Oversight Report

REPORT ON QUALITY CONTROL REVIEW OF PRICEWATERHOUSECOOPERS LLP AND DEFENSE CONTRACT AUDIT AGENCY FOR OFFICE OF MANAGEMENT AND BUDGET CIRCULAR NO. A-133 AUDIT REPORT OF MASSACHUSETTS INSTITUTE OF TECHNOLOGY FISCAL YEAR ENDED JUNE 30, 1999

Report Number D-2001-6-004 March 22, 2001

Office of the Inspector General
Department of Defense

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Acronyms

CFDA	Catalog of Federal Domestic Assistance
DCAA	Defense Contract Audit Agency
FFRDC	Federally Funded Research and Development Center
MIT	Massachusetts Institute of Technology
OMB	Office of Management and Budget
PwC	PricewaterhouseCoopers, LLP

March 22, 2001

Controller
Massachusetts Institute of Technology

Partner-in-Charge
PricewaterhouseCoopers, LLP

Director
Defense Contract Audit Agency

SUBJECT: Report on Quality Control Review of PricewaterhouseCoopers LLP and Defense Contract Audit Agency for Office of Management and Budget Circular A-133 Audit Report of Massachusetts Institute of Technology, Fiscal Year Ended June 30, 1999
Report No. D2001-6-004 (Project No. D2001-OA-0015)

We are providing this report for your review and comment. The firm of PricewaterhouseCoopers LLP (PwC) and the Defense Contract Audit Agency (DCAA), performed the single audit for the Massachusetts Institute of Technology (MIT), a private, independent, non-profit research university located in Cambridge, Massachusetts. The audit is required by the Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations" (Circular A-133). MIT expended approximately $721 million against Federal awards, representing $391 million for the DoD and $330 million for other Federal agencies in the fiscal year ended June 30, 1999.

Quality Control Review Objective. As the Federal cognizant agency for MIT, the Office of the Inspector General, DoD, performed a quality control review to determine whether the FY 1999 report that MIT submitted to the Single Audit Clearinghouse met the applicable reporting standards and whether PwC and DCAA conducted the audit as required by applicable standards and the Circular A-133. See Appendix A for a discussion of the scope and single audit requirements.

Review Results. PwC complied with the Circular A-133 in performing the audit of the financial statements. MIT complied with all Circular A-133 requirements except the Schedule of Expenditures of Federal awards did not identify all Type A programs (see

finding A). DCAA did not coordinate the audit of classified programs at Lincoln Laboratory to ensure that all programs were included in its review (see finding B). In addition, the DCAA Boston Branch Office did not adequately perform the testing of internal controls over the Reporting compliance requirement and the Special Tests and Provisions compliance requirement (see finding C).

Finding A. Identification of Major Federal Programs. MIT did not task PwC or DCAA to perform a risk-based analysis of all Federal programs at the institute and, as a result, a Type A[1] MIT program was not identified or audited for FY 1999.

The Circular A-133 defines a Federal program as all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance (CFDA). When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and should be considered as one program. Another example of Federal programs, referred to as clusters, are Federal awards from different agencies made for the same purpose. Circular A-133 identifies three different clusters: Research and Development, Student Financial Aid, and "Other clusters."

The Circular A-133 requires the auditor to use a risk-based approach in determining which Federal programs are to be audited. The auditor uses this approach to classify Federal programs as either Type A or Type B. The distinction between Type A and Type B is the dollar threshold, which fluctuates, depending on the total amount of Federal expenditures for the year. Type A programs are above the threshold and Type B programs are below. In the case of MIT, $3 million was the dollar threshold for FY 1999. The next step in the analysis is to determine whether the Federal programs are high-risk or low-risk. All Type A Federal programs determined to be high-risk are classified as major programs and must be audited.

MIT held a pre-audit meeting in July 1999 with PwC and DCAA to assign audit responsibilities for the FY 1999 audit. MIT presented two program clusters as Type A, high-risk (major) programs: Student Financial Aid and Research and Development. MIT assigned responsibility for audit of the Student Financial Aid program to PwC, and DCAA agreed to audit the Research and Development program. MIT prepared a Schedule of Expenditures of Federal Awards that identified individual grants and contracts within each of these major programs. The Schedule contained a third section of contracts and grants totaling $19.4 million that did not fall within either of the major programs, and MIT identified these as "Non-Major Programs."

