U.S. Department of Energy
Office of Inspector General
Office of Audit Services

Audit Report

University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory

DOE/IG-0596

April 2003

Department of Energy
Washington, DC 20585

April 16, 2003

MEMORANDUM FOR THE SECRETARY

FROM: Greg Friedman
Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Audit Report on the "University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory"

BACKGROUND

Since 1943, the University of California has operated the Los Alamos National Laboratory (Laboratory) under contract with the Department of Energy and its predecessor agencies. Now part of the Department's National Nuclear Security Administration (NNSA), the Laboratory has critical national security responsibilities, including helping to ensure the safety, security, and reliability of the nation's nuclear weapons stockpile. Recently, Los Alamos and the University have been criticized for perceived internal control weaknesses at the Laboratory, particularly as they relate to property loss and theft.

In light of these issues, NNSA requested the Office of Inspector General to perform an audit of costs incurred by Los Alamos National Laboratory. Consistent with that request, we sought to determine the allowability of the $5.2 billion charged to the contract for Fiscal Years 2000 through 2002 and evaluate relevant controls.

RESULTS OF AUDIT

Our review identified potentially unallowable costs of about $14.6 million that were charged to the contract, including the following:

- $3.7 million for "working" meals;
- $7.4 million for travel costs in excess of contract limits; and,
- $3.5 million for an internal audit function that did not meet Department requirements.

As part of our review, we also identified a series of internal control weaknesses that contributed to an environment in which these potentially unallowable costs could be incurred and claimed. Specifically, we found control weaknesses in the following areas:

- Laboratory audit function;
- Financial system reconciliation;
- Payroll and travel approval processes;
- Financial management personnel turnover; and,
- Financial system review and approval.

Further, we identified a significant backlog in the completion of required audits of Laboratory subcontracts. Given the fact that subcontracting represents about half of all Laboratory expenditures, we concluded that this issue was of concern.

Recent reports by the Office of Inspector General and others have disclosed similar problems regarding the business operations of the Laboratory. For example, our recent special inquiry report on *Operations at Los Alamos National Laboratory* (DOE/IG-0584, January 2003), described actions taken by Laboratory officials that weakened or overrode property and procurement management controls. We also issued reports in 2002 that noted problems with the Los Alamos internal audit function. In addition, a recent external review of the University's purchase card program at Los Alamos concluded that a number of critical weaknesses existed that left the Laboratory vulnerable to fraud and abuse.

As a result of the identified weaknesses, the Department, in our judgment, has had less than adequate assurance that costs claimed by Los Alamos National Laboratory are allowable under the contract. To address this situation, we recommended that NNSA recover unallowable costs and require the University to improve internal controls that ensure costs are allowable.

In response to the control weaknesses, the University of California has announced an aggressive corrective action plan. The questioned costs described in this report, however, can – as was the case with many of the issues raised in the previous reviews – be attributed in large measure to management decisions and policies that did not ensure the interests of the Federal taxpayers were adequately protected.

MANAGEMENT REACTION

NNSA generally agreed with the audit recommendations contained in the attached report and indicated that corrective actions had been taken or were planned. These planned actions included conducting a review of the allowability of the $14.6 million in questioned costs identified in this report. NNSA also commended the University of California for positive steps that it has recently undertaken to improve and strengthen the control environment of the Laboratory.

Attachment

cc: Deputy Secretary
Acting Administrator, National Nuclear Security Administration

UNIVERSITY OF CALIFORNIA'S COSTS CLAIMED AND RELATED INTERNAL CONTROLS FOR OPERATION OF LOS ALAMOS NATIONAL LABORATORY

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BACKGROUND

The University of California (University) has operated the Los Alamos National Laboratory (Laboratory) under contract with the Department of Energy (Department) and its predecessor agencies since 1943. The Laboratory's financial accounts are integrated with the Department's, and the results of financial transactions are reported monthly according to a uniform set of accounts. Now part of the Department's National Nuclear Security Administration (NNSA), the Laboratory has critical national security responsibilities, including helping to ensure the safety, security, and reliability of the nation's nuclear weapons stockpile.

