling universe and specific audit objectives and procedures are considered when designing the sample, the planning of the single audit remains inadequate.

Consideration of the Work of Others. The Grant Thornton auditors did not properly assess and consider audits and reviews performed by the DCAA and the CNAC internal compliance group. GAS 6.14 states that the auditor should determine whether other auditors have previously done or are doing audits of the program or entity for planning and performing the audit. If other auditors have identified areas that warrant further study, that audit work may influence an auditor's selection of objectives and methodology as well as limit the extent of their own testing.

During our review, we found that the auditors did not consider the results of all DCAA audit reports issued during CNAC's fiscal year ending September 30, 2001. This occurred because the auditors relied solely on CNAC statements that during the audit period the DCAA had only issued one report. However, the DCAA had issued 11 reports between October 2000 and September 2001. Five of the 11 reports identified deficiencies with compliance with cost accounting standards, employee compensation policies and procedures, internal controls over the data processing system, and labor charging. These deficiencies should have been considered in assessing the risk for noncompliance with laws and regulations and in determining the nature and extent of the compliance testing.

Based on our review of the Grant Thornton working papers, the CNAC internal compliance group acted as the internal audit function in a limited capacity and performed reviews of time charging and compliance under "government contracting standards." However, no evidence existed that Grant Thornton auditors coordinated with the internal compliance group to obtain review results.

As a result of Grant Thornton's failure to assess and consider the results of these audits and reviews in their risk assessment process, we could not determine whether the auditors obtained sufficient evidence to support their opinion on compliance with major program requirements.

Determination of Applicable Compliance Requirements. The Grant Thornton auditors excluded three compliance requirements from the single audit because the auditors did not obtain sufficient knowledge about CNAC operations. The Compliance Supplement (the Supplement) identifies 14 compliance requirements applicable to the

R&D cluster. When determining not to test a requirement, the Supplement requires an auditor to conclude why the requirement does not apply to the non-Federal entity or that noncompliance with the requirement would not have a material effect on a major program.

The Grant Thornton auditor's determination that the following three compliance requirements were not applicable to CNAC for FY 2001 was not accurate. The three compliance requirements are:

- Equipment and Real Property Management;
- Subrecipient Monitoring; and
- Matching, Level of Effort, Earmarking.

The working papers document that the auditors concluded that the three compliance requirements were not applicable because CNAC did not purchase any property with Federal funds, did not provide any funds to subrecipients, and did not have contracts with matching or level of effort requirements.

However, CNAC advised us during our review that in FY 2001 they had Government-furnished equipment, had purchased equipment using Federal funds, and had provided $1.7 million to subrecipients. Also, delivery orders based on a level of effort could be issued on the FFRDC contract. Because Grant Thornton did not perform any audit procedures on those requirements, we could not determine whether the auditors obtained sufficient evidence to support their opinion on compliance with major program requirements.

Review of Internal Controls and Compliance. The Grant Thornton auditors did not perform adequate tests of internal controls and compliance for the identified applicable compliance requirements. OMB Circular A-133 and GAS require that the single audit be planned to identify and test internal controls over Federal programs for all compliance requirements relevant to a major program. In addition, the Supplement identifies 14 compliance requirements applicable to the R&D cluster (see Appendix A). To accomplish this, the auditor must identify all of the applicable and material compliance requirements, develop an understanding of the internal controls related to the objectives of each compliance requirement, plan tests of internal controls for each requirement to support a low assessed level of control risk, and perform the planned tests of controls. The auditor uses the knowledge gained from this process to design the nature and extent of compliance testing necessary to provide the auditor with sufficient evidence to support an opinion on compliance for a major program.

The Grant Thornton auditors identified 6 of the 14 compliance requirements to be applicable to CNAC. The following deficiencies in Grant Thornton's review of the six compliance requirements were present:

Activities Allowed or Unallowed and Allowable Costs/Cost Principles. The auditors did not identify and test major key controls to meet the objectives of those two compliance requirements. For example, the objectives of the compliance requirements include obtaining assurance that direct and indirect costs charged to grants and contracts comply with applicable cost principles for allowability and allocability. The tests of controls the auditors documented consisted of management assertions that

CNAC provided program managers with training and a statement that the CNAC policy manual provided guidance on allowable costs and activities. However, no evidence existed in the working papers that showed the auditors performed the necessary procedures to corroborate or evaluate the information.

