OFFICE OF INSPECTOR GENERAL
U.S. Department of Energy

AUDIT REPORT

DOE-OIG-21-24 April 2021

FISCAL YEAR 2017 EVALUATION OF INCURRED COST COVERAGE AT THE LOS ALAMOS NATIONAL LABORATORY

Department of Energy
Washington, DC 20585

April 9, 2021

MEMORANDUM FOR MANAGER, LOS ALAMOS FIELD OFFICE

SUBJECT: Audit Report on "Fiscal Year 2017 Evaluation of Incurred Cost Coverage at the Los Alamos National Laboratory"

The attached report discusses our review of incurred cost coverage during fiscal year 2017 for selected areas at the Los Alamos National Laboratory. This report contains three recommendations. Management generally concurred with one recommendation and did not concur with two recommendations.

We conducted this audit from November 2019 through November 2020 in accordance with generally accepted government audit standards. We appreciated the cooperation and assistance received during this evaluation.

Jennifer L. Quinones
Deputy Inspector General
Office of Inspector General

cc: Deputy Secretary
Chief of Staff

DOE-OIG-21-24

Department of Energy
Office of Inspector General

Fiscal Year 2017 Incurred Cost Coverage at the Los Alamos National Laboratory

(DOE-OIG-21-24)

WHY OIG PERFORMED THIS REVIEW

In 1994, the Office of Inspector General (OIG), Department of Energy officials, and internal audit directors from selected sites with management and operating contractors implemented the Cooperative Audit Strategy, which allows management and operating contractors to audit their own incurred costs. Based on recent work conducted by the OIG and concerns expressed by external stakeholders, such as the Government Accountability Office, the OIG is evaluating the Cooperative Audit Strategy. As part of that effort, the OIG commenced six audits in fiscal year 2020 to review certain contractors' incurred cost coverage of selected areas. We initiated this audit to evaluate incurred cost coverage of selected areas during fiscal year 2017 at the Los Alamos National Laboratory.

What Did OIG Find?

We found that Los Alamos National Security, LLC's allowable cost audit for fiscal year 2017 did not adequately evaluate incurred costs for allowability, allocability, and reasonableness. We noted weaknesses in Los Alamos National Security, LLC Internal Audit's design of the audit risk assessment, sampling approach, and Acquisition Services Management's classification of subcontracts.

What Is the Impact?

Given the large amount of taxpayer funding used for Department management and operating contracts, and the reliance on contractor Internal Audit functions to audit such funds, weaknesses in the annual evaluation of incurred costs could result in significant amounts of unallowable costs being charged to the Department and going undetected.

What Is the Path Forward?

The results of this audit will be used in conjunction with the results of multiple other audits, inspections, and investigations in arriving at conclusions regarding the Cooperative Audit Strategy and providing recommendations to the Department in an upcoming report.

BACKGROUND

Beginning June 2006, Los Alamos National Security, LLC (LANS) operated the National Nuclear Security Administration's Los Alamos National Laboratory (LANL) for the Department of Energy. LANL is a multi-program laboratory with critical national security responsibilities, including research and a limited production mission that helps to ensure the safety, security, and reliability of the Nation's nuclear weapons stockpile. LANL was managed under a $27.6 billion cost-plus contract, including both award and incentive fees, which ran from June 1, 2006, to October 31, 2018. LANS incurred and claimed costs totaling approximately $2.2 billion from October 1, 2016, to September 30, 2017, which is fiscal year (FY) 2017.

As a management and operating contractor, LANS' financial accounts were required to be integrated with those of the Department, and the results of financial transactions were required to be reported monthly according to a reciprocal set of accounts. LANS was required by its contract to account for all funds advanced by the Department annually on its Statement of Costs Incurred and Claimed (SCIC), 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.

In 1994, the Office of Inspector General (OIG), Department officials, and internal audit directors from selected sites with management and operating contractors implemented the Cooperative Audit Strategy. The Cooperative Audit Strategy places reliance on the contractors' internal audit function to provide operational and financial audits, including allowable cost audits, as well as assessing the adequacy of management control systems. The Cooperative Audit Strategy requires that audits performed internally must, at a minimum, meet the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*. The OIG relies upon the contractors' internal audit activities and provides guidance to cognizant Contracting Officers, Heads of Contracting Activity, Department site managers, and cognizant Chief Financial Officers on the sufficiency of the design and operation of internal audit activities, particularly as they support the SCIC. Consistent with the Cooperative Audit Strategy, LANS was 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, LANS was required to conduct or arrange for audits of its subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor. To assist internal audit activities, the OIG provided a sample allowable cost audit program through its OIG Audit Manual with the expectation that internal auditors would exercise professional judgment when creating an audit program appropriate for its operating environment.