Within the section on Non-Major Programs was a Federal program, CFDA 47.076, that had FY 1999 expenditures totaling $4.7 million. This program exceeded the $3 million threshold and should have been identified for audit purposes as a Type A

[1] A Type A program at MIT is one that exceeds a dollar threshold of $3 million.

Federal program. This Type A program might be classified as a major program but this will not be known until MIT designates an auditor to perform a major program determination for its FY 1999 audit.

Recommendations

A. We recommend that the Controller, Massachusetts Institute of Technology:

1. Designate an auditor to perform a complete major program determination for the FY 1999 audit in compliance with Office of Management and Budget Circular A-133.

MIT Comments. MIT will engage PwC to perform a major program determination for the FYs 1999 and 2000 audits in compliance with OMB Circular A-133 (see page 13).

2. Obtain an Office of Management and Budget Circular A-133 audit of all major programs not audited in its fiscal year 1999 report submitted to the Federal clearinghouse.

MIT Comments. MIT agreed to obtain any appropriate audit coverage necessary after performing the major program determination identified by Recommendation A.1.

3. Designate one auditor with the responsibility for major program determination in all future Office of Management and Budget Circular A-133 audits.

MIT Comments. MIT will engage PwC to perform a major program determination for future OMB Circular A-133 audits.

Finding B. DCAA Audit of Lincoln Laboratory Classified Contracts. DCAA did not adequately plan the review of internal controls for the Research and Development cluster at Lincoln Laboratory to ensure that all classified programs were included in the audit and that all applicable compliance requirements were reviewed. This condition occurred because the DCAA Boston Branch Office did not provide the DCAA Field Detachment with the necessary information for the reconciliation of Federal expenditures applicable to classified programs. In addition, the DCAA Boston Branch Office did not task the DCAA Field Detachment to determine which of the Circular A-133 compliance requirements applied to classified programs during FY 1999, and to test the internal controls and compliance over those requirements. As

a result, $7.8 million of the $57 million (approximately 13.8 percent) of the direct costs related to classified contracts were not audited by the DCAA Field Detachment. In addition, there was no testing of the internal controls and compliance over some requirements related to classified contracts.

The Circular A-133 requires that the audit shall cover the entire operations of the auditee. The DCAA Field Detachment provides audit services to procurement offices that have classified contracts. The DCAA Boston Branch Office relied on the Field Detachment to perform the audit of direct costs within the classified programs (all part of the major program cluster, Research and Development) at Lincoln Laboratory. However, the DCAA Boston Branch Office did not provide the Field Detachment with the total dollar amount of Federal expenditures that applied to classified programs. Therefore, the Field Detachment did not know the universe they were to audit. In addition, the DCAA Boston Branch Office did not compare the amount that the Field Detachment reported for classified Federal program expenditures to the amount reported in the Circular A-133 report. As a result, DCAA did not audit $7.8 million of the $57 million related to classified programs. The Field Detachment is taking steps to gain access to all classified programs at Lincoln Laboratory and to determine the correct amount of direct cost Federal expenditures attributable to Lincoln Laboratory classified programs.

The Circular A-133 requires auditors to plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program and to test compliance with the internal controls. There are 14 compliance requirements that might be determined to be relevant to any major program (see list at Appendix A). The DCAA Boston Branch Office tasked the Field Detachment to review "allowable costs/cost principles," and "activities allowed/unallowed" requirements for the classified programs at Lincoln Laboratory. However, the DCAA Boston Branch Office did not instruct the Field Detachment to determine whether the other compliance requirements applied to the classified programs at Lincoln Laboratory. The DCAA Boston Branch Office believed that it was not necessary to review any of the other applicable compliance requirements because the system of internal controls over classified programs would be the same as the system of internal controls over unclassified programs. However, because the DCAA Boston Branch Office does not have access to the classified programs, it could not know whether the internal controls for the untested compliance requirements over classified programs are the same as those identified and tested for unclassified contracts. In addition, the DCAA Boston Branch Office should have relied on the Field Detachment to determine the materiality of a noncompliance issue related to classified contracts.