Based on our review, no documentation of procedures existed that would test CNAC compliance with the Cost Accounting Standards. Furthermore, the auditors incorrectly used OMB Circular A-122, "Cost Principles for Non-Profit Organizations," as the criteria for testing the allowability of payroll costs. CNAC is not subject to OMB Circular A-122 cost principles but rather subject since 1997 to the cost principles of the Federal Acquisition Regulation (FAR). To compound the error, the auditors did not use the most recent version of OMB Circular A-122, revised in June 1998.

Period of Availability of Federal Funds. The Grant Thornton auditors did not adequately test key controls related to the requirement objectives and did not perform tests of compliance. Internal control testing generally consisted of inquiries and observations, and the auditors relied on management assertions that project managers monitored activities. The auditors did not, however, perform procedures to determine the accuracy of the information. Specifically, the working papers documented that the auditors "observed" that management had established procedures to comply with the availability of Federal funds requirement, but did not provide specifics. We were also unable to locate any working papers to show that the auditors performed tests of compliance for this requirement. Although the audit administrator referred us to a working paper that documented the tests of "subsequent disbursements" for the financial statement audit, the working paper was not relevant to testing for the period of availability compliance requirement. Testing for subsequent disbursements ensures that expenses are recorded in the proper period. Testing for availability of funds ensures that the CNAC contractors are not incurring expenses without authorized funding.

Based on our review of the working papers, there were indicators of noncompliance with the requirement for availability of funds that the auditors failed to address. The working papers made several references to unbilled receivables for costs incurred "in absence of executed delivery orders or adequate funding." CNAC contracts are subject to the FAR, and the FFRDC contract includes clauses that require the Government to be notified when contract cost expenditures reach 75 percent of estimated costs or obligated funds. The requirement is applicable to each delivery order. In addition, the FFRDC contract requires that the contracting officer make in writing all delivery orders and revisions and that work not begin until the contracting officer issues a delivery order. The contract also requires that work accepted by the Institute for Public Research, CNAC's non-FFRDC division, be fully funded. The Grant Thornton auditors did not consider these requirements in the single audit and did not perform any procedures to verify CNAC assertions that cost overruns and unfunded costs were not uncommon with the type of contract arrangement CNA has and that the Navy would approve the expenditures in the near future. Without approval, the costs should be classified as unallowable.

Procurement and Suspension Debarment. The Grant Thornton auditors did not adequately perform tests of controls and compliance to ensure that CNAC was in compliance with the objectives of the procurement, suspension, and debarment requirement. The auditors primarily relied on observations and inquiries to evaluate management assertions. Two of the objectives for the procurement, suspension, and

debarment requirement are: determine whether procurements were made according to applicable procurement regulations, and determine whether non-Federal entities obtained the required certifications, specifically suspension and debarment certifications.

The procurement policies should ensure that contract files document the history of the procurement including, but not limited to, the rationale for the procurement method, verification of full and open competition, the basis of contract price, and the required suspension and debarment certifications. As testing for the objectives, the auditors documented that they had observed the procurement manual made available to CNAC staff on the intranet and concluded that the manual was designed to meet the requirements of the FAR. The working papers also indicate that the auditors tested the requirement as part of the tests for disbursements procedures. However, the referenced test procedure showed that the auditors relied on the supervisor's approval signature on the vouchers as evidence that the procurement complied with policies and procedures.

No documentation existed to support the auditor conclusion that the procurement manual met the requirements of the FAR or that the auditors reviewed contract files to verify the history of the procurement, method of procurement, basis of contract price, and whether the procurement provided for full and open competition. In addition, the auditors did not perform adequate procedures to validate that CNAC obtained required suspension and debarment certificates. Auditors observed that CNAC procurement staff had online access to the Government's "List of Parties Excluded from Federal Procurement or Non-procurement Programs," but the auditors did not review the procurement files for the required certifications or check a sample of procurements against the published Government list.

