DOE F 1325.8
(08-93)

United States Government **Department of Energy**

Memorandum

DATE: March 8, 2011 Audit Report Number: OAS-L-11-03

REPLY TO
ATTN OF: IG-32 (A10LV007)

SUBJECT: Report on "Audit of National Security Technologies, LLC Internal Audit Function"

TO: Manager, Nevada Site Office

INTRODUCTION AND OBJECTIVE

National Security Technologies, LLC (NSTec), has managed and operated the Nevada National Security Site since July 1, 2006, for the National Nuclear Security Administration's (NNSA) Nevada Site Office. NSTec is a joint venture between Northrop Grumman Corporation (Northrop Grumman), AECOM, CH2M Hill, and Nuclear Fuel Services. The contract requires NSTec to establish and maintain an independent internal audit function and to develop an Internal Audit Implementation Design that describes the audit organization, lines of reporting, oversight responsibilities, and auditing standards to be followed.

To help ensure that only allowable costs are claimed by Department of Energy's (Department) management and operating contractors, the Office of Inspector General, the Department's Office of Procurement and Assistance Management, and contractors implemented a Cooperative Audit Strategy. This strategy relies on the contractors' internal audit function to provide audit coverage of the allowability of incurred costs claimed by contractors. It requires that contractors structure their organizations so that the internal audit manager reports functionally to the Board of Directors (Board), audit committee or equivalent corporate independent governing body. The strategy's success depends on the organizational placement of the internal audit department and the internal audit function's adherence to the audit standards established by the International Standards for the Professional Practice of Internal Auditing (Standards) as promulgated by the Institute of Internal Auditors (IIA).

Because the role of contractor internal audit departments is critical to the success of the Cooperative Audit Strategy, we performed this audit to determine whether audits conducted by the NSTec Internal Audit Department (Internal Audit) during Fiscal Years (FY) 2008 and 2009 met both quality and professional auditing standards.

CONCLUSIONS AND OBSERVATIONS

Although we found that NSTec Internal Audit generally met IIA Standards for the seven audits we reviewed, we identified a number of exceptions in one audit that resulted in that audit not meeting quality and professional standards. Specifically, we identified instances in which Internal Audit had not ensured that relevant audit work supported audit conclusions and results. Further, although Standards require that the Internal Audit Manager communicate directly with the Board, NSTec's Internal Audit Manager did not have direct contact with the Board. We also found that, during FYs 2008 and 2009, the Audit Committee Chairman (Chairman) was not independent of company management since he was also NSTec's Treasurer responsible for management of the company's bank accounts. *The Audit Committee Handbook*, as referenced by the IIA, states that audit committee members consist of outside members or independent directors.

Internal Audit had not always met IIA Standards, in part, because it lacked a quality assurance and improvement program. Specifically, a 2009 NSTec Internal Audit Peer Review found that Internal Audit had not conformed to the IIA Standard for a quality assurance and improvement program because it had not established a formal process to monitor and periodically assess the overall effectiveness of the audit quality. In response to Peer Review findings, Internal Audit began monitoring ongoing performance, and in the first quarter of FY 2010, began performing self-assessments.

On the matter of organizational placement, we were told by the Internal Audit Manager that he was not invited to Board meetings because he reports to the Audit Committee. Finally, we noted that, in May 2010, NSTec appointed a new Chairman who was not involved in the day-to-day management of the company.

The audit quality exceptions that we identified were isolated and NSTec officials told us that they have acted to improve both the quality and independence of its internal audit organization since the time the audit in question was completed. To ensure these actions are completely implemented, we make several suggestions to address the issues identified in this report.

Audit Support

Contrary to the Standards' requirement that relevant audit work support conclusions and results, we found that changes made in the re-issuance of a 2008 Internal Audit report were not fully supported. Specifically, Internal Audit issued a report entitled *Livermore Operations Charging Practices*, in December 2007, that identified (1) approximately $103,000 in charges to an inappropriate project account, and, (2) an unsupported accounting adjustment of $35,000. The workpapers supporting the audit indicated that NSTec's Livermore Operations Division had performed work on a cost reimbursement basis for Livermore National Laboratory and had overcharged the project account by $103,000. Internal Audit also reported that it was unable to verify the accuracy of a $35,000 accounting adjustment to reallocate other mischarges (self-identified by management) to Livermore projects. Subsequently, Internal Audit re-issued the report in April 2008 but did not fully include either of the above issues. Our review showed that, although its workpapers provided support for the original issues, Internal Audit's workpapers did not explain the reason for not fully disclosing these issues in the re-issued report.