During Fiscal Years 2000 through 2002, the University incurred $5.2 billion in costs under its contract (W-7405-ENG-36) with the Department in over 6 million separate transactions. These expenditures were made on the Government's behalf at the Laboratory to carry out its missions and functions. The contract requires the University to comply with the Federal Acquisition Regulation (FAR) for allowable cost determinations. We evaluated costs incurred under the contract for allowability using a combination of statistical and non-statistical methodologies.

RESULTS OF AUDIT

Questioned Costs

Our audit disclosed that costs claimed by the University for Fiscal Years 2000 through 2002 were generally allowable. However, we question the allowability of $14.6 million claimed during that period as shown in the table below.

	Total Costs	Costs Questioned
Working Meals	$ 4,179,584	$ 3,660,383
Travel Claims	101,725,002	7,383,069
Performance Awards	2,190,299	53,247
Audit Function	3,503,175	3,503,175
Totals	$ 111,598,060	$ 14,599,874

A discussion of each category follows.

Working Meals

Total		Projected Questioned
Costs	Transactions[1]	Costs
$4,179,584	13,534	$3,660,383

We question as unreasonable $3,660,383 that the University charged the contract for meals and entertainment. The majority of the questioned meals were provided at the Laboratory by the operator of the cafeteria and included recurring costs for coffee supplies, breakfast items, and other meals. The remainder was for meals at restaurants in Los Alamos, Santa Fe, and Albuquerque. In most cases, the meals were provided to Laboratory employees and guests. In some instances these meals were also provided to Department employees. We estimated the questioned amount based on the results of a random sample projection, using statistical sampling software provided by the Defense Contract Audit Agency (DCAA). We did not question meals that were related to bona fide conferences or professional meetings, or those that were paid for through the employee morale fund.

The FAR does not specifically address working meals, but does contemplate that such costs could be allowed if associated with certain meetings, conferences, and symposia. All costs, however, must be consistent with prudent business practices. In our judgment, the number, frequency, and apparent routine nature of most meals provided indicates that the University was not exercising care to distinguish situations where working meals truly are in the Government's best interests. Other sources of information, while not binding on this contract, indicate that these types of costs are unallowable on Government contracts. The DCAA Contract Audit Manual requires meals to be an integral part of meetings to be allowable. In an October 2002 Advisory Opinion, the Chief Counsel of the Department of Energy's Chicago Operations Office concluded that, generally, meals for contractor employees are unallowable because the cost of meals is considered a personal expense of the individual.[2] In addition, according to the Defense Acquisition Homepage, meals for contractors are

[1]Each of these transactions potentially included meals for multiple individuals.
[2]While the opinion did outline some exceptions to the general rule, it emphasized that, absent a specific contract provision or advance agreement regarding the allowability of the cost, each cost should be evaluated on a case-by-case basis against considerations including reasonableness of the cost, integrality to the associated business function, and other FAR and DEAR provisions.

generally unallowable, and for a business meal to be allowable, it must be an inseparable part of a meeting agenda. It also states that incidental business discussions during a meal do not make the meal costs allowable.

The Laboratory has an internally generated "Cost Allowability Guide" that establishes certain criteria for the allowability of meal costs. In practice, the working meals policy has been interpreted by the University as allowing meals in association with an extremely broad range of activities. In response to our concerns that this policy was unreasonable, the University provided a written justification. The University's primary position was that the FAR, the contract, and the Department of Energy Acquisition Regulations (DEAR) did not specifically address the allowability of meals. However, we confirmed that the FAR is clear that a contractor is not allowed the presumption of allowability when a cost is not specifically addressed in the FAR.