Reporting. Auditors did not perform adequate procedures to support their conclusion that CNAC was in compliance with the reporting requirement. The auditors did not design or perform procedures to determine whether required reports were complete, accurate, and submitted in a timely manner. This condition occurred because the auditors did not obtain a sufficient knowledge about the types of reports and submission requirements in CNAC contracts.

The working paper documentation for the review of internal controls and compliance showed that the auditor's conclusion that CNAC was in compliance with this requirement generally consisted of broad management statements that the auditor did not confirm. The objective of the reporting requirement is to determine that reports submitted to awarding agencies and pass-through entities include all activity for the reporting period and are supported by applicable accounting records. The working papers referenced tests of the disbursement and payroll process and consisted of tracing transactions from the accounts payable check register and payroll journal to the general ledger. The tests did not provide assurance for the objectives of the reporting requirement.

Special Tests and Provisions. The Grant Thornton auditors did not perform adequate procedures to determine that CNAC had effective internal controls in place to ensure compliance with the contract provisions. The auditors did not adequately identify and test significant special contract provisions, and the documented tests of internal controls generally consisted of broad management assertions and auditor observations.

The auditors did not identify many of the special contract provisions designed to address the unique nature of the FFRDC contracting environment. Some of the provisions that the auditor failed to identify and test include restrictions on CNA initiated projects and reporting requirements on the related projects; requirements for approval to use consultants and subcontractors, including specific approval considerations for former senior government officials; and minimum educational requirements for employees and consultants.

Auditor testing of compliance for three contract provisions was inadequate. The FFRDC contract limits certain costs for employees on educational leave and for employees detained overseas. The contract also requires that CNAC provide the contracting officer with reports on activities the Institute for Public Research performed. As support for the testing of internal controls over the Special Tests and Provisions compliance requirement, the working papers provided only descriptions of certain contract provisions. The working papers did not provide any specifics on the audit procedures performed to test compliance with the contract provisions. Furthermore, we could not find any correlation between the disbursement and payroll transactions selected for testing and how the same transactions would achieve the testing objectives for compliance with the Special Tests and Provision compliance requirement. The working papers concluded that the Special Tests and Provision compliance requirement was met based on inquiries with CNAC personnel that the contract administrator received reports in a timely manner. However, no evidence existed in the working papers to indicate that the auditors verified the number of reports that should have been submitted or that the contracting officer actually received the reports in a timely manner.

Performing Audit Followup Procedures. The Grant Thornton auditors did not exercise professional skepticism because they did not perform adequate audit followup procedures concerning an occurrence of employee theft, unresolved DCAA findings and questioned costs from prior years, and a pending investigation on the hiring of two Government officials. The American Institute of Certified Public Accountants Statement on Auditing Standards AU §230.08 states that when gathering and objectively evaluating audit evidence, the auditor is required to consider the competency and sufficiency of the evidence. Because evidence is gathered and evaluated throughout an audit, professional skepticism should be exercised throughout the audit process. At the beginning of the single audit, CNAC management informed the auditors about an employee theft that occurred over a period of 4 years and CNAC estimated the loss at $50,000. CNAC management stated that new policies and procedures were implemented to correct the breakdown in internal controls and that the audit committee was informed of the employee theft. We did not find any indications that the auditors performed any followup procedures to confirm CNAC assertions. Our review of the minutes for the Board of Trustees meetings in FY 2001 showed no evidence that CNAC management informed the audit committee of the employee theft. In addition, as a result of the employee theft, the auditors should have considered the impact of this particular known fraud in the single audit planning process. We found no evidence to indicate that this had occurred.

The Grant Thornton working papers document information on DCAA findings and questioned costs from prior years that remain unresolved, and the auditors used that information to verify the reasonableness of the reserve for unallowable costs for the financial statement audit. However, no evidence existed in the working papers that the auditors performed procedures to verify CNAC assertions on the status of the unresolved issues.