Recommendations

B. We recommend that the Manager, Defense Contract Audit Agency Boston Branch Office:

1. Reconcile the amount of expenditures related to classified programs reported in the Schedule of Federal Expenditures to the amount reported by the Defense Contract Audit Agency Field Detachment for the FY 1999 audit.

DCAA Comments. DCAA completed the reconciliation of Lincoln Lab's classified contract costs and provided us a copy on March 1, 2001 (see page 15).

2. Task the Defense Contract Audit Agency Field Detachment to determine which compliance requirements are applicable for FY 1999 for all classified contracts at Lincoln Laboratory and to perform the required testing.

DCAA Comments. DCAA Boston Branch Office and the Field Detachment prepared a matrix documenting each organization's responsibilities for single audit requirements and provided a copy to us on March 1, 2001. Also the Field Detachment was tasked to perform additional audit work related to compliance requirements.

3. Instruct the Defense Contract Audit Agency Field Detachment, in all future Office of Management and Budget Circular A-133 audits, to determine which requirements apply to classified contracts.

DCAA Comments. The Boston Branch Office and Field Detachment will annually prepare a matrix similar to that discussed on Recommendation B.2. which will address single audit requirements (including classified contrcts) applicable to Lincoln Laboratory's R&D program cluster.

Finding C. Review of Internal Control Over Compliance at Lincoln Laboratory. The DCAA Boston Branch Office did not meet the requirements of Circular A-133 related to the Reporting compliance requirement and the Special Tests and Provisions compliance requirement for unclassified work performed at Lincoln Laboratory. This condition occurred because the DCAA Boston Branch Office performed procedures for the Reporting compliance requirement that did not fulfill the planned audit steps and because the DCAA Boston Branch Office did not perform procedures as planned for the Special Tests and Provisions compliance requirement. As a result, Government agencies have no assurance that Lincoln Laboratory is managing the programs in accordance with Federal regulations and sub-sponsoring agreement terms.

To facilitate a long-term relationship between the Government and an FFRDC, establish the FFRDC mission, and ensure a periodic reevaluation of the FFRDC, the Government and the FFRDC prepare a written agreement of sponsorship when the FFRDC is established. Sub-sponsoring agreements are agreements with other Government agencies to perform Research and Development within the scope of the sponsoring agreement. The sponsoring agreement at Lincoln Laboratory exists with the Air Force. For FY 1999, work performed under the Air Force sponsoring agreement amounted to $287.4 million of unclassified Research and Development expenditures at Lincoln Laboratory. Of the $287.4 million, $194.7 million, or approximately 68 percent, was expended through sub-sponsoring agreements with other Government agencies.

The DCAA Boston Branch Office review of internal controls identified audit steps related to testing of sub-sponsoring agreements for the Reporting requirement and the Special Tests and Provisions requirement. The purpose of testing to the sub-sponsoring agreement level is to provide feedback to Government agency program managers regarding the cost management of the programs under sub-sponsoring agreements. However, the DCAA Boston Branch Office did not perform adequate procedures to fulfill the audit steps for either compliance requirement.

Reporting Requirement. For the Reporting requirement, DCAA Boston Branch Office personnel relied on a sub-sponsor questionnaire, sent out by the Air Force, which requested comments on satisfaction with financial and technical reporting. However, a customer feedback survey is not relevant evidence to support the conclusion that Lincoln Labs was in compliance with reporting requirements for sub-sponsors. The objective of the reporting requirement is to determine that financial reports include all activity of the reporting period and are supported by accounting records. This is generally accomplished by verifying report content to Lincoln Lab books and records. The working papers indicated that the DCAA Boston Branch Office relied solely on the results of this questionnaire to satisfy the reporting requirement objectives. Without further testing, the DCAA Boston Branch Office could not determine the validity of information at the sub-sponsoring agreement level. As a result, the DCAA Boston Branch Office did not fulfill the audit steps related to the Reporting requirement.