In addition, the University believes that its policy describes when a meal is a "reasonable business expense." However, we noted that meals paid for with University funds must be approved two supervisory grade levels higher than those paid for with Government funds. Thus, the University of California has a more restrictive policy on meal expenses than the policy it has implemented at Los Alamos, the latter being reimbursed through appropriated funds. We could not reconcile this inconsistency. Lastly, the University established these guidelines without consulting or obtaining approval from the contracting officer because the policy was considered "an internally generated guidance document."

Travel Claims

Total Costs	Projected Questioned Costs
$101,725,002	$7,383,069

We question $7.4 million charged to the contract by the University for travel costs that were not in compliance with Federal Travel Regulations (FTR). In November 1999, a modification to the contract required the University to follow the FTR for travel reimbursements for its employees. The FTR limits reimbursements for lodging to rates established by the General Services Administration (GSA)[3] and requires receipts for all costs over $75. However, we found that travelers were reimbursed for lodging that exceeded established GSA rates, conference fees without providing a receipt, and various other costs not in accordance with the FTR.

To determine the questioned amounts, we:

- Randomly selected 386 travel transactions with a value of $846,800;

- Identified the associated travel claim and evaluated the claim for compliance with the FTR; and,

- Projected costs, not in compliance with the FTR, using statistical sampling software provided by the DCAA.

In our sample, we found 109 travel claims with $53,868 costs questioned:

Cost Type	Questioned Transactions	Questioned Costs	Rationale
Conferences	40	$37,073	Costs were not supported by a receipt
Lodging	54	6,670	Exceeded GSA rates without justification
Other Errors	33	10,125	Various errors
Totals	109*	$53,868	

** This column does not total 109 because some transactions contained multiple errors.*

Subsequent to our review, we were informed that the Laboratory was able to locate additional supporting documentation, which was not in the payment files at the time of our review. This information should be utilized by the Department in determining allowability of specific items questioned in this report. However, the delay in providing the information and the fact that the information was not in the payment files calls into question the scrutiny of travel claims by the Laboratory prior to payment.

[3]According to the FTR, reimbursement for actual expenses is warranted when: lodging or meals are procured at a prearranged place; costs have escalated because of a special event; or, lodging and meals expenses within prescribed allowances cannot be obtained nearby and costs to commute from a nearby location consumes savings that would be achieved.

Performance Awards

Total Costs	Costs Questioned
$2,190,229	$53,247

We question $53,247 in cash awards charged to the contract. The University funds the Contract Worker Award Program to recognize the efforts of subcontractor employees. This award program was not specifically allowed by the contract, but the University received Departmental approval in 1996 to fund these awards. The cost of this program was limited by the University to 0.1 percent of the salary base for the subcontractors. These limits were $62,210 in 2000, $67,753 in 2001, and $64,429 in 2002.[4] However, we found that the University exceeded these limits by $50,247.

Also, the contract provided for costs related to employee morale activities to fund a variety of programs to enhance employee morale with an overall limitation of $16 per employee. In addition to the contract, the University imposed additional limitations that specifically prohibited use of the fund for individual cash awards. However, we found that the University charged $3,000 to this fund in FY 2002 for individual cash awards for four employees.

Audit Function

Total Costs	Cost Questioned
$3,503,175	$3,503,175

We question as unreasonable $3,503,175 charged to the contract by the University for costs of operating an audit function that did not meet the requirements of the Department's Cooperative Audit Strategy or standards established by the Institute of Internal Auditors. Specifically, the audit function was not organizationally independent; did not adequately plan its audit work; and did not conduct timely follow-up reviews. These shortcomings are discussed in more detail in the Related Controls section of this report.

[4] These limits were imposed by the University on a "cap year" that ran from April 1st to March 31st in any given year.

Related Controls

As part of our review, we identified internal control weaknesses that contributed to an environment where the questioned costs identified in this report and potentially other questionable costs could be incurred and claimed. A discussion of each identified control weakness follows.