The Grant Thornton auditors were notified in the CNAC management letter that CNAC was under investigation for possible violations in hiring two former Government officials. CNAC asserted that the result would not have a material effect on the financial statements. The working papers document that outside counsel for CNAC confirmed the status of the investigation but did not comment on any loss contingency. The auditors did not perform any other audit procedures to verify the CNAC assertion.

Schedule of Expenditures of Federal Awards. The working papers did not provide sufficient evidence that Grant Thornton performed the steps necessary to support the audit opinion that the Schedule of Expenditures of Federal Awards was fairly presented in all material respects in relation to the financial statements taken as a whole. Specifically, the working papers did not contain an objective, scope, and methodology, and did not document the work performed as it relates to the audit objectives. We could not determine on some of the working papers the source of the information, what analysis was performed, and the purpose, relevance, and conclusion of the analysis as it related to the Schedule of Expenditures of Federal Awards. As a result, we had no assurance that the Schedule of Expenditures of Federal Awards was complete and accurate.

Summary. The Grant Thornton, LLP audit work does not meet the requirements of OMB Circular A-133, the related Compliance Supplement, and GAS auditing standards. As a result, Federal agencies and pass-through entities cannot rely on the CNAC audit report to monitor and manage Federal awards.

Based on the deficiencies, we conclude that the audit team members lacked an understanding of the requirements for performing audits in accordance with GAS and the OMB Circular A-133 audit requirements. Although the audit team members met the required 24 hours of continued professional education, we believe that additional training related to GAS and OMB Circular A-133 audits should be provided to team members engaged in such audits. In addition, proper supervision should have ensured that the audit was conducted according to GAS and OMB Circular A-133 requirements.

Recommendation A.1. We recommend that the Controller, Center for Naval Analyses Corporation:

a. Direct Grant Thornton, LLP to perform additional audit procedures to address the specific deficiencies identified in this report and revise the reporting package to reflect, at a minimum, the date the work is completed. The additional audit procedures should satisfy the terms of the engagement letter for the single audit of the Center for Naval Analyses Corporation for the fiscal year ended September 30, 2001, and be performed at no additional cost to the Federal Government.

b. Notify the Office of the Inspector General of the Department of Defense when Grant Thornton provides the revised reporting package to CNAC so that we can perform a followup quality control review before submission of the revised FY 2001 single audit reporting package to the Federal Audit Clearinghouse.

c. Identify as unallowable any costs associated with audit services Grant Thornton, LLP provided related to the FY 2001 single audit until they perform an adequate audit as determined by our office.

Management Comments. We request that CNAC management provide comments to the recommendation and corrective actions planned or taken by February 28, 2003.

Recommendation A.2. We recommend that the Partner in Charge, Grant Thornton, LLP:

a. Perform additional audit procedures and revise the reporting package to reflect, at a minimum, the date the work is completed to satisfy Government Auditing Standards and the Office of Management and Budget Circular A-133 requirements. The additional audit procedures should address the specific deficiencies identified in this report. The revised reporting package should be provided to CNAC.

Management Comments. Grant Thornton management nonconcurred, stating that they believed that the 2001 audit of CNAC complied with professional standards and the requirements of the Office of Management ad Budget Circular A-133 related to the audit of Federal programs. Grant Thornton believed that the extent of the procedures requested by the Inspector General (IG) is generally in excess of the professional standards and the requirements of Office of Management and Budget Circular A-133. However, Grant Thornton agreed to perform certain additional procedures requested by the IG in order to meet the IG requirements. Grant Thornton will provide the additional information directly to the IG for review and acceptance prior to inclusion in the 2001 workpapers.

Evaluation Response. We disagree with Grant Thornton that their FY 2001 single audit of CNAC met Government Auditing Standards and the Office of Management and Budget Circular A-133 audit requirements. The audit standards and requirements for a single audit are established in the Government Auditing Standards and the Office of Management and Budget Circular A-133, not by the IG office. Our reported findings are based on the review of working papers prepared by Grant Thornton auditors during the audit engagement. We consider those working papers as the record of the procedures applied, the tests performed, the information obtained, and the conclusions reached in the audit. We intend to perform a followup quality control review after Grant Thornton provides CNAC with the revised reporting package. We will review the Grant Thornton working papers for the additional audit procedures at that time.

