

Memorandum

DATE: September 30, 2010

Audit Report Number: OAS-L-10-09

REPLY TO

ATTN OF: IG-321 (A09LL036)

SUBJECT: Final Report on "Subcontract Auditing at Lawrence Livermore National Laboratory"

TO: Senior Procurement Executive, National Nuclear Security Administration
Manager, Livermore Site Office

INTRODUCTION AND OBJECTIVE

Lawrence Livermore National Security, LLC, manages and operates the Lawrence Livermore National Laboratory (Livermore) under a contract with the Department of Energy's (Department) National Nuclear Security Administration (NNSA). In each Fiscal Year (FY) from 2006 and 2008, Livermore incurred approximately \$1.3 billion of costs on behalf of the Department. Livermore spent an average of \$650 million annually on products and service acquisitions.

Livermore's contract incorporated *Department of Energy Acquisition Regulation* clauses 970.5232-3 and 970.5244-1 that required Livermore to provide for periodic post-award audits of cost-reimbursement subcontractors and subcontracts where costs incurred are a factor in determining the amount payable. To ensure the integrity and reliability of contractor cost data, the Office of Inspector General (OIG), the Office of the Chief Financial Officer, the Office of Procurement and Assistance Management, and the Contractor Internal Audit Council, developed the Cooperative Audit Strategy (Strategy). The Strategy became a contractual requirement under *Department of Energy Acquisition Regulation* 970.5232-3, in November 2004, through Acquisition Letter 2005-04. Under the Strategy, contractors must provide an Implementation Design plan which includes identifying what auditing standards will be used and the plan for pre-award and post-award audits of subcontractors. As part of the Strategy, contractors may use their own internal auditor staff, engage contract auditors, or use the services of the Defense Contract Audit Agency (DCAA) to audit subcontractors. The Strategy also requires that internally performed audits must, at a minimum, meet The Institute of Internal Auditors (IIA) Standards for auditing that provide criteria for, among other things, measuring the quality of internal audits.

Livermore used cost/price analysts in its Supply Chain Management Department to perform post-award reviews of cost-reimbursement subcontractors. During FYs 2006 to 2008, the cost/price analysts completed 233 incurred cost reviews, covering \$764 million of subcontractor costs, and 262 subcontract closeout reviews. Due to the significant amount of subcontract costs, reviewed by these analysts, the OIG initiated this audit to determine whether Livermore's subcontract reviews met the Department's requirements for audits of subcontracts.

CONCLUSIONS AND OBSERVATIONS

Livermore's subcontract reviews did not always meet the Department's subcontract audit requirements. Specifically, Livermore's subcontract reviews did not always meet, among other things, the quality requirements established by the IIA Standards. Based on our examination of 16 of the 233 reviews performed during FYs 2006 through 2008, covering \$26 million of \$764 million in incurred costs, we determined that Livermore had not always performed transaction tests necessary to determine the reasonableness of subcontractor charges in 4 of the 16 reviews; including tests to determine whether:

- A subcontractor's \$41,666 charge for two trucks which had an initial combined value of \$16,045 was reasonable; and,
- The electronic ordering system prices charged by two subcontractors were consistent with available catalogs and the contract pricing schedule. Our test work revealed that the subcontractors charged \$11,009 more than the pricing in the catalog schedules.

Further, Livermore had not always provided evidence that the supervisor reviewed workpapers supporting the 16 subcontract review reports to ensure the quality of the performed work.

We also noted that Livermore did not always meet the IIA Standards in the areas of independence, objectivity, due professional care, and continuing professional development. The cost/price analysts performing the reviews were not organizationally independent and they were placed in situations that could impair their objectivity. Specifically, the analysts reported to the same procurement official as the contract administrators whose contract actions the analysts reviewed for reasonableness and allowability. Additionally, we determined that the cost/price analysts had not questioned potentially unallowable costs, including sales taxes that were specifically identified in supporting vendor invoices for three subcontracts, raising doubt about whether the analysts carefully examined the invoices. In the area of continuing professional development, we noted that the cost/price analysts completed significantly fewer hours of continuing education than that recommended by the IIA.

Although the dollar values of the questionable cost that we identified are relatively minor compared to overall subcontract costs, they illustrate that the current practices could lead to future errors and increased risk.

Audit Requirements

The NNSA's Livermore Site Office did not enforce the Department's requirements for auditing subcontract incurred costs. Specifically, Livermore's contract Statement of Work did not require subcontract audits. Additionally, the Livermore Site Office approved Livermore's approach to performing subcontract reviews rather than requiring it to perform subcontract audits in accordance with professional auditing standards.

While Livermore's contract Statement of Work did not require audits, the contract clearly establishes that compliance with Department regulations takes precedence over the provisions in the Statement of Work. Additionally, the Livermore Site Office allowed Livermore to perform subcontract reviews rather than audits because of Livermore's concern that following standards would increase the workload and thereby prevent timely subcontract closeouts. While compliance with professional auditing standards is likely to increase the investment in resources, we concluded that the resulting increase in assurance that payments are made only for allowable costs outweighs the incremental investment in resources.