Laboratory Audit Function

An effective internal audit function is crucial to effective program management. The University's contract requires the Laboratory to establish an audit function to conduct audits at the Laboratory that are acceptable to the Department, including an annual allowable cost audit and subcontract audits as needed. It also requires the University to make the results of these reviews available to the contracting officer. The Cooperative Audit Strategy, as set forth in the Department's Acquisition Guide, provides the criteria used to determine whether a contractor's audit function is acceptable. Among other requirements, the acquisition guide requires the audit functions to be organizationally independent and prepare a satisfactory audit plan. In addition, the Institute of Internal Auditors' standards recommend establishment of an audit follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action. In our judgment, the Los Alamos audit function, which includes internal and subcontract audit functions, did not meet these requirements.

Independence

The Laboratory's audit function had reporting relationships with various levels of University and Laboratory management. However, we determined that the manager responsible for the chief auditor's performance appraisals and annual salary increases was also responsible for areas that were the subject of both internal and subcontractor audits, including the procurement, property, and accounting functions. In our opinion, this relationship led to an impairment of independence.

An apparent lack of independence was also evident in the Laboratory's reporting of audit findings to the Department. When the audit function issues an audit report, it also issues a Management Action Plan (MAP) and enters required management actions into the Laboratory's Issues Tracking system (I-TRACK). We compared the findings in the audit reports to the related MAP and I-TRACK actions and found that the

MAP and I-TRACK contained significantly more detail. However, only the audit reports are issued to the Department, while the MAP and I-TRACK are treated as internal documents. For example, we noted that an internal audit conducted in 2000 identified potentially unallowable costs listed at $117,247 in the MAP. However, the associated audit report issued to the Department did not include specific information about these costs. Although the issue was identified in the report, the value of the questioned costs was not. At the time of our review, the costs had not been recovered. It should also be noted that the Office of Inspector General encountered reluctance on the part of the audit function to share MAP and I-TRACK documents with our audit team.

Finally, we found supervisory documentation warning the audit function against throwing "grenades" and encouraging the function to "work with management." Such admonishments could have encouraged a reluctance to report audit findings to the Department.

Planning and Performance of Audits

We also found that the audit function did not adequately plan internal or subcontract work. During our review period, the internal audit function typically only completed one-third of the audits planned, while the subcontract audit function did not prepare audit plans.

The internal audit function planned up to 13 audits per year for a total of 32 audits planned from FY 2000 to FY 2002, but during that same time, completed only 11 audits (34 percent). According to the University, the internal audit group is expected to complete between 70 and 85 percent of its audit plans. This lack of production by the internal audit function may be attributed to spending 15 percent of available time on advisory services[5] and 31 percent on audits that were started but not completed. While the internal audit function did not follow its plans, the subcontract audit function did not prepare an audit plan at all for FYs 2000 through 2002.

In addition to overall planning, we found the allowable cost audit for FY 2000, which was specifically required by the contract, was not adequately planned. The audit did not cover the full scope of operations and relied on judgmental sampling techniques from which results could not be projected. In addition, the audit did not reconcile the costs shown on the Statement of Cost Incurred and Claimed[6] to

[5]Advisory services addresses management's concerns in areas such as human resources, security, and various consultations. The results of these services are not distributed to the Department.
[6]The annual statement the University submits to the Department as an accountant of costs incurred for the year.

either the Laboratory's Letter-of-Credit or its Financial Management Information System (FMIS)[7].

Subcontract Audits

The Laboratory had responsibility for auditing selected subcontracts under its purview and had completed 70 audits during the last three fiscal years. However, at the time of our review, the Laboratory provided documentation that indicated a backlog of 500 subcontract audits for contracts with a total value of $1.2 billion. The backlog included the incurred cost audits and close out audit of Johnson Controls Northern New Mexico (Johnson Controls) that accounted for over $150 million per year charged to the Department. The FY 2001 audit of Johnson Controls began in March 2002 and is still ongoing. The FY 2002 incurred cost and closeout audits of Johnson Controls have not been started. After we completed our fieldwork, the Laboratory provided a revised list for closeout audits that indicated a backlog of 77 audits with contract values of $1.1 billion. As indicated above, the Laboratory has not developed a plan to address the backlog of required audits.