Finding B. Documentation of Audit Work Performed. The Grant Thornton auditors did not adequately document the audit work performed for the single audit of CNAC for the fiscal year ending September 30, 2001, because they did not comply with GAS requirements for working papers. Specifically, the Grant Thornton auditors did not adequately document the sampling methodology for the selection of transactions; and did not adequately document the testing of internal controls and compliance with the compliance requirements.

GAS Working Paper Requirements. GAS requires that working papers contain sufficient information to enable an experienced auditor with no previous connection with the audit to ascertain the evidence that supports an auditor's significant conclusions and judgments. Working papers should contain objectives, scope, and methodology as well as any sampling criteria used. The working papers should also contain documentation of the work performed, including descriptions of transactions and records examined, that would enable an experienced auditor to examine the same transactions and records.

Sampling Methodology. The Grant Thornton working papers did not adequately document the methodology used to establish their sample for the single audit of CNAC for FY 2001. Although the working papers showed the number of direct and indirect cost transactions to be tested, the working papers did not document how the selected transactions would accomplish the testing of objectives for internal control over financial

reporting and internal control and compliance with the R&D cluster requirements. For example, our review of the FFRDC contract between CNAC and the Navy showed that special requirements existed that the Grant Thornton auditors should have considered for testing purposes when establishing their sample. Some of the special requirements included submitting certification of compliance for performing non-FFRDC work; obtaining prior approval to use and charge consultants/subcontractors to CNA projects; and that the total reimbursement for salaries, fringe benefits, tuition and fees for personnel on education or administrative leave did not exceed 3 percent of total costs. The working paper that Grant Thornton auditors developed to document their sampling did not address these requirements.

Internal Controls Over Compliance Requirements. The Grant Thornton working papers did not contain sufficient, competent, and relevant evidence to support their conclusions and judgments for the test of internal controls over the compliance requirements. The working papers documented observations and inquiries the auditors performed but did not include specific information such as the names of the individuals interviewed, documents reviewed, or procedures observed. The working papers also did not contain auditor conclusions of key controls tested for support of the overall control risk assessment for the compliance requirements that the auditors identified as applicable to the major program. For example, auditors documented "we have observed that the accounting system allows for the segregation of allowable and unallowable costs," as testing for one of several key controls for the Allowed Cost/Cost Principles and Activities Allowed/Unallowed compliance requirements. As documentation for the test of a key control for the Procurement and Suspension and Debarment compliance requirement, the auditors indicated that, "We have observed that procurement staff have the 'Lists of Excluded Parties' available in an online format." Those statements do not provide sufficient evidence to support the auditor's conclusion that controls for the two compliance requirements were operating effectively.

Compliance Requirements. The working papers did not adequately document the review and audit conclusions for the testing of the six compliance requirements that the Grant Thornton auditors tested. The working papers referenced for the testing of the six compliance requirements did not provide sufficient evidence to support the auditor's conclusion that CNAC was in compliance with requirement objectives.

For the testing of the Allowable Cost/Cost Principles and Activities Allowed or Unallowed requirements, the working papers did not adequately document the procedures performed for establishing compliance with the compliance requirements. Specifically, the working papers mentioned a number of "observations" by the Grant Thornton auditors, and the audit procedures performed were primarily designed to test the disbursement and payroll systems/processes. The working papers did not document specific audit procedures performed and documents reviewed to assess the allowability of the costs against the cost principle criteria of the FAR or the terms and conditions of the contracts. In addition, to identify the working papers that demonstrated the testing of the Period of Availability compliance requirement, we needed verbal explanations from the Grant Thornton audit administrator. Without the audit administrator, we would not have been able to associate the working paper with the testing for the Period of Availability compliance requirement. The audit procedure identified in the working paper did not address the objectives of the compliance requirement, and the working paper did not contain a conclusion relevant to the compliance requirement.