During our review, we asked the DCAA Boston Branch Office to determine whether a reconciliation of public vouchers or other reports had been done during the incurred cost audit that would satisfy the Reporting requirement objective. DCAA Boston Branch Office personnel demonstrated that during the incurred cost audit they had reconciled the total contract costs to the books and records. The reconciliation indicated that although adequate testing was not conducted, the financial information related to the Air Force contract was accurate.

Special Tests and Provisions Requirement. For the Special Tests and Provisions requirement, DCAA Boston Branch Office personnel could not identify the reason why they did not perform the procedures to fulfill the planned audit steps. During our review, DCAA Boston Branch Office personnel stated that they relied on information provided by the Administrative Contracting Officer, specifically that there are no Special Tests and Provisions within unclassified contracts or sub-sponsoring agreements. As a result of our review, DCAA Boston Branch personnel reviewed two sub-sponsoring agreements, and found no Special Tests and Provisions.

Recommendation

C. We recommend that the Manager, Defense Contract Audit Agency Boston Branch Office test all applicable internal control requirements to the level of the sub-sponsoring agreements in all future Office of Management and Budget Circular A-133 audits.

DCAA Comments. DCAA nonconcurred with this recommendation. DCAA stated in its comments (see page 16) that sub-sponsoring agreements were not subject to the provisions of OMB Circular A-133 or the Circular A-133 Compliance Supplement.

Evaluation Response. Although sub-sponsoring agreements are not specifically addressed by Circular A-133, OMB has indicated in conversation that sub-sponsoring agreements should be treated the same as any other Federal expenditures by non-profit recipients. We plan to submit a suggested change to the Circular A-133 Compliance Supplement that will clarify the handling of sub-sponsoring agreements. A meeting will be scheduled with OMB to discuss the proposed change and DCAA will be invited to attend.

We appreciate the courtesies extended during the review. If you have questions on this report, please contact Mr. Wayne Berry at (703) 604-8789 or Mr. M. Thomas Heacock at (703) 604-8756. The report distribution is at Appendix B. The audit team members are listed inside the back cover.

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 PricewaterhouseCoopers, LLP, and DCAA audit of the Massachusetts Institute of Technology for the fiscal year ended June 30, 1999, and the resulting reporting submission to the Single Audit Clearinghouse received on April 12, 2000. 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, revised June 24, 1997. The Guide is the approved checklist of the President's Council on Integrity and Efficiency for performing the quality control review procedures. We reviewed the audit as required by the Circular A-133, generally accepted government auditing standards issued by the Comptroller General of the United States, and generally accepted auditing standards issued by the American Institute of Certified Public Accountants. Our review was conducted from October 2000 through January 2001 and covered areas related to the financial statements and the one major program, research and development. As the cognizant audit agency for MIT, we focused our review on the following qualitative aspects of the single audit:

- Qualifications of auditors
- Independence
- Due professional care
- Quality control
- Planning and supervision
- Internal controls and compliance testing
- Schedule of Expenditures of Federal Awards
- Schedule of Findings and Questioned Costs
- Data Collection Form

In conducting the review, we reviewed all working papers prepared by the PwC and DCAA auditors, discussed the audit with the auditor and MIT cognizant personnel, and retested selected audit procedures.

Prior Quality Control Reviews

Since January 1997, we have performed 10 quality control reviews of Coopers & Lybrand, 1 quality control review of Pricewaterhouse, and 4 quality control reviews of PricewaterhouseCoopers. In 4 of the 15 reports, we identified 6 deficiencies resulting in findings and made recommendations. In addition, 3 of the 15 reports contained 7 conditions that were reported and suggestions made for improvements.