By the terms of its contract, the Laboratory was required to provide for the timely involvement of the Department's contracting officer in resolution of subcontract cost allowability. In at least one instance, the audit function conducted a subcontract audit that identified potential questioned costs of approximately $12.8 million, but a report was never provided to the contracting officer.

Follow-up

The audit function did not follow-up on issues identified in its audit reports in a timely fashion. We found several instances where there was a significant delay between the time management closed an audit finding and the time the audit function verified that appropriate action was taken to close the finding. In some cases this delay was 6 years or more. For example, the internal audit function issued two audits on the purchase card program, resulting in 10 findings requiring management action that closely mirrored recent findings of an external review team. Management closed all of the audit findings issued between December 1996 and December 2000, but the audit function did not indicate verification of these actions until February 2003 and had not conducted follow-up reviews. The audit function also had a considerable backlog

[7]These reconciliations would have shown the auditors that all costs charged by the University were subject to audit.

of open actions. We noted that there were at least 260 open actions in I-TRACK at the end of FY 2002 that required management closure or audit function verification.

Recent Actions

In response to a draft of this report, the University informed us of several actions they had recently taken or were planning to take to address weaknesses in the audit function at the Laboratory. Specifically, the University reported that it had: revised the reporting structure; made staffing changes; started assessing its practices to enhance productivity and timeliness; engaged in a program to catch-up on delinquent audit follow-up activities; and, begun development of performance measures. In addition, the University stated that it was planning to create a Laboratory audit committee adhering to the University of California model for campus audit committees. If successfully implemented, these initiatives should address the internal control concerns related to the Laboratory audit function identified in this report.

Financial System Reconciliation

The University has established over 60 feeder systems at the Laboratory that provide cost information to the Financial Management Information System (FMIS) and ultimately to the annual statement the University submits to the Department as an account of costs incurred for the year. However, the University has not established a process to periodically reconcile costs generated by these systems to FMIS. We attempted to reconcile the costs generated by both the payroll system and the travel disbursement systems. We were able to reconcile the payroll system to within $1.4 million of payroll costs in FMIS (0.08 percent of total payroll costs) and the travel disbursements system to within $2.3 million of costs in FMIS (2.31 percent of total travel costs). University officials told us that a complete reconciliation could be completed, but only with great difficulty. As a result of these inconsistencies, costs claimed by the University could be misstated and the universe of costs subjected to audit could be incomplete.

Payroll and Travel Approval Processes

The University established controls over travel reimbursements and time and attendance at the Laboratory that allowed payments to be made based upon electronic signatures of administrative staff or, in some cases, subcontractor support staff. The written policy for approvals stated that travel claims and payroll time sheets required supervisory approval -- Deputy Group Leader and above -- using either online electronic signature or hardcopy signature prior to paying travel claims and salaries. In cases where supervisors manually approved these payments, the University allowed them to delegate electronic approval of the costs to administrative staff. We found that supervisors made only 15 of the 120 electronic approvals that we checked. Although in some instances we were able to verify that hardcopy signatures did exist, our primary concern was that the Business Operations Division made payments based exclusively on the electronic signatures. Thus, these payments were made without any process, test-basis or otherwise, for verification of supervisory approvals.

Financial Management Personnel Turnover

During our audit we noted that there had been substantial turnover in Laboratory personnel responsible for financial management activities. As of March 2003, 43 percent of the managers (Team Leader and above) in the Business Operations Division had less than one year of experience in their current positions at the Laboratory. In particular, Accounting, a sub-component of this division, had been severely affected. Five of seven managers (71 percent) had less than one year of experience in their current positions at the Laboratory. While we recognize the challenge of retaining qualified personnel, the fact is that excessive turnover left a void in the Accounting Department's ability to fully understand and execute the interfaces and capabilities of the Laboratory's financial management systems. To clarify, we did not review, nor are we questioning, the professional credentials and core qualifications of the financial management personnel. Rather, our concern is position-specific experiences of personnel in the Business Operations Division.

