



OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

ASSESSMENT REPORT

OAI-V-17-04

May 2017

**AUDIT COVERAGE OF COST ALLOWABILITY FOR
BATTELLE MEMORIAL INSTITUTE UNDER ITS
CONTRACT TO MANAGE THE PACIFIC
NORTHWEST NATIONAL LABORATORY
DURING FISCAL YEARS 2013 AND 2014
UNDER DEPARTMENT OF ENERGY
CONTRACT NO. DE-AC05-76RL01830**



Department of Energy
Washington, DC 20585

May 17, 2017

MEMORANDUM FOR THE MANAGER, PACIFIC NORTHWEST SITE OFFICE

A handwritten signature in black ink, appearing to read "David Sedillo".

FROM: David Sedillo
Deputy Assistant Inspector General
for Audits and Inspections
Office of Inspector General

SUBJECT: INFORMATION: Assessment Report on the “Audit Coverage of Cost Allowability for Battelle Memorial Institute Under its Contract to Manage the Pacific Northwest National Laboratory During Fiscal Years 2013 and 2014 Under Department of Energy Contract No. DE-AC05-76RL01830”

BACKGROUND

Since 1965, Battelle Memorial Institute (Battelle) has operated the Pacific Northwest National Laboratory under contract with the Department of Energy. This Laboratory, in the Department’s Office of Science, performs research and innovations in the areas of environmental protection and clean up, energy resources, and national security. The Laboratory is managed under a performance-based management contract, through September 30, 2022. During Fiscal Years (FYs) 2013 through 2014, Battelle expended and claimed costs totaling approximately \$1.8 billion.

As a management and operating contractor, Battelle’s financial accounts are integrated with those of the Department, and the results of transactions are reported monthly according to a uniform set of accounts. Battelle is required by its contract to account for all funds advanced by the Department annually on its Statement of Costs Incurred and Claimed, to safeguard assets in its care, and to claim only allowable costs. Allowable costs are incurred costs that are reasonable, allocable, and allowable in accordance with the terms of the contract, applicable cost principles, laws, and regulations.

To help ensure only allowable costs are claimed by the Department’s integrated contractors and to make efficient use of available audit resources, the Office of Inspector General, the Department’s Office of Acquisition Management, and the integrated management and operating contractors and other select contractors have implemented a Cooperative Audit Strategy. This strategy places reliance on the contractors’ internal audit function (Internal Audit) to provide

audit coverage of the allowability of incurred costs claimed by contractors. Consistent with the Cooperative Audit Strategy, Battelle is required by its contract to maintain an Internal Audit activity with responsibility for conducting audits, including audits of the allowability of incurred costs. In addition, Battelle is required to conduct or arrange for audits of its subcontractors when costs incurred are a factor in determining the amount payable to a subcontractor. During FYs 2013 through 2014, the Laboratory's Business Systems Directorate was responsible for pre-award and post-award subcontract audits.

To help ensure that audit coverage of cost allowability was adequate during FYs 2013 through 2014, the objectives of our assessment were to determine whether:

- Internal Audit conducted cost allowability audits that complied with professional standards and could be relied upon;
- Battelle conducted or arranged for audits of its subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor; and
- Questioned costs and internal control weaknesses identified in audits and reviews and affecting allowable costs have been adequately resolved.

RESULTS OF ASSESSMENT

Based on our assessment, nothing came to our attention to indicate that the allowable cost related audit work performed by Battelle's Internal Audit for FYs 2013 through 2014 could not be relied upon. We did not identify any material internal control weaknesses with cost allowability audits, which generally met the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing (IIA Standards). During its FYs 2013 and 2014 audits of cost allowability, Internal Audit identified \$375,983 in questioned costs, all of which had been resolved. However, we identified the following issues that need to be addressed to ensure that only allowable costs are claimed by and reimbursed to the contractor. Specifically:

- Although we ultimately determined that we could rely on Battelle's Internal Audit work, we noted that work papers did not always include sufficient documentation. In some cases, work papers did not support supervision of audit work before report issuance or document all potential impairments to auditor independence and objectivity. Together, these two issues led to us to question the validity of a judgmental sample taken in the FY 2014 subcontract allowable cost audit.
- Battelle did not always conduct periodic post-award or interim audits of subcontracts. We noted that Battelle did not have a documented risk-based approach for conducting periodic post-award or interim audits of cost reimbursement subcontractors in effect during FY 2013 and most of FY 2014. This issue was previously reported in our *Assessment of Audit Coverage of Cost Allowability for Pacific Northwest National Laboratory under Department of Energy Contract No. DE-AC05-76RL01830 during Fiscal Year 2012* (OAS-V-14-15, August 2014). To its credit, Battelle included a documented process to address periodic post-award or interim audits in its Internal Audit