Recommendation B. We recommend that the Partner in Charge, Grant Thornton, LLP:

1. Review the working papers supporting the additional audit procedures performed for the FY 2001 Office of Management and Budget Circular A-133 audit to ensure that they are prepared in accordance with Government Auditing Standards and include the objectives, scope and methodology, as well as work performed including descriptions of transactions and records examined to support significant conclusions and judgments reached.

Management Comments. Grant Thornton stated that they believe that the level of documentation requested by the IG is generally in excess of the professional standards and the requirements of the Office of Management Budget Circular A-133. However, Grant Thornton agreed to provide additional documentation with respect to auditing procedures, audit considerations, and audit conclusions already performed and reached by Grant Thornton during the 2001 audit.

Evaluation Response. OMB Circular A-133 §__500 requires that audits be conducted in accordance with Government Auditing Standards. Grant Thornton is subject to and did not meet the documentation requirements of the Government Auditing Standards. The documentation requirements for a single audit are established in the Government Auditing Standards, not by the IG office. We cannot consider and accept significant supplemental working papers created more than one year later as evidence for the work performed during the initial 2001 single audit engagement. However, we will review the Grant Thornton working papers for the additional audit procedures performed to determine whether the single audit meets the requirements of Government Auditing Standards and the Office of Management and Budget Circular A-133.

Finding C. OMB Circular A-133 Reporting Package. CNAC did not submit a complete reporting package for FY 2001 to the Federal Audit Clearinghouse as required by OMB Circular A-133. The package did not present a clear Schedule of Expenditures of Federal Awards. The package also did not contain a Summary Schedule of Prior Audit Findings.

Schedule of Expenditures of Federal Awards. CNAC did not clearly present in the Schedule of Expenditures of Federal Awards expenditures received as pass-through awards or the identifying number the pass-through entities assigned. As a result, Federal awarding agencies and pass-through entities may have difficulty using the information in the Schedule to monitor their awards.

Summary Schedule of Prior Audit Findings. CNAC did not include a Summary Schedule of Prior Audit Findings in the OMB Circular A-133 reporting package for open DCAA audit findings for FY 1997 through FY 1999.

Recommendation C. We recommend that the Controller, Center for Naval Analyses Corporation:

1. Prepare the Schedule of Expenditures of Federal Awards and a Summary Schedule of Prior Audit Findings according to the Office of Management and Budget Circular A-133 requirements and provide those documents to Grant Thornton, LLP for the performance of additional audit procedures for the FY 2001 Office of Management and Budget Circular A-133 audit.

2. Prepare the Schedule of Expenditures of Federal Awards according to the Office of Management and Budget Circular A-133 requirements, specifically to include pass-through entity information.

3. Prepare a Summary Schedule of Prior Audit Findings: (1) and provide to the auditors performing future Office of Management and Budget Circular A-133 audits, and, (2) include when appropriate, in any future Office of Management and Budget Circular A-133 audit reporting packages that are submitted to the Federal Audit Clearinghouse.

Management Comments. CNAC management concurred and agreed to implement the recommendations as stated.

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. Carolyn R. Davis at (703) 604-8877 (DSN 664-8877). See Appendix B for the report distribution. The review team members are listed inside the back cover of the report.

Patricia A. Brannin
Deputy Assistant Inspector General
for Audit Policy and Oversight

Appendix A. Quality Control Review Process

Scope and Methodology

We conducted a quality control review of the Grant Thornton, LLP audit of CNAC for the fiscal year ended September 30, 2001, and the resulting reporting package that was submitted to the Federal Audit Clearinghouse dated June 3, 2002. We performed our review 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. Our review was conducted from June 2002 through January 2003 and covered areas related primarily to the audit of the CNAC R&D cluster. As the cognizant agency for CNAC, we focused our review 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
- Schedule of Findings and Questioned Costs
- Summary Schedule of Prior Audit Findings
- Data Collection Form

In conducting our review, we reviewed the working papers Grant Thornton, LLP prepared as well as audit reports the DCAA auditors prepared. We also discussed the audit with the Grant Thornton, LLP auditors and CNAC personnel and retested selected sample transactions.