Financial System Review and Approval

We also found that the University did not obtain Departmental approval for its existing financial system or approval for a new financial system currently under development. These systems typically consist of the organization, processes, and computer applications for accounting, purchasing, and property management. The contract requires Departmental review and approval of the financial systems, the purchasing systems, and the property systems. The contract also requires Departmental approval of plans for new systems or major enhancements to existing systems. We found that both the property and purchasing systems were subject to review and approved by the Department on a regular basis. In addition, all the systems were subject to an annual self-assessment by the University and a Business Management Oversight Review by the Department. However, we found no evidence that the Department approved the Laboratory's financial systems. Furthermore, we noted that the University initiated an overhaul of its financial system that is expected to take 5 years at a cost of $70 million. As with the existing system, the new initiative had not been approved by the Department.

Diminished Assurance

As a result of the control weaknesses identified in this report, the Department has, in our judgment, less than adequate assurance that costs claimed by the University for operation of the Laboratory are allowable under the contract. Absent a strong control structure, a definitive assessment of allowability of costs cannot be made. Based on the record we developed, in our judgment, business operations at the Laboratory have not been given adequate emphasis. As a result, the caliber of business operations is simply inadequate given the nature and size of operations at Los Alamos and the requirements of the University's contract with the Department of Energy.

RECOMMENDATIONS

To address the issues discussed above, we recommend that the Administrator of the National Nuclear Security Administration:

1. Direct that a determination of allowability be made on the $14,599,874 in questioned costs identified in this report, in accordance with the provisions of contract clause I.100 for costs determined to be unallowable, and recover costs and penalties as appropriate.

2. Require the University to either develop and implement a policy for meals that makes them expressly unallowable, or establish a contractually binding arrangement with the Department that recognizes meal costs allowability in very narrowly defined scenarios consistent with current regulatory guidance.

3. Require the University to:

    a. Obtain prior approval and provide adequate justification for exceeding lodging and meal rates established by the GSA and require travelers to provide receipts for all costs over $75 prior to providing final reimbursement;

b. Amend current approval policies to allow only Group Leaders or above to approve payroll and travel costs, and eliminate from all financial systems the capability to delegate electronic approvals below the Group Leader Level; and,
c. Conduct yearend reconciliations of costs from feeder systems to the FMIS.

4. Require the University to re-align its audit function to:

   a. Report directly to the University of California or be overseen by an audit committee consisting of members independent of Laboratory management;
   b. Enhance its audit planning process to reconcile with its existing resources and address the backlog of subcontract audits; and,
   c. Establish a follow-up process to ensure that management actions have been effectively implemented in a timely fashion.

5. Take action to review and approve the Laboratory's financial systems.

6. Working in conjunction with the Chief Financial Officer and the Chief Information Officer, establish the University's project to overhaul the financial systems as a line item project.

MANAGEMENT REACTION

Management generally agreed with the recommendations and indicated that corrective actions had been taken or were planned. Management's comments are included as Appendix 3. Management also provided technical comments from NNSA and the Laboratory. These comments are addressed in the report as appropriate. In its official comments, management specifically recognized actions already taken by the University and new Laboratory management to strengthen the Laboratory's control environment and business practices as a result of this and prior reviews. They applauded the University's commitment to the formal improvement plan that had been instituted, specifically citing among other initiatives, the University Auditor assuming management of the Laboratory's audit function.

NNSA's plan to monitor corrective actions established how each recommendation would be managed. In this plan, with one exception, NNSA agreed to take the recommended actions or review the need to take action on each of our recommendations. The one exception related to our recommendation to require the University to obtain prior approval and provide adequate justification for exceeding lodging and meal rates established by the GSA. NNSA asserted that systems and documentation were in place.

Subsequent to our review, we were informed that supporting documentation related to some of the questioned costs existed that was not available during our review.