Implementation Design Plan, approved by the Department in May 2014. We determined that the process met the intent of the Department's criteria and appeared to be effective for the period in which it was implemented in FY 2014. Battelle informed us that no subcontracts met the risk-based approach threshold for interim audits as of September 30, 2014. Our future assessment of FY 2015 will fully evaluate the effectiveness of the risk-based audit approach.

Audit Documentation

Although we ultimately determined that we could rely on Internal Audit's work, we found instances where Internal Audit's work papers did not always contain sufficient documentation of supervision and independence. Specifically, in some cases, the Internal Audit work papers did not support supervision of audit work prior to report issuance. For example, in three of the four FY 2014 Allowable Cost audits, many of the work papers were not reviewed in the official internal audit documentation system until after the report was issued. Specifically, 300 of 302 fieldwork work papers for those three audits received documented review after the audit report had been issued. As required by IIA Standards, engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

Additionally, Internal Audit did not always document identification of potential independence and objectivity impairment. In one instance, an auditor did not complete a conflict of interest statement, though the auditor had multiple relatives that worked at the laboratory. In reviewing a draft of our report, Internal Audit stated that the employee added a note to the conflict of interest work paper that claimed there was no conflict, and subsequently the work paper was signed and reviewed. However, we noted that the submitted form was not completed and was, in fact, largely blank. We confirmed that the auditor added a note that claimed there was no conflict of interest; however, we found that this employee had close relatives who were employed by Battelle but did not document disclosure nor evaluation as to whether impartiality would be impaired. Though we did not find an instance where the auditor reviewed the work of their relatives, at a minimum, there was a potential for an appearance of impaired impartiality.

Another time, an auditor did not document disclosure of prior employment in the Contracts Department at the laboratory, even though the auditor was assigned to the FY 2014 subcontract allowable cost audit with a scope that covered the employment timeframe. According to IIA Standards, if independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties.

In reviewing our draft report, Internal Audit stated that they were aware of the auditor's previous employment, had discussed appropriate assignments for the auditor because of the previous employment, and the auditor completed a conflict of interest statement. However, Internal Audit did not document the auditor's prior employment with the Contracts Department in the internal audit documentation system, the discussions about the prior employment were not documented, and the conflict of interest statement only listed friends working at the laboratory and not the prior employment. Though we did not find instances where the auditor reviewed their own prior

work, we observed that this auditor selected a judgmental sample for one portion of the subcontract allowable cost audit. Accordingly, there may be an appearance that the selection was made in a manner that was not fully impartial.

To better align with professional standards, in October 2016 Internal Audit implemented an updated auditor conflict of interest form to include the presumption of impairment of objectivity if the auditor is auditing an activity for which they had responsibility within the previous year. The update also includes the statement that impairment to objectivity exists or could be inferred if the auditor has relatives or close personal friends working at the Laboratory.

Periodic/Interim Subcontract Audits

Battelle did not always conduct periodic post-award or interim audits of subcontracts in which costs incurred were a factor in determining the amount payable to a subcontractor as required by contract clause I.105 Department of Energy Acquisition Regulation 970.5232-3 *Accounts, Records and Inspection* and clause I.115 Department of Energy Acquisition Regulation 970.5244-1 *Contractor Purchasing System*. This is a repeat finding identified in our prior assessment, *Assessment of Audit Coverage of Cost Allowability for Pacific Northwest National Laboratory under Department of Energy Contract No. DE-AC05-76RL01830 during Fiscal Year 2012* (OAS-V-14-15, August 2014).

For this assessment, we reviewed 1,764 records of cost reimbursable, cost plus fixed fee, and time and materials subcontracts that were awarded, active, or closed during FYs 2013 through 2014 to determine if periodic or interim audits were conducted. Based upon our review of these records, we determined that the majority of the 433 cost reimbursable subcontracts were awarded to entities subject to Office of Management and Budget Circular A-133, thus covered under the *Single-Audit Act* and not subject to an interim audit by Battelle. We determined that 1,310 time and materials subcontracts, as well as a few other cost-type subcontracts, were not awarded to entities covered under A-133 and therefore may have been subject to an interim audit by Battelle. Further, applicable guidance did not contain a documented risk-based approach to determine when periodic post-award or interim audits were to be performed for this subcontract type. However, the majority of active time and materials subcontracts reviewed were awarded or modified for relatively small amounts or qualified for quick closeout procedures.