Prior Quality Control Reviews

Since 1996 we have issued three quality control review reports of OMB Circular A-133 audits that Grant Thornton performed. In our report issued in February 2001, we reported that the Grant Thornton audit documentation did not meet GAS requirements. Specifically, we could not rely on the working papers to determine that the audit was adequately planned and performed to meet OMB Circular A-133 requirements. The nature and extent of the deficiencies were discussed with Grant Thornton at that time. Significant verbal explanations were required to establish that the audit met the intent of the single audit requirements. We elected to omit some of the deficiencies as report findings from the February 2001 report by accepting verbal explanations and supplemental working papers provided by Grant Thornton to establish the adequacy of

the audit. As a result of the verbal discussions, Grant Thornton took actions to prevent similar deficiencies from occurring in future audits. Grant Thornton provided single audit training and developed a matrix intended to fully document the identification and testing of compliance requirement key internal controls. Despite corrective actions taken, similar deficiencies were found in the current OMB Circular A-133 audit of CNAC. Copies of Inspector General of the Department of Defense (IG DoD) reports can be accessed over the Internet at http://www.dodig.osd.mil/audits/reports.

Single Audit Requirements

The intention of the Single Audit Act, Public Law 98-502, as amended, and OMB Circular A-133 was to improve the financial management of state and local governments and non-profit organizations. The Single Audit Act and OMB Circular A-133 establishes 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. OMB Circular A-133 requires that Federal departments and agencies rely on and use the single audit work to the maximum extent practicable. Entities that expend $300,000 or more of Federal awards in a fiscal year are subject to the Single Audit Act and the audit requirements in OMB Circular A-133 and, therefore, must have a annual single or program-specific audit performed under GAS. To meet the intent of the law and OMB Circular A-133 requirements, the auditee (non-Federal entity) submits to the Federal Audit Clearinghouse a complete reporting package and a Data Collection Form on each single audit. The submission includes the following:

- Data Collection Form, certified by the auditee that the audit was completed in accordance with the OMB Circular A-133;
- Financial statements and related opinion;
- Schedule of Expenditures of Federal Awards and related opinion;
- Report on compliance and internal control over financial reporting;
- Report on internal control over compliance for major programs;
- Report on compliance with requirements for major programs and related opinion;
- Schedule of Findings and Questioned Costs;
- Summary Schedule of Prior Audit Findings; and
- A corrective action plan, when appropriate.

The OMB Compliance Supplement (the Supplement) assists auditors to identify compliance requirements the Federal Government expects to be considered as part of the single audit. For each compliance requirement, the Supplement describes the related audit objectives that the auditor shall consider in each audit conducted under OMB Circular A-133 as well as suggested audit procedures. The Supplement also describes the

objectives of internal control and characteristics that, when present and operating effectively, may ensure compliance with program requirements. The following 14 compliance requirements identified in the Supplement are applicable to the R&D cluster.

A. Activities Allowed/Unallowed
B. Allowable Costs/Cost Principles
C. Cash Management
D. Davis-Bacon Act
E. Eligibility
F. Equipment and Real Property Management
G. Matching, Level of Effort, Earmarking
H. Period of Availability of Federal Funds
I. Procurement and Suspension and Debarment
J. Program Income
K. Real Property Acquisition and Relocations Assistance
L. Reporting
M. Subrecipient Monitoring
N. Special Tests and Provisions

The Statement of Position 98-3, "Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards," published by the American Institute of Certified Public Accountants, provides guidance on auditor responsibilities for conducting audits according to the Single Audit Act and OMB Circular A-133. In general, the Statement of Position 98-3 provides auditors with an understanding of the unique planning, performance, and reporting considerations for single audits performed under GAS. In addition, the Statement of Position 98-3 uses summary tables and detailed discussions to provide the auditor with an understanding of the additional general, fieldwork, and reporting requirements under GAS, including the additional standards relating to quality control systems, continuing professional education, working papers, audit followup and reporting.