The objective of this audit was to evaluate incurred cost coverage of selected areas during FY 2017 at LANL. Therefore, we did not specifically evaluate individual incurred costs for allowability, allocability, and reasonableness.[1]

[1] The details of the objective, scope, and methodology is contained in Appendix 1, and prior related work is contained in Appendix 2.

INTERNAL AUDIT'S ALLOWABLE COST AUDIT WAS INADEQUATELY DESIGNED

LANS Internal Audit's (Internal Audit) allowable cost audit was not designed to adequately evaluate incurred costs for allowability, allocability, and reasonableness. The *International Standards for the Professional Practice of Internal Auditing* requires that internal auditors exercise due professional care by considering the relative complexity, materiality, or significance of matters to which assurance procedures are applied, and to be alert to the significant risks that might affect objectives, operations, or resources. Under the Cooperative Audit Strategy, the Department and OIG rely upon the contractor's internal audit activity to review the allowability of costs claimed on the SCIC in accordance with the audit program approved by the OIG. The Department implements the Cooperative Audit Strategy through Department of Energy Acquisition Regulation contract clause 970.5232-3, *Accounts, Records, and Inspection*. We identified the following areas that were not adequately addressed:

- Direct and indirect costs were not fully considered in Internal Audit's risk assessment and transaction testing;

- Sampling was not always adequate to determine whether incurred costs were allowable, allocable, and reasonable; and

- Internal control testing did not always adequately test labor qualifications.

Costs Were Not Fully Considered in Assessing Risk and Transaction Testing

Internal Audit did not evaluate the substantial risks of indirect costs separate from direct costs in its allowable cost audit. At LANS indirect costs of about $1 billion accounted for about 45 percent of the approximate $2.2 billion incurred during FY 2017 reported on the SCIC. The OIG Audit Manual, Chapter 14, *Guidelines for Contractor Internal Auditors*, includes procedures to evaluate the risks associated with direct and indirect costs. A direct cost is any cost that specifically supports a single cost objective.[2] On the other hand, an indirect cost is any cost that supports two or more cost objectives, is grouped with similar costs, and then allocated to multiple cost objectives based on relative benefits received or another equitable relationship. Accordingly, indirect costs are inherently riskier when compared to direct costs. The OIG Audit Manual, Chapter 14, also states that Internal Audit should evaluate changes in direct and indirect charging practices, changes in Cost Accounting Standards Disclosure Statements, and fluctuations in direct and indirect labor charges, as well as verify that costs are properly classified by expense category, are consistently treated, and comply with Cost Accounting Standards. In addition, Internal Audit's own audit program for the FY 2017 Allowable Cost Audit recognized the need to perform an evaluation of major changes in the ratio and number of direct and indirect employees, and a comparison of direct and indirect labor accounts to the prior year's budget. However, we noted that Internal Audit did not evaluate changes in the ratio of direct and indirect employees or compare direct and indirect labor accounts to prior years or budgets.

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[2] Cost Accounting Standard 402-30, *Definitions,* defines a "cost objective" as a function, organizational subdivision, contract, or other work unit for which cost data is desired and for which provision is made to accumulate and measure the cost to processes, products, jobs, capitalized projects, etc.

Further, Internal Audit's allowable cost audit transaction testing did not always differentiate between direct and indirect costs. For example, Internal Audit's transaction testing was at the major disbursement category level (e.g., travel, accounts payable, or labor) and did not break down costs to "auditable entities," such as indirect cost pools. Rather, Internal Audit evaluated individual direct and indirect cost transactions to determine if like costs in similar circumstances were accounted for consistently or whether the costs were allocable to the project to which the costs were charged. Internal Audit did not perform substantive testing to ensure that indirect costs were accumulated in indirect cost pools that were homogeneous, or that pooled costs were allocated to cost objectives in a reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives, as required by Cost Accounting Standards. Further, we did not find evidence that Internal Audit tested or considered whether sampled costs were properly burdened.