Single Audit Requirements

The Circular A-133 establishes policies to guide implementation of the Single Audit Act of 1996 (Public Law 98-502) amendments and provides an administrative foundation for uniform audit requirements for non-Federal entities that administer Federal awards. In addition, Circular A-133 serves to ensure that Federal departments and agencies rely on and use the audit work to the maximum extent practicable. To meet the intent of the law and Circular A-133, a complete reporting package on each single audit is submitted to the Single Audit Clearinghouse from the auditee (non-Federal entity) that includes the following:

- Data collection form certified by the auditee that the audit was completed in accordance with the Circular A-133;
- Financial statements and related opinion;
- Schedule of Expenditures of Federal Awards and related opinion;
- Report on internal controls over compliance and on compliance with laws, regulations, and the provisions of contracts or grant agreements, and related opinion on compliance of major programs; and
- Schedule of Findings and Questioned Costs.

OMB also issues a Compliance Supplement (the Supplement). The Supplement assists the auditors in determining the audit scope of the Circular A-133 requirements for review of internal control. For each compliance requirement, the Supplement describes the objectives of internal control and certain characteristics that when present and operating effectively may ensure compliance with program requirements. The Supplement gives examples of the common characteristics for the five components of internal controls (control environment, risk assessment, control activities, information

and communication, and monitoring) for each compliance requirement. The following 14 compliance requirements applicable to the various Federal programs are identified in the Supplement:

A. Activities Allowed/Unallowed*
B. Allowable Costs/Cost Principles*
C. Cash Management*
D. Davis-Bacon Act
E. Eligibility of Federal Funds*
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/Relocation Assistance
L. Reporting*
M. Subrecipient Monitoring*
N. Special Tests and Provisions*

* Identifies those compliance requirements applicable to MIT

Appendix B. Report Distribution

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Massachusetts Institute of Technology Comments

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

James L Morgan,
Controller
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February 28, 2001

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Patricia A. Brannin
Deputy Assistant Inspector General for Audit Oversight
Inspector General, Department of Defense
400 Army Navy Drive
Arlington, VA 22202

RE: Proposed Report Project No. D2001-OA-0015

Dear Ms. Brannin:

The Massachusetts Institute of Technology (Institute) received the DoD Inspector General Discussion Draft of a Proposed Report for Project No. D2001-OA-0015, dated February 6, 2001 (the Report). The primary focus of this communication is to respond to the recommendations presented within this draft report.

Finding A, Recommendation A1

We recommend that the Controller, Massachusetts Institute of Technology designate an auditor to perform a complete major program determination for the FY 1999 audit in compliance with OMB Circular A-133.

Institute Response

The Institute will engage PricewaterhouseCoopers (PwC) to perform a major program determination for the FYs 1999 and 2000 audits in compliance with OMB Circular A-133.

The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program.

Finding A, Recommendation A2

We recommend that the Controller, Massachusetts Institute of Technology obtain an OMB Circular A-133 audit of all major programs not audited in its fiscal year 1999 report submitted to the Federal clearinghouse.

Institute Response

Upon the completion of PwC's determination of all major Federal programs at the Institute, we will appropriately classify all Type A programs (§___.520 Major program determination of OMB Circular A-133) into the appropriate existing cluster of programs or within a newly identified cluster as appropriate. For those Federal funds identified, if any, as part of an existing cluster of programs, we will consult with the appropriate auditor on any additional steps to be taken to assure that our OMB Circular filing for the year ended June 30, 1999 is accurate in all material respects. All and any newly identified Type A program(s) will be audited in accordance with OMB Circular A-133.

Finding A, Recommendation A3

We recommend that the Controller, Massachusetts Institute of Technology designate an auditor with the responsibility for major program determination in all future OMB Circular A-133 audits.

Institute Response

The Institute will engage PricewaterhouseCoopers (PwC) to perform a major program determination for future OMB Circular A-133 audits.

If you have any questions or wish to discuss the contents of this letter, please contact me directly.

Very truly yours,

James L. Morgan,
Controller

cc: John R. Curry, Executive Vice President, MIT
Deborah L. Fisher, Institute Auditor, MIT
Kathy Griffith, Supervisory Auditor, DCAA
John A. Mattie, PricewaterhouseCoopers, LLP
Julie T. Norris, Director, Office for Sponsored Programs, MIT

Defense Contract Audit Agency Comments

DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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PQA 225.4 (D2001-OA-0015) March 8, 2001

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND OVERSIGHT, DEPARTMENT OF DEFENSE, INSPECTOR GENERAL

SUBJECT: DCAA Comments on the Discussion Draft of DoDIG Report on the Quality Control Review of MIT's FY 1999 OMB Circular A-133 Audit, Project No. D2001-OA-0015

Thank you for the opportunity to respond to the subject draft report. We also appreciate the meeting that we had with your staff on March 1, 2001 to discuss the matters below.