The Statement of Position 98-3 emphasizes that when planning an audit to meet the requirements of OMB Circular A-133, several factors should be considered in addition to those ordinarily associated with an audit of financial statements in accordance with Generally Accepted Auditing Standards and GAS. The factors include but are not limited to:

- Determining that the Schedule of Expenditures of Federal Awards is presented fairly in relation to the financial statements;
- Determining major programs for audit using a risk-based approach;
- Determining compliance requirements;
- Gaining an understanding of internal control over Federal programs;
- Testing internal control over major programs;

- Determining compliance with laws, regulations, and the provisions of contract or grant agreements that have a direct and material effect on each major program;
- Satisfying the additional requirements of the Single Audit Act and OMB Circular A-133 regarding working papers, audit followup, and reporting.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Defense Procurement

Other Defense Organizations

Director, Defense Contract Audit Agency

Department of the Navy

Chief, Office of Naval Research
Audit Liaison, Assistant Secretary of the Navy
Financial Management and Comptroller
Naval Inspector General

Other Federal Agencies

Office of the Inspector General, National Science Foundation
Office of the Inspector General, Central Intelligence Agency
Office of the Inspector General, Department of Transportation
Regional Inspector General for Auditing, General Services Administration

Non-Government Organizations

Board of Trustees, The CNA Corporation
Audit Committee, The CNA Corporation
CFO and Treasurer, The CNA Corporation
Assistant Controller, The CNA Corporation
Partner, Grant Thornton, LLP
Partner in Charge, Grant Thornton, LLP
Senior Manager, Grant Thornton, LLP
Board of Directors, American Institute of Certified Public Accountants

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Subcommittee on Acquisition and Technology, Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy

CNA Corporation Comments

The CNA Corporation

A Non-Profit Research and Analysis Corporation

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November 26, 2002

Inspector General
Department of Defense
400 Army Navy Drive
Arlington, VA 22202-2884

Attention: Ms. Sharon Vasquez

Subject: Draft Report on Quality Control Review of Grant Thornton LLP Office of Management and Budget Circular A-133 Audit Report of The CNA Corporation, Fiscal Year Ended September 30, 2001

Dear Ms. Sharon Vasquez:

We will ensure that all Schedule of Expenditures of Federal Awards prepared in the future clearly identify pass-through entities and the identification number assigned by the pass-through entities. Further, we will ensure that open DCAA audit findings are included in the Summary Schedule of Prior Audit Findings, which is part of the OMB Circular A-133 audit reporting packages submitted to the Federal Audit Clearinghouse.

We also agree to prepare revised FY 2001 Schedule of Expenditures of Federal Awards and Summary Schedule of Prior Audit Findings according to the specifications stated above. These reports will be provided to Grant Thornton for re-performance of the FY 2001 OMB Circular A-133 audit as recommended.

Sincerely,

Jonathan Myrick
Assistant Controller

Grant Thornton, LLP Comments

Grant Thornton

Accountants and Management Consultants

January 30, 2003

Ms. Janet Stern
Office of the Inspector General
Department of Defense
400 Army Navy Drive
Arlington Virginia 22202-2884

Dear Ms. Stern:

Grant Thornton LLP ("Grant Thornton" or "we") believes that the 2001 audit of the Center for Naval Analysis Corporation ("CNAC") complied with professional standards and the requirements of OMB Circular A-133 related to the audit of federal programs.

We believe that the extent of the procedures and the level of documentation requested by the IG is generally in excess of the professional standards and the requirements of OMB Circular A-133. However, as we discussed in our meeting with DoD IG staff, we will agree to provide additional documentation with respect to auditing procedures, audit considerations and audit conclusions already performed and reached by Grant Thornton during the 2001 audit and to perform certain additional procedures requested by the IG in order to meet the IG requirements. We will provide such additional information directly to the IG for review and acceptance prior to inclusion in the 2001 workpapers.

Sincerely,

GRANT THORNTON LLP

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Professional Standards Partner

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The Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Inspector General of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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