These issues occurred for several reasons. When questioned about these issues, Internal Audit stated that it followed the methodologies contained in the OIG Audit Manual. However, the OIG Audit Manual does not set forth detailed procedures for the allowable cost audit. Instead, the OIG Audit Manual makes it clear that internal auditors must exercise professional judgment and ensure procedures are applicable to their operating environment. Internal Audit also stated that its approach to auditing incurred costs focused on risks associated with internal controls that are designed to prevent unallowable costs versus large transactional testing samples. However, to comply with LANS' contract requirement to only claim allowable costs, the cost allowability audits should be primarily designed to specifically evaluate costs for allowability, allocability, and reasonableness. As for the other items that we noted Internal Audit did not specifically address when performing preliminary procedures to identify allowable cost audit risks, Internal Audit indicated that generally those areas were considered in the annual planning risk analysis. We could not find documentation in Internal Audit's allowable cost audit workpapers where those items were consistently considered.

Sampling Was Not Always Adequate to Evaluate Allowability, Allocability, and Reasonableness

Internal Audit did not always perform adequate sampling in its allowable cost audit to determine whether incurred costs were allowable, allocable, and reasonable. OIG Audit Manual, Chapter 14, states that it is expected that a recognized statistical sampling methodology will be used to sufficiently reach a conclusion on the allowability of costs and permit the projection of unallowable costs. If not statistical, it states that the rationale for using judgmental sampling should be clearly documented in the auditor's workpapers. However, we noted concerns with Internal Audit's sampling methods. For example, in the FY 2017 Allowable Cost Audit, Internal Audit did not always perform statistical sampling or adequately document its rationale for using other sampling methodologies. Internal Audit's FY 2017 Allowable Cost Audit tested approximately $125 million, or about 5.7 percent of the approximately $2.2 billion total claimed on the SCIC, without documenting how the overall sampling approach would permit sufficient coverage. To illustrate, Internal Audit identified a non-statistical sample of "higher value" transactions representing 20 percent of the costs of Tuition Reimbursement but did not clearly document its rationale for using non-statistical sampling. Additionally, Internal Audit, in part, relies on subcontract audits to support its annual allowable cost audit work. In one subcontract audit, Internal Audit reviewed a direct labor universe of approximately $47 million where it elected to perform a non-statistical sample of approximately $601,327, or about 1.3 percent of the dollar universe.

This occurred because Internal Audit did not follow the OIG Audit Manual when selecting and documenting its sampling approach. As mentioned previously, per the OIG Audit Manual, Chapter 14, a recognized statistical sampling methodology should be used to sufficiently reach a conclusion on the allowability of costs and permit the projection of unallowable costs; if statistical sampling is not used, the rationale for using another approach should be clearly documented in the auditor's workpapers. Internal Audit told us it believes the risk of unallowable costs is very low, so it focused on risks associated with internal control testing and modified its sampling approach based on its prior audit experience. However, Internal Audit did not clearly document how its approach provided sufficient coverage to answer the objective of whether the costs charged are allowable, allocable, and reasonable, or perform testing as expected.

Internal Control Testing Did Not Always Adequately Test Labor Qualifications

We found that Internal Audit did not adequately test LANS' subcontract labor qualification internal controls. Specifically, Internal Audit did not test LANS' internal controls designed to ensure that Compa Industries, Inc. (Compa) subcontract labor was qualified commensurate with the requirements of LANS' job postings. The associated Compa subcontract labor costs totaled $81,937,711 incurred from August 2015 through March 2018, which included $30,283,788 in labor costs for FY 2017.

Although Internal Audit performed various labor-related internal control tests, none of these tests addressed whether the employees for which costs were billed met the specified qualifications required to perform the scope of work. When a subcontractor bills for an employee that does not meet a specified skill level, the prime contractor may be paying for less-qualified labor. According to LANS' subcontract with Compa and a statement from a LANS Acquisition Services Management (ASM) official, an LANS' hiring official must document review of the successful applicant's qualifications in Fieldglass Vendor Management System before the person starts work and ultimately gets paid.

This issue occurred because Internal Audit relied on certain internal controls without testing their effectiveness. According to Internal Audit, it considered labor qualifications to be low-risk because it believed LANS had established a reliable system of internal controls to ensure that Compa subcontract employees met labor qualifications. For example, LANS uses Fieldglass Vendor Management System to identify job requirements and postings, hire Compa subcontract labor, and manage Compa subcontract labor hours and travel expenses. Through the Fieldglass Vendor Management System, LANS approves Compa timesheets, controls the hiring of Compa employees, and establishes the billing rates of Compa employees. However, we determined Internal Audit had not performed tests of these controls to ensure that they were operating effectively, and that appropriately skilled labor was being properly assigned (labor qualifications).