We noted that Battelle modified and incorporated language into Pacific Northwest National Laboratory Acquisition Guide 31 Cost/Price, Section 3.3, Periodic/Interim Audits requiring a risk-based audit plan in May 2014. Battelle also further developed a risk-based audit approach which was revised in Pacific Northwest National Laboratory Acquisition Guide 31 and is included in its Implementation Design Plan, approved by the Department in May 2014. The revised plan required the Business Systems Directorate to develop a documented risk-based approach to determine when periodic or interim audits will be performed and that audits be conducted to professional audit standards. For the period not covered by the implemented risk-based audit approach, Battelle implemented invoice reviews by Accounts Payable, but portions of subcontracts still remained unaudited.

We determined that the risk-based audit approach met the intent of the Department's criteria and identified no material concerns for the short period in which it was implemented in FY 2014.

Battelle informed us that no subcontracts met the risk-based approach threshold for interim audits as of September 30, 2014. Because the risk-based audit approach was only in effect for a limited period of time, our next assessment will fully evaluate the effectiveness of the risk-based audit approach.

RECOMMENDATIONS

We recommend that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure:

1. Internal Audit maintains sufficient documentation of audit supervision prior to Internal Audit report issuance.
2. Internal Audit reselects the judgmental sample selected by the auditor that previously worked in the Contracts Department for the FY 2014 subcontract allowable cost audit or performs alternative procedures to mitigate the potential impaired impartiality issue discussed in this report.
3. Battelle evaluates the cost-type subcontracts requiring audit for FY 2013 and 2014, before the risk-based approach was implemented, to determine if subcontracts may be subject to an interim audit.

MANAGEMENT RESPONSE

Management agreed with the findings, concurred with the recommendations, and proposed planned corrective actions that were responsive to our recommendations.

Management's comments are included in Attachment 2.

SCOPE AND METHODOLOGY

This assessment was performed from March 2016 to May 2017 at Battelle's Pacific Northwest National Laboratory located in Richland, Washington. The assessment was limited to Internal Audit's activities, subcontract audits, and resolution of questioned costs and internal control weaknesses that affect costs claimed by Battelle on its Statement of Costs Incurred and Claimed for FYs 2013 through 2014. This assessment was conducted under the Office of Inspector General Project Number A16RL033.

To accomplish our objectives, we:

- Assessed allowable cost audit work conducted by Internal Audit which included a review of audit reports, work papers, auditor qualifications, independence, audit planning including risk assessments and overall internal audit strategy, and compliance with applicable professional auditing standards;
- Conducted interviews with Department and Laboratory personnel;

- Reviewed policies, procedures, and practices to identify subcontracts requiring audit and arrange for audits;
- From a universe of 1,764 records of subcontracts that had been awarded, active, or closed in FYs 2013 through 2014, we judgmentally selected 34 subcontracts to determine if they contained pre-award, post-award, and closeout documentation. We also reviewed the selected subcontracts to determine whether the pre-award analyses included a documented risk-based process to identify subcontracts requiring periodic post-award and interim audits. Sample selection was judgmental based on subcontract type, dollar value, vendor frequency, and relation to a hotline complaint; and
- Evaluated the resolution of questioned costs and control weaknesses affecting cost allowability that were identified in prior audits and reviews conducted by the Office of Inspector General, Internal Audit and other organizations.

We conducted our assessment in accordance with generally accepted Government auditing standards for attestation engagements. Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our conclusions based on our objectives. A review is substantially less in scope than an examination or audit where the objective is an expression of an opinion on the subject matter and accordingly, for this review no such opinion is expressed. Also, because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our review. We relied on computer-processed data to accomplish our objectives. We determined that the computer-processed data was sufficiently reliable for the purposes of the review by comparing the data to source documents.

Management waived the exit conference on April 27, 2017.

This report is intended for the use of the Department contracting officers and field offices in the management of their contracts and is not intended to be and should not be used by anyone other than these specified parties.