AUDITOR COMMENTS

Management's comments were generally responsive to our recommendations.

With respect to our recommendation on approval and justification for exceeding lodging and meal rates established by the GSA, we believe that adequate systems and documentation were not in place. For the costs questioned in our sample, documentation of rationale for exceeding appropriate limits was not included in the travel claim and was not provided from other sources during our review. We did not question costs in excess of the limits that included a justification or explanation consistent with exceptions provided for in the FTR. We recognize that there are situations where it is acceptable to exceed the GSA limits but believe that the rationale should be documented in the travel claim.

While subsequently located documentation related to the costs questioned in this report can be utilized by the Department in determining allowability of specific items, it should be noted that the lack of availability of required documentation at the time of the review indicated a breakdown in internal controls that allowed the payment of these questioned costs without the appropriate supporting documentation. At the time of our review the required receipts or justifications for the costs we questioned were not included in the payment file, nor was the Laboratory able to produce them from other sources during the 2 months of our review. While these costs may ultimately be deemed allowable, the underlying control problems need to be addressed.

Appendix 1

OBJECTIVE

The objective of this audit was to determine whether the University of California has established 1) an adequate system of internal controls at Los Alamos National Laboratory to ensure that costs reimbursed under the contract are allowable; 2) an internal audit function that is operating effectively; and, 3) critical management systems that are approved, maintained, and updated in accordance with contractual requirements.

SCOPE

The audit was performed from January to March 2003 at the Los Alamos National Laboratory in Los Alamos, New Mexico. The scope of the audit included a review of expenditures for Fiscal Year 2000 through Fiscal Year 2002. Our scope excluded costs related to Johnson Controls of Northern New Mexico that totaled $410,784,452 during our review period.

METHODOLOGY

To accomplish the audit objective, we:

- Researched applicable laws, regulations, contract terms, policies, procedures, and guidance relevant to the University and the Laboratory;

- Interviewed the Albuquerque and Los Alamos Office contracting officers and other personnel responsible for monitoring accounting for allowable costs;

- Interviewed management and personnel from various Laboratory departments;

- Reviewed the University's internal controls over allowability of costs;

- Reconciled the University's expenses from FMIS to the amounts reported on the annual Statements of Costs Incurred and Claimed;

- Selected random samples of Travel, Meals and Conferences, Subcontracts, Payroll, and miscellaneous other expenses from FMIS and tested these transactions for cost allowability. We also selected and tested additional transactions on a judgmental basis. We evaluated these transactions statistically and non-statistically and, as appropriate, projected these results to the relevant populations;

- Evaluated the Laboratory's audit function for independence, planning, audit finding follow-up, and subcontract auditing;

- Evaluated the University's major accounting systems for contract compliance; and,

- Tested the University's compliance with various contractual cost ceilings.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits. It included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Because our audit was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. In performing this audit, we assessed the accuracy of data generated from the Laboratory's data−processing system.

An exit conference was held with NNSA and Laboratory Officials on April 10, 2003.

PRIOR REPORTS

- *External Review of The Purchase Card Program, Report of Findings, Los Alamos National Laboratory,* (Price Waterhouse Coopers Review, December 12, 2002). The Report concluded that internal control weaknesses existed in the program, which left the Laboratory vulnerable to fraud and abuse. Examples include failure to reconcile and approve monthly statements, failure to resolve disputed transactions, and purchase of restricted items in violation of Laboratory policies.

- *Internal Audit Report, Audit of the Procurement Purchase Card Program*, (IA-98-02, October 31, 1997). According to the report, the cardholders and approving officials did not always follow policies, procedures, and internal controls for the Purchase Card Program. As a result, managers do not have reasonable assurance that policies, procedures, and controls were adequate to ensure purchases were properly authorized and accurately charged, received, and reported.