SUBCONTRACT TYPES WERE NOT ALWAYS PROPERLY CLASSIFIED

LANS did not always properly classify subcontracts to ensure consideration for audit. Specifically, we identified 3 subcontracts with a current funded value totaling approximately $7,708,198 that were classified as firm-fixed-price (FFP) but had flexibly-priced elements. Our review included a judgmental selection of 11 FFP subcontracts out of a total population of 183 FFP subcontracts with a FY 2017 incurred amount of approximately $27,869,039. The 11 subcontracts selected had a FY 2017 incurred amount of approximately $11,529,328.

Federal Acquisition Regulation (FAR) 52.230-6, *Administration of Cost Accounting Standards*, as incorporated in the contract, includes, but is not limited to defining, fixed-price subcontracts as those subcontracts where the price is not adjusted or final payment is not based on actual costs incurred; and flexibly-priced subcontracts as those subcontracts where the prices may be adjusted based on actual costs incurred and/or where final payment is based on actual costs incurred. FAR 30.001, *Definitions*, states that flexibly-priced contracts include, among others, cost-reimbursement contracts, orders issued under indefinite-delivery contracts where final payment is based on actual costs incurred, certain fixed-price subcontracts, and portions of time and materials and labor hour contracts. Because the contractor's payments may be adjusted based on actual costs incurred, flexibly-priced contracts typically do not provide incentives to the contractor for cost control or labor efficiency, and are considered higher-risk.

In prior reports issued by the U.S. Government Accountability Office's OIG and Defense Contract Audit Agency (DCAA), similar issues were identified with the misclassification of contracts and subcontracts. The U.S. Government Accountability Office's OIG report explained that contracts can be categorized as FFP or flexibly-priced contracts. FFP contracts generally are not subject to price adjustments based on the actual costs that the contractor incurs. The DCAA report on a Department contractor found that the contractor did not classify fixed-price and flexibly-priced subcontracts correctly. DCAA identified subcontracts with costs based on actual hours worked and travel expenses incurred that should have been classified as flexibly-priced subcontracts because there was no firm value determined. In another subcontract, subcontracts with quantities impacting the cost incurred were estimated (not fixed) and also should have been classified as flexibly-priced. For example, DCAA noted that a subcontract price, calculated by the actual quantities times the unit price, results in actual cost (Actual Quantities * Unit Price = Actual Cost = Subcontract Price). DCAA noted that "the price of a truly fixed-price subcontract should not be affected or changed by the actual quantities incurred." DCAA found that the contractor's procurement system did not ensure accurate classification of flexibly-priced subcontracts and its internal polices did not include the requirement for representatives to understand all applicable subcontract types included in FAR 16, *Types of Contracts*.

Additionally, Department of Energy Acquisition Regulation 970.5232-3, *Accounts, Records, and Inspection*, paragraph (c), *Audit of subcontractors' records*, requires that subcontracts be audited if costs incurred are a factor in determining the amount payable. Since the subcontracts we examined had flexibly-priced elements and were erroneously classified as FFP, they likely would not have been considered for audit.

The three subcontracts where we had concerns had Performance and Payment Bonds with Not to Exceed cost limitations. According to an LANS' ASM official, performance and payment bonds are generally flexibly-priced and reimbursed at actual cost and not a fixed amount. In addition, one of the subcontracts contained payment terms for materials and services at actual costs, not a fixed amount. While all three of the subcontracts had a majority of cost elements that were a fixed amount, because at least one cost element was flexibly-priced, the subcontracts should have been classified as a hybrid,[3] not FFP. When we brought these issues to the attention of LANS, an ASM official stated that some subcontracts with flexibly-priced cost elements were incorrectly classified by LANS buyers. The official also stated that during FY 2017, the LANS' procurement system did not have the hybrid classification option, which therefore reduced the likelihood that these subcontracts would be subject to audit as required.