Functional Reporting

The absence of a functional reporting relationship between the analysts and Livermore's Audit Committee also contributed to nonconformance with standards. As noted above, the analysts reported to a procurement manager but did not report functionally to the Audit Committee. The Strategy indicates that an audit activity should report functionally to the Board of Directors, Audit Committee, or equivalent corporate independent governing body. We concluded that the lack of a functional reporting relationship with the Audit Committee weakened organizational independence, and created the appearance of impaired objectivity.

Our concern regarding the independence of groups responsible for auditing subcontract costs is not new. Specifically, in our previous report entitled *Audit of Implementation of the Cooperative Audit Strategy by National Nuclear Security Administration Managed Contractors* (OAS-L-09-11, July 2009), we noted that, at some sites, non-independent procurement groups were conducting subcontract cost audits. During our current audit, we noted that, similar to Livermore, Los Alamos National Laboratory (Los Alamos) conducted subcontract audits under its procurement division and had eliminated the requirement to follow professional auditing standards. However, according to Los Alamos' Ethics and Audit Manager, Los Alamos is currently in the process of transferring its subcontract audit function to the Ethics and Audit Division in order to increase independence, follow the IIA Standards, and restore functional reporting to the Audit Committee.

Management Actions

NNSA management did not agree that Livermore's subcontract review practices have increased cost risk at a level warranting a requirement to audit all subcontracts. Management acknowledged that Livermore's review practices do not comply with the *Department of Energy Acquisition Regulation* and that auditors should be used to perform audits in accordance with acceptable audit standards. However, management stated that Livermore Site Office Contracting Officers should have sufficient discretion to determine when an audit or review would be required. As such, NNSA approved Livermore Site Office's request for a deviation from the *Department of Energy Acquisition Regulation's* subcontract audit requirements on September 24, 2010. With the approved deviation, the Livermore Site Office Contracting Officers will have sufficient discretion to determine

and influence Livermore's internal policy to determine when an audit or a review would be best used. Management indicated that it would hold the Livermore Site Office's Contracting Officers accountable to determine and assure Livermore's policies and practices on reviews or audits reflect both objectivity and effectiveness. Further, in NNSA's deviation approval, management indicated that when audits are required, they will be performed by professional, properly trained auditors who follow accepted audit procedures and standards specified in the IIA Standards for auditing.

While we acknowledge that NNSA has the authority to approve a deviation from Department regulations, we believe the audit requirements identified in the *Department of Energy Acquisition Regulation* are sound and should be adhered to, especially given that Livermore incurs approximately \$650 million each year in subcontract costs. We also recognize that audits of subcontracts should be cost effective and that not every subcontract needs to be subjected to audit. Rather, the decision to perform an audit should be based on the level of risk represented by the circumstances surrounding the subcontract such as type of subcontract, dollar value, and past performance of the subcontractor. NNSA, however, has not established risk-based criteria, such as dollar thresholds, to determine when audits will be performed by auditors in accordance with acceptable audit standards.

Accordingly, we suggest that the NNSA Senior Procurement Executive provide guidance to the Livermore Site Office that establishes risk-based criteria for when the Contracting Officer should require subcontract audits that comply with IIA standards.

Our scope and methodology is described in the attachment.



David Sedillo, Director
NNSA and Science Audits Division
Office of Inspector General

Attachment

cc: Director, Office of Risk Management, CF-80
Team Leader, Office of Risk Management, CF-80
Audit Resolution Specialist, Office of Risk Management, CF-80
Director, Office of Field Financial Management, NZ
Director, Internal Controls Management, NA-66
Audit Liaison, Livermore Site Office

SCOPE AND METHODOLOGY

This audit was performed between May 2009 and September 2010, at Livermore, located in Livermore, California, and Los Alamos National Laboratory (Los Alamos), in Los Alamos, New Mexico. Our audit included Livermore's cost/price analyst reviews, and Los Alamos' audit reports covering subcontractor costs incurred in Fiscal Years (FY) 2006, 2007, and 2008.

To accomplish the audit objective, we:

- Interviewed personnel at Livermore, Los Alamos, and the National Nuclear Security Administration's (NNSA) Livermore and Los Alamos Site Offices;
- Reviewed Livermore and Los Alamos' policies and procedures;
- Reviewed Livermore and Los Alamos' Prime Contract with the Department and applicable federal regulations and policy guidance;
- Reviewed Los Alamos interim subcontract audit reports;
- Judgmentally selected a sample of Livermore's cost/price analyst reviews of subcontracts where costs incurred were a factor in determining the amount payable to the subcontractor;
- Reviewed the subcontract files and workpapers for the sample;
- Tested each review for compliance with The Institute of Internal Auditors Standards and effectiveness in detecting questionable costs; and,
- Reviewed prior audit reports related to the audit objective.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. We also reviewed performance measures in accordance with the Government Performance and Results Act of 1993 relevant to subcontractor auditing. We found that Livermore did not have performance measures specifically relating to subcontractor auditing during the scope of audit work. However, in Livermore's FY 2009 performance measures, the Livermore Site Office required Livermore to demonstrate an effective and efficient audit organization consistent with contractual and Cooperative Audit Strategy requirements. We did not rely on computer-processed data to satisfy our audit objective. NNSA waived an exit conference.

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