- *Assessment of Changes to the Internal Control Structure and their Impact on the Allowability of Costs Claimed by and Reimbursed to Los Alamos National Laboratory Under Department of Energy Contract No. W-7405-ENG-3*, (WR-V-02-07, September 2002). Los Alamos provided meals on site without documentation showing participation in the meals by individuals other than Laboratory employees. Los Alamos incurred the questioned costs for catered on-site meals because meals could be ordered from the Laboratory's cafeteria without evidence of non-lab participation and without an Associate Director's approval. In addition, Los Alamos reimbursed travel costs in excess of the Federal Travel Regulations (FTR) per diem rates. It was noted that employees incurred, and were reimbursed, excess lodging and M&IE costs.

- *Special Inquiry on "Operations at Los Alamos National Laboratory,"* (DOE/OIG-0584, January 28, 2003). The report noted a series of actions by Laboratory officials that had the effect of obscuring serious property and procurement management problems and weakened or overrode relevant internal controls. These actions created an atmosphere in which Los Alamos employees were discouraged from, or had reason to believe they were discouraged from, raising concerns to appropriate authorities. In short, management's actions − whether intended as a cover-up or not − resulted in delayed identification and resolution of the underlying property and procurement weaknesses and related security concerns.

- *FY 2002 Business Management Oversight Process Report.* The report summarizes the business and administrative performance of the University of California, Los Alamos National Laboratory, for FY 2002. The functional areas assessed had the following scores: personal property management - excellent, financial management - excellent, human resources management - outstanding, procurement management − outstanding, and information management - outstanding.

Department of Energy
National Nuclear Security Administration
Washington, DC 20585

APR 0 8 2003

MEMORANDUM FOR William S. Maharay
Assistant Inspector General
for Audit Services

FROM: Anthony R. Lane Anthony R. Lane
Associate Administrator
for Management and Administration

SUBJECT: Comments to IG's LANL Cost Claimed Draft Report

Acknowledging that NNSA requested the Inspector General (IG) to perform an audit of costs incurred by Los Alamos, we appreciate the opportunity to have reviewed the draft report. The report, "University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory," questions the allowability of about $14.6 million incurred during the Fiscal Year 2000 - 2002-period. Therefore, NNSA will conduct a review of the allowability of these costs for the Los Alamos Site Manager, as the Contract Administrator/Contracting Officer, to make a determination of allowability or unallowability. (Unallowable costs are not paid by the Government.)

It is important to note in the report the progress that has been achieved by the University of California, Office of the President and the new Laboratory management. Both the University and the Laboratory have taken positive steps to strengthen the Laboratory's control environment and business practices. We applaud the University's commitment to the formal improvement plan that they instituted. The concerns identified in the draft audit report are among the issues the University has recognized and taken action on. As a result, a number of actions that are recommended in this report are already accomplished and/or are the subject of ongoing efforts that are supported by sustainable processes. As does the IG and NNSA, the University recognizes the need for a strong Internal Audit function. In early 2003, the University Auditor was asked to assume the management of the Laboratory's Internal Audit function. Since that time, the University Auditor has led a comprehensive initiative designed to revitalize the Internal Audit function providing assurance to NNSA, the University Regents, and management that the Internal Audit function meets the highest professional standards for independence and performance through a risk-based audit program that provides comprehensive audit coverage, timely and thorough investigations of all allegations of wrongdoing, and assistance to management on internal control improvement initiatives. We have provided a copy of a letter, dated April 3, 2003, from the Laboratory that provides technical comments to the draft report. Additionally, we have attached the NNSA management comments to the recommendations. This attachment lays out our plan to monitor corrective actions.

Should you have any questions regarding our response, please contact Richard Speidel, Director for Policy and Internal Controls Management at 202-586-5009.

Attachments

cc: Tyler Przybylek, General Counsel
and Acting Chief Operating Officer, NA-2.1
Ralph Erickson, Manager, Los Alamos Site Office
David Marks, Director, Field Financial Management, SvcCen/NV
Robert Braden, Senior Procurement Executive, NA-63

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