During the course of our audit, we discovered that Internal Audit performed two separate reviews (one audit and one review) in calendar year 2018 related to this topic and identified 19 of 48 subcontracts that were classified as FFP but had flexibly-priced elements. At LANS, Internal Audit is responsible for conducting the necessary audits of subcontractors. Internal Audit's subcontract audit strategy includes annually performing a risk-based assessment and random sample selection of flexibly-priced subcontract audits. In constructing our sample, we selected two of the same subcontracts that Internal Audit had previously reviewed and arrived at a similar conclusion.

These issues occurred because of weaknesses in LANS' subcontract classification system. Specifically, LANS did not have formal subcontract classification policies and procedures. In addition, LANS had not adequately trained its procurement personnel regarding proper classification of subcontract types. On the recommendation of Internal Audit, LANS provided training to its procurement personnel in FY 2019; however, we did not review the effectiveness of the training as part of the scope of our audit. Further, an LANS ASM official asserted that the procurement software was not conducive to accurately classifying subcontracts because it limited the number of subcontract types available for selection. As a result of Internal Audit's FY 2018 recommendations, LANS updated its procurement system in FY 2019 to include additional subcontract type options and is in the process of implementing an entirely new procurement system.

THERE IS AN INCREASED RISK OF UNALLOWABLE COSTS AND IMPROPER COST ALLOCATION

As a result of the issues identified above, there is an increased risk that LANS charged unallowable costs to the Department and LANS' FY 2017 incurred costs were improperly allocated to some of its cost objectives. Weaknesses in the design of the allowable cost audit increased the risk that LANS claimed unallowable costs because the level of testing and substantive procedures performed were adversely impacted, particularly regarding indirect costs. This is significant because LANS' indirect costs totaled approximately $1 billion, or about 45 percent of the approximate total of $2.2 billion claimed during FY 2017. Overall, the

[3] The term "hybrid" is a subcontract classification term used by LANL to identify a subcontract that has FFP elements but also contains either Fixed Unit Rate or Cost Reimbursement elements (i.e., performance and payment bond costs).

weaknesses we identified in Internal Audit's allowable cost audit design lessened the value of Internal Audit's determination that incurred costs were allowable, allocable, and reasonable. For example, costs could be mischarged between the Department and Strategic Partnership Projects, which impacts funding levels and project performance measures. Additionally, by not adequately auditing time and materials subcontracts, the Department is exposed to increased risk of paying costs that are unallowable. LANS incurred $102,229,878 in time and materials subcontract costs in FY 2017, of which $47,124,352 (including labor and travel) were for Compa.

As a result of not always correctly classifying subcontracts, some flexibly-priced subcontracts may not be subject to required audits. Internal Audit provided audit coverage of LANS' subcontracts when costs incurred were a factor in determining the amount payable to a subcontractor. However, if subcontracts are not classified accurately in LANS' procurement system, they would not be subject to audit, increasing the risk of unallowable costs charged to the Department. LANS Internal Audit did audit one of the three subcontracts for which we had concerns but only because the subcontract administrator requested the audit as part of the subcontract closeout procedures.

RECOMMENDATIONS

This audit was performed as part of the OIG's overall initiative to review the Cooperative Audit Strategy. The results of this audit will be used in conjunction with the results of multiple other audits, inspections, and investigations in arriving at conclusions regarding the Cooperative Audit Strategy and providing recommendations to the Department in an upcoming report. In the meantime, to address the issues identified in this report, we recommend that the Manager, Los Alamos Field Office, work with the Department and LANS to address the following:

1. Ensure the appropriate design and execution of allowable cost audits;

2. Require the proper use and documentation of sampling in allowable cost audits; and

3. Require subcontract classification policies and procedures.

MANAGEMENT RESPONSE

National Nuclear Security Administration management nonconcurred with two of our three recommendations and disagreed with our findings. The disagreement focused on past practices that management considered acceptable and not previously questioned by the OIG.

Management's comments are included in Appendix 3.

AUDITOR COMMENTS

While management nonconcurred with two of our three recommendations, the OIG stands by its findings and has significant concerns with the manner in which Internal Audit performed its cost allowability audit risk assessment, sampling approach, and testing of labor qualifications. The relevance of the OIG's findings to allowability and allocability of incurred costs is clearly described in the report. In addition, the possibility of significant unallowable costs being incurred and paid by the Department is plausible given the amount of costs LANL incurred in FY 2017 ($2.2 billion) and the issues identified in the report. Therefore, the OIG continues to assert that it is necessary the recommendations in this report be implemented.