The subject report provides the results of your office's quality control review of the OMB Circular A-133 audit performed at Massachusetts Institute of Technology (MIT) for MIT's fiscal year (FY) 1999. PricewaterhouseCoopers (PwC) and DCAA performed the audit on a coordinated basis. Your findings and recommendations pertaining to DCAA are directed solely to the OMB Circular A-133 effort completed at Lincoln Laboratory, a Federally Funded Research and Development Center (FFRDC) operated by MIT. Our comments on the individual report recommendations and/or related findings follow.

Recommendations B. 1, 2, and 3. The draft report recommends that the Manager, DCAA Boston Branch Office:

1. Reconcile the amount of expenditures related to classified programs reported in the Schedule of Federal Expenditures to the amount reported by the DCAA Field Detachment (FD) for the FY 1999 audit.

2. Task the DCAA FD to determine which compliance requirements are applicable for FY 1999 for all classified contracts at Lincoln Laboratory, and to perform the required testing.

3. Instruct the DCAA FD, in all future OMB Circular A-133 audits, to determine which requirements are applicable to classified contracts.

DCAA Comments to Recommendations B. 1, 2, and 3. DCAA concurs with the three B recommendations and has already initiated/taken the following actions:

1. With respect to B.1, on November 1, 2000 the Boston Branch Office working with the Agency's FD, prepared a reconciliation of Lincoln Laboratory's classified contract costs for FY 1999. On March 1, 2001, we provided a copy of the reconciliation to your staff. We believe this action satisfies recommendation B.1.

2. With respect to recommendation B.2, on February 28, 2001 the Boston Branch Office and FD prepared a matrix documenting each organization's responsibilities regarding the single audit requirements applicable to the R&D program. On March 1, 2001 we provided a copy of the

matrix to your staff. Furthermore, the FD office cognizant of the classified work at Lincoln Laboratory was tasked to perform additional audit work. The objective of this work is to ensure satisfactory coverage of those contract costs and compliance requirements that may not have been adequately covered during the FD office's previously completed assist audit. Should the additional audit work result in findings that have a material impact on the results previously reported, the FD office will issue a supplemental audit report to the Boston Branch.

3. Lastly, with respect to recommendation B.3, we agree that in planning the OMB Circular A-133 audit at Lincoln Laboratory, the Boston Branch Office and cognizant FD office should improve and better document their coordination activity. In consonance with the Agency's policy at CAM sections 13-703.3.e and f on coordinating A-133 audits, the two offices will annually prepare a matrix like the one noted above that addresses the single audit requirements applicable to Lincoln Laboratory's research and development (R&D) program cluster. The matrix will ensure that the respective audit responsibilities and applicable compliance requirements are appropriately identified and documented. We believe this action satisfies recommendation B.3.

Recommendation C:

> The draft report recommends that the Manager, DCAA Boston Branch Office test all applicable internal control requirements to the level of the sub-sponsoring agreements in all future OMB Circular A-133 audits.

DCAA Comments to Recommendation C. We nonconcur in principle to recommendation C, based on our interpretation of the applicable A-133 requirements; however, we recognize that your review has raised valid issues that need further exploration.

The draft report stated that the Boston Branch Office did not adequately comply with the OMB Circular A-133 provisions covering the (1) *Reporting compliance requirement,* and (2) *Special Tests and Provisions compliance requirement* for unclassified work performed at Lincoln Laboratory. (The *Reporting compliance requirement* applicable to the R&D program at Lincoln Laboratory is financial reporting. The applicable *Special Tests and Provisions requirement* is described in the Section III.N of the *Compliance Supplement* as special terms and conditions which could have a direct and material effect on the R&D Cluster. The draft report further states:

> In order to facilitate a long-term relationship between the Government and an FFRDC, establish the FFRDC's mission and ensure a periodic reevaluation of the FFRDC, a written agreement of sponsorship between the Government and the FFRDC is prepared when the FFRDC is established. Sub-sponsoring agreements are agreements with the other Government agencies to perform R&D within the scope of the sponsoring agreement. ...