Attachments

PRIOR REPORTS

- Assessment Report on *Audit Coverage of Cost Allowability for Pacific Northwest National Laboratory under Department of Energy Contract No. DE-AC05-76RL01830 during Fiscal Year 2012* (OAS-V-14-15, August 2014). Based on our assessment, nothing came to our attention to indicate that the allowable cost related audit work performed by Battelle Memorial Institute's (Battelle) Internal Audit could not be relied upon. However, we found that Battelle did not always conduct periodic post-award or interim audits of subcontracts. Battelle also did not have a documented risk-based approach for conducting periodic post-award or interim audits of cost reimbursement subcontractors. We recommended that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure that Battelle follow-up on the implementation of its corrective action plan in response to recommendations made in our prior assessment.
- Assessment Report on *Audit Coverage of Cost Allowability for Pacific Northwest National Laboratory under Department of Energy Contract No. DE-AC05-76RL01830 during Fiscal Years 2010 and 2011* (OAS-V-14-04, January 2014). Based on our assessment, nothing came to our attention to indicate that the allowable cost related audit work performed by Battelle's Internal Audit could not be relied upon. However, we found that Battelle did not always conduct periodic post-award or interim audits of subcontracts. Battelle also did not have a documented risk-based approach for conducting periodic post-award or interim audits of cost reimbursement subcontractors. We recommended that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure that Battelle develop and implement a documented risk assessment process for determining when subcontracts should be subject to an interim or post-award audit, as well as ensure that Battelle audits or arranges for audits of subcontracts.

MANAGEMENT COMMENTS



Department of Energy
Pacific Northwest Site Office
P.O. Box 350, K9-42
Richland, Washington 99352

APR 26 2017

17-PNSO-0205

MEMORANDUM FOR DAVID SEDILLO
DIRECTOR, WESTERN AUDITS DIVISION
OFFICE OF INSPECTOR GENERAL
IG-323

FROM: ROGER E. SNYDER
MANAGER

A handwritten signature in black ink, appearing to read "R. Snyder", written over the printed name "ROGER E. SNYDER".

SUBJECT: DRAFT ASSESSMENT REPORT ON THE "AUDIT COVERAGE
OF COST ALLOWABILITY FOR BATTELLE MEMORIAL
INSTITUTE UNDER ITS CONTRACT TO MANAGE THE
PACIFIC NORTHWEST NATIONAL LABORATORY DURING
FISCAL YEARS 2013-14 UNDER DEPARTMENT OF ENERGY
CONTRACT NO. DE-AC05-76RL01830"

Below is Pacific Northwest Site Office's response to the Office of Inspector General's recommendations:

Recommendation 1: We recommend that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure Internal Audit maintain sufficient documentation of audit supervision prior to Internal Audit report issuance.

Management Response: Concur.

Action Plan: The Contracting Officer will direct Battelle to perform an independent effectiveness review of the corrective actions taken to address whether or not Internal Audit is maintaining sufficient documentation of audit supervision prior to the Internal Audit report issuance.

Estimated Completion Date: May 31, 2018

Mr. D. Sedillo
17-PNSO-0205

APR 26 2017

2

Recommendation 2: We recommend that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure Internal Audit reselects the judgmental sample selected by the auditor that previously worked in the Contracts Department for the FY 2014 subcontract allowable cost audit or performs alternative procedures to mitigate the potential impaired impartiality issue discussed in this report.

Management Response: Concur.

Action Plan: The Contracting Officer will direct Battelle Internal Audit to reselect the judgmental sample for the FY 2014 Subcontract Allowable Cost Audit and reissue the audit report or perform the alternative procedures that adequately mitigated the potential impaired impartiality issue discussed in the report.

Estimated Completion Date: May 31, 2018

Recommendation 3: We recommend that the Manager, Pacific Northwest Site Office, direct the Contracting Officer to ensure Battelle evaluates the cost-type subcontracts requiring audit for FY 2013 and 2014, before the risk-based approach was implemented, to determine if subcontracts may be subject to interim audit.

Management Response: Concur.

Action Plan: The Contracting Officer will direct Battelle to provide DOE the outcome of their evaluation that determined whether or not the subcontracts were subject to interim audits before the risk-based approach was implemented.

Estimated Completion Date: October 6, 2017

If you or your staff have any questions, please contact Ryan Kilbury, Contracting Officer, at (509) 372-4030.

cc: T. D. Fuller, CF-12
G. Gozum, CF-50
M. W. Hayes, ORO
V. L. Keith, ORO
J. M. McKeehan, ORO
T. J. Pooler, ORO
J. B. Venneri, SC-41.3