Further, where management noted this report appears to contradict past OIG reports, the OIG maintains that this audit did not have the same objective or scope as our previous review level engagements, and different procedures were used to identify potential gaps in Internal Audit's coverage of incurred costs.

Where management disputes the finding regarding indirect cost testing by asserting that the OIG has known of these prior practices, the OIG indicates on pages 2 and 3 that the standards for testing have been included in the OIG Audit manual for many years and should have been followed by Internal Audit in any event. Additionally, as stated above, this audit did not have the same objective or scope as the OIG's previous review level engagements.

Management disputes the finding about inadequate sampling by asserting that no evidence is provided on such inadequacies. On pages 3 and 4, the OIG notes examples of inadequacies it discovered, such as LANS not adequately documenting how its approach provided sufficient coverage of whether the costs charged are allowable, allocable, and reasonable. The OIG continues to assert that Internal Audit did not adequately document its rationale for its selected sampling methodologies during the performance of the 2017 cost allowability audit, as required by the OIG Audit Manual.

Where management concurs in principle with the subcontract misclassification finding but disagrees with the auditor's interpretation of the policy regarding what constitutes a flexibly-priced component of a fixed-price contract, the OIG refers to page 6. The three subcontracts where the OIG had concerns had Performance and Payment Bonds with Not to Exceed cost limitations, and according to a LANS' ASM official, performance and payment bonds are generally flexibly-priced and reimbursed at actual cost and not a fixed amount.

Finally, as mentioned on page 7, the results of this audit will be used in conjunction with the results of multiple other audits, inspections, and investigations in arriving at conclusions regarding the Cooperative Audit Strategy and providing recommendations to the Department in an upcoming report.

OBJECTIVE

We conducted this audit to evaluate incurred cost coverage of selected areas during fiscal year (FY) 2017 at Los Alamos National Laboratory.

SCOPE

The audit was performed from November 2019 through November 2020 at the Department of Energy's Los Alamos National Laboratory in Los Alamos, New Mexico. The audit scope included costs incurred and claimed by Los Alamos National Security, LLC (LANS) for FY 2017. The audit was conducted under Office of Inspector General project number A20ID009.

METHODOLOGY

To accomplish our audit objective, we:

- Reviewed applicable Federal laws and regulations, United States Code, Cost Accounting Standards, Department, LANS, and Los Alamos National Laboratory policies and procedures, LANS' contract provisions, and other legal requirements related to the audit objective.

- We reviewed LANS' allocation of General and Administrative costs to Laboratory Directed Research and Development cost objectives for compliance with applicable Federal laws.

- Interviewed Department officials and Contractor officials, including LANS Internal Audit, responsible for management and oversight of incurred costs.

- Reviewed LANS' Cost Accounting Standards Disclosure Statement, Revision 31, for consistency in application.

- Evaluated whether direct/indirect costs were consistently charged to projects.

- Evaluated whether home office costs were properly treated in accordance with contractual requirements.

- Evaluated unallowable costs for inclusion in allocation bases and removal from claimed costs.

- Reviewed FY-end variances and evaluated disposition of the variances.

- Reviewed LANS' average labor rates and evaluated disposition of the variances.

- Reviewed and evaluated LANS Internal Audit's risk assessment process for preparing its annual audit plan and individual audit risk assessments, and LANS Internal Audit's conduct of its cost allowability audits and subcontract audits.

- Reviewed and evaluated LANS Internal Audit performance regarding sampling and workpaper documentation.

- Reviewed and evaluated LANS' classification of subcontract types for accuracy and firm-fixed-price subcontract modifications for adequate justification.

- We used judgmental sampling throughout the project and adequately documented the applicable details in the relevant work papers. Because the selection was based on a judgmental or non-statistical sample, results and overall conclusions are limited to the items tested and cannot be projected to the entire population or universe of costs.

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 objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We assessed internal controls and compliance with laws and regulations necessary to satisfy the audit objective. In particular, we assessed the internal control components and underlying principles significant to the audit objective. Specifically, we assessed the control environment and underlying principles regarding control activities as implemented through policies and procedures and the establishment and performance of monitoring activities. However, because our review was limited to these internal control components and underlying principles, it may not have disclosed all internal control deficiencies that may have existed at the time of this audit.