> ... the purpose of testing to the sub-sponsoring agreement level is to provide feedback to Government agency program managers regarding the cost management of the programs under sub-sponsoring agreements. However, DCAA Boston Branch did not perform adequate procedures to fulfill the audit steps for either compliance requirement.

Based on our reading of OMB Circular A-133, the auditors are only required to plan the testing of internal control at the R&D program/federal award level and not down to the *sub-sponsoring agreement* level. We based this on the following:

- The FFRDC has a single R&D program operating under a *cost no-fee* contract from the Air Force. At the FFRDC, the auditor's responsibility is limited to the R&D program and federal awards within that program. OMB Circular A-133 § __.105 defines:

  -- a Federal program as all Federal awards to a non-federal entity, and

  -- a Federal award as Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. [underlining added]

- The term *sub-sponsoring agreement* is not defined or used in OMB Circular A-133. As these agreements exist at MIT, there is no **direct** relationship between the Lincoln Laboratory FFRDC and the sub-sponsoring organizations. Consequently, sub-sponsoring agreements do not meet the A-133 definition of a *Federal award*, and there is no regulatory requirement for the DCAA auditor to identify and test applicable significant internal control requirements to the level of the sub-sponsoring agreements.

- The FFRDC received **direct** federal financial assistance **only** from the Air Force. The FFRDC's sponsors are represented on a Joint Advisory Committee, and the Air Force acts as the Executive Agent and Primary Sponsor for the Committee. Although the FFRDC's R&D program includes expenditures for the Air Force award and other agency sponsoring agreements, it is important to note that there is **no direct** relationship between the FFRDC and the other Federal agencies. The relationship is between the FFRDC and the Air Force, via the *cost no-fee* contract.

- As supported by the citations below, the OMB Circular A-133 only requires auditor testing of internal controls at the Federal program level (see definition above).

The auditee shall:

(b) Maintain internal control over Federal **programs** (emphasis added) that provides reasonable assurance the auditee is managing Federal awards in compliance ... [A-133 §_.300(b)]

(c) Comply with laws, regulations, and the provisions of **contracts or grant** (emphasis added) agreements related to each of its Federal programs. [A-133 §_.300(c)]

The auditor shall:

... perform procedures to obtain an understanding of internal control over Federal **programs** (emphasis added) ... [A-133 §_.500(c)(1)]

... plan the testing of internal control over **major programs** (emphasis added) ... [A-133 §_.500(c)(2)(i)]

- Our interpretation of the Circular requirements appears to be in sync with the response that OMB, Financial Standards and Reporting Branch, Office of Federal Financial Management, provided to a recent inquiry from your staff. The response relied on the term "award" and noted that a sub-sponsoring agreement must meet that definition. The fact remains, however, that the sub-sponsoring agreements referred to by the DoDIG are not awards that are made directly to MIT's Lincoln Laboratory FFRDC.

Notwithstanding our position above, and the fact that the concept of sub-sponsoring agreements is not addressed by either the Circular or its Compliance Supplement, it appears that detailed financial information is being provided to the sub-sponsoring agencies by the FFRDC and is being relied upon by them. Because of this, we believe that it would be in the best interests of the government if we agreed to gather additional relevant information on the issues regarding sub-sponsoring agreements and jointly approach OMB for discussion.

Please direct any questions you may have regarding this memorandum to Mr. Marc Parvin, Quality Assurance Division, DCAA Headquarters, at (703) 767-2250 or to the following E-mail address: dcaa-pqa@dcaa.mil.

/s/ Robert DiMucci
/for/ Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Review Team Members

This report was prepared by the Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Assistant Inspector General for Auditing, DoD. Personnel of the Office of the Inspector General, DoD, who contributed to this report are listed below.

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