We assessed the reliability of LANS' FY 2017 financial cost data by reconciling underlying database information to the Statement of Costs Incurred and Claimed. We validated a portion of the database transactions by reviewing documentation supporting the data and the system that produced the data, and interviewing LANS officials knowledgeable about the data. We determined that the data was sufficiently reliable for the purposes of this report.

Management officials waived an exit conference on April 5, 2021.

Assessment Report on *Audit Coverage of Cost Allowability for Los Alamos National Laboratory from October 1, 2013, to September 30, 2016, Under Department of Energy Contract No. DE-AC52-06NA25396* (DOE-OIG-20-20, December 2019). The assessment[4] determined that the allowable cost-related audit work performed by Los Alamos National Security, LLC's Internal Audit (Internal Audit) for costs incurred from October 1, 2013, to September 30, 2016, could be relied upon. Based on limited sampling, the Office of Inspector General (OIG) found that Internal Audit's cost allowability audits generally met the Institute of Internal Auditors *International Standards for the Professional Practice of Internal Auditing*; however, the OIG identified issues with the identification of questioned costs, as well as workpapers that did not meet Internal Audit's policies. Specifically, the OIG questioned $14,348 in costs that Internal Audit did not question, despite identifying these costs in findings associated with control weaknesses over cost allowability. This issue did not impact the OIG's ability to complete the objectives of this assessment and the OIG questioned $8,437,970 in questioned costs identified by Internal Audit. In addition, the OIG found that Internal Audit conducted reviews of subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor. Of the $1,464,475 in total subcontract costs questioned by Internal Audit, $1,457,827 were resolved and the OIG questioned the remaining $6,648 in unresolved questioned subcontract costs. The OIG made three recommendations to address the identified issues.

[4] We conducted our assessment as a review attestation. A review is substantially less in scope than an examination or audit. Our review was limited and would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our review.

Department of Energy
Under Secretary for Nuclear Security
Administrator, National Nuclear Security Administration
Washington, DC 20585

March 31, 2021

MEMORANDUM FOR TERI L. DONALDSON
INSPECTOR GENERAL

FROM: CHARLES P. VERDON Charles P. Verdon
ACTING UNDER SECRETARY FOR NUCLEAR SECURITY AND ADMINISTRATOR, NNSA

SUBJECT: Response to the Office of Inspector General Draft Report *Fiscal Year 2017 Incurred Cost Coverage at the Los Alamos National Laboratory* (A20ID009)

Thank you for the opportunity to review and comment on the subject draft report. The Office of Inspector General (OIG), implemented the Cooperative Audit Strategy in October 1992, which shifted significant cost and responsibility to the Department of Energy and its Management and Operating Contractors (M&Os) to assist the OIG in fulfilling its responsibility for auditing the costs incurred by the Department's major facilities contractors. Since that time, Los Alamos National Laboratory (LANL) and our other M&Os have consistently demonstrated compliance with IIA standards and a unique understanding by their internal audit teams of operations, risk, and materiality, in designing and implementing audit programs to effectively and efficiently evaluate the allowability, allocability, and reasonableness of costs paid by the Government. We respectfully disagree with the report's conclusion that LANL's allowable cost audit for fiscal year 2017 did not adequately evaluate incurred costs, potentially resulting in significant amounts of unallowable costs being charged to the Department and going undetected.

The report takes exception to two primary audit activities relating to consideration of indirect costs in the risk assessment and testing program, and selected use of non-statistical sampling techniques. First, it is important to note that the OIG is making this claim for the first time in draft reports for six sites across the Department, using the same language for the rationale and conclusion in each report. As these approaches have been transparent to the OIG in their prior reviews, which have not previously questioned these practices, it is clear that this represents a new proposed or preferred approach by the OIG and not a deficiency or unaddressed risk in the audit program. Further, the report provides no analysis or additional audit work to support the claim that significant unallowable cost may go undetected under the current approach, nor that there is a potential cost benefit to their suggested methodology.

Finally, in sharp contrast to the current report's conclusion, OIG work conducted over the past 28 years (with the most recent report issued in December 2019) and independent peer reviews, have consistently confirmed that LANL Internal Audit adheres to appropriate professional standards when conducting audits, as required by their contract. LANL's 2017 incurred cost audit followed substantially the same rigorous audit program as in prior years. The current draft report generally reflects subjective conclusions about audit methods that are contradictory to LANL's formal risk assessment and not required by Institute of Internal Auditors (IIA) Standards. The conclusions are also not supported by a structured risk assessment by the OIG auditors, or sufficient audit work to demonstrate a deficiency in the effectiveness of the LANL's audit program. Further, the issues raised in the report generally lack materiality or relevance to overall allowability and allocability of costs, and there is no credible, objective evidence of any non-compliance with IIA Standards or other validated risks, to warrant this sudden change in evaluation of LANL's 2017 audit program as inadequate.

For these reasons, NNSA non-concurs with two of the three recommendations in the report, which are overly broad and linked to the general unsupported conclusion, versus the minor specific observations in the report. We will, however, consider expanded audit work should future testing by the OIG validate that such action would be effective and cost beneficial in identifying additional unallowable costs. I would also suggest that we schedule a meeting with our Audit Director, your Team, and the Department to discuss these issues in the broader context of potential changes to the Cooperative Audit Strategy. Detailed responses to each recommendation are included in the attached management decision. Our subject matter experts have also provided extensive technical comments under separate cover for the auditors' consideration to address the issues noted above. If you have any questions regarding this response, please contact Mr. Dean Childs, Director, Audits and Internal Affairs, at (301) 903-1341.

Attachment

Attachment

NATIONAL NUCLEAR SECURITY ADMINISTRATION
Management Decision

*Fiscal Year 2017 Incurred Cost Coverage at the Los Alamos National Laboratory (*A20ID009*)*

The Office of Inspector General (OIG) recommended that the Manager, Los Alamos Field Office (NA-LA), work with the Department and the management and operating contractor to address the following:

Recommendation 1: Ensure the appropriate design and execution of allowable cost audits;

Management Response: Non-concur. As noted in the cover memorandum for this decision, this recommendation is overly broad and linked to the general unsupported conclusion that Los Alamos National Laboratory's (LANL) allowable cost audit for fiscal year (FY) 2017 did not adequately evaluate incurred costs, potentially resulting in significant amounts of unallowable costs being charged to the Department and going undetected. To support this conclusion, the report takes exception to two primary audit activities relating to: a) consideration of indirect costs in the testing program; and b) selected use of non-statistical sampling techniques. As these approaches have been transparent to the OIG in their prior reviews, which have not previously questioned these practices, it is clear that this represents a new proposed or preferred approach by the OIG, and not a deficiency or unaddressed risk in the audit program. Further, the report provides no analysis or additional audit work to support the claim that significant unallowable cost may go undetected under the current approach, nor that there is a potential cost benefit to the suggested additional audit work. All evidence supports a conclusion that LANL's audit program is adequate and complies with applicable professional audit standards. Should requirements change, or if future audit work by the OIG validates that their preferred method would be effective and cost beneficial in identifying additional unallowable costs, NNSA will re-evaluate the recommendation.

Recommendation 2: Require the proper use and documentation of sampling in allowable cost audits;

Management Response: Non-concur. The OIG observations regarding sampling represent differences in professional opinion between the OIG and LANL Internal Audit. The guidance provided in the OIG Audit Manual recognizes and addresses both statistical and other sampling methods to sufficiently reach a conclusion on the allowability of costs, noting that if statistical sampling is not used, the rationale for using another approach should be clearly documented in the auditor's workpapers. Each of the areas selected for testing in LANL Internal Audit's FY 2017 allowable cost audit had explicit documentation for the rationale for selection of the sampling method used. The IG report provides no credible evidence that the sampling methods used were inappropriate or that different sampling methods would have identified significant questioned costs. Should future audit work by the OIG validate that their preferred method

Attachment

would be effective and cost beneficial in identifying additional unallowable costs, NNSA will re-evaluate the recommendation.

Recommendation 3: Require subcontract classification policies and procedures.

Management Response: Concur in Principle. The underlying issue regarding subcontract classification was self-identified by LANL Internal Audit as part of its normal risk assessment process in FY 2018. Internal Audit then performed the necessary audits, and made recommendations to Acquisition Services Management, who executed improvements. Specifically, LANL developed a new policy in this area as part of a new Procurement Policies and Procedures Manual, which is currently being reviewed by NNSA. Note that, while we acknowledge that LANL self-identified a few subcontracts that were classified as fixed-price but had flexibly-priced components, NNSA does not agree with the auditors' interpretation of the policy regarding what constitutes a flexibly-priced component of a fixed-price contract. The estimated completion date for finalizing the new policy and validating closure is June 30, 2021.

FEEDBACK

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