Specifically, we found that the report was re-issued after the Audit Committee Chairman had auditors from Northrop Grumman's parent company review the internal auditors' work. The Chairman requested the assistance of the Northrop Grumman auditors because the original report had been issued without management's comments. Based on the Northrop Grumman review, NSTec Internal Audit re-issued the report that identified approximately $89,000 of the $103,000 originally reported and did not discuss the $35,000 accounting adjustment. According to Internal Audit, the Northrop Grumman auditor assisted in preparing the re-issued report, but it was signed by the then Internal Audit Manager and the Audit Committee Chairman.

Our review found that the Internal Audit workpapers did not provide a rationale for the reduction in mischarges or support the revised total of mischarges, and did not contain additional support for the $35,000 accounting adjustment. Regarding changes in the re-issued report, the Northrop Grumman auditor that prepared the re-issued report:

- Explained that NSTec Internal Audit did not have access to the entire history of events that led to the reduction in the identified mischarge amount. The Northrop Grumman auditor also stated that management's review supported the lower amount of $89,000. However, the auditor acknowledged there was no support for the revised amount in the workpapers or a reconciliation to support the $14,000 reduction in reported mischarges; and,

- Did not recall why the $35,000 accounting adjustment issue was not included in the revised report. Based on our review of the workpapers, we concluded that the Northrop Grumman auditor had not developed support for eliminating the observation from the re-issued report.

We also determined that when Internal Audit originally reported on the matter it had not correctly calculated the $35,000 in mischarges identified in the initial report. Specifically, Internal Audit had not added the overhead costs to the mischarged $35,000 identified by management. We were unable to determine the amount of overhead costs that should have been added to the mischarged costs. The Department's *Accounting Handbook*, Chapter 15, *Cost Accounting*, requires that the proper allocation of overhead costs be included when determining a product's costs.

Finally, while Internal Audit issued the initial report stating that it complied with audit standards, the revised report did not cite compliance with any audit standards. We were unable to ascertain why the report did not cite any standards. The Department's Cooperative Audit Strategy requires that audits meet, at a minimum, the Standards.

Communication Requirements

Although not associated with the prior reporting problems, we found that the current Internal Audit Manager is not invited to and does not attend or participate in senior management or NSTec's Board of Managers (NSTec's equivalent to a Board of Directors) meetings. IIA Standards require that the Internal Audit Manager communicate and interact directly with the Board. According to the Cooperative Audit Strategy, direct communication occurs, in part, when the Internal Audit Manager regularly attends and participates in meetings. The Internal Audit Manager further stated that he has not requested to attend the senior management meetings because his position is not considered senior staff. Although the Internal Audit Manager told us that he is briefed by NSTec's Chief Operating Officer on the senior management meetings and has access to the minutes and presentations of meetings, we concluded that the Internal Audit Manager's inability to attend senior management meetings limits his opportunity to be apprised of strategic business and operational developments, and to raise high-level risks or control issues at an early stage.

Independence

According to *The Audit Committee Handbook*, as referenced by the IIA, audit committee members should consist of outside or independent directors. We reference the handbook as a best practice to help engender a high degree of integrity in the overall audit process. However, during FYs 2008 and 2009, we identified an independence issue with the Chairman, who was also NSTec's Treasurer during that time. As Treasurer, the Chairman maintained primary signatory authority and overall responsibility for all of NSTec's bank accounts. Accordingly, we did not consider the Audit Committee Chairman an outside or independent director because he was directly involved in managing the corporation. While we did not consider the Chairman independent, we are not aware of any improper transactions the Chairman made while serving as NSTec's Treasurer. In May 2010, a new Chairman was appointed who was not involved in any day-to-day NSTec operations.

Quality Assurance

Internal Audit had not always met the IIA quality standard, in part, because it lacked a quality assurance and improvement program. IIA Standards require that NSTec Internal Audit have a quality assurance and improvement program. We noted that an independent 2009 NSTec Internal Audit Peer Review, covering FYs 2004 through 2008, found that Internal Audit had not conformed to the Standard for a quality assurance and improvement program. The peer review team reported that NSTec had not established a formal process to monitor and periodically assess the overall effectiveness of the audit quality. For example, Internal Audit had not established a formal process to monitor ongoing performance of the internal audit activity, and had not performed periodic reviews through self-assessments. The Internal Audit Manager stated that his predecessors believed that sending out client surveys after each audit was sufficient to constitute a quality assurance program. As a result of the peer review, Internal Audit instituted a quality assurance and improvement program. In June 2009, Internal Audit began monitoring ongoing performance, and in the first quarter of FY 2010 began performing self-assessments.

Suggested Actions

We noted that the NNSA Service Center's Office of Field Financial Management (OFFM) recently issued a report in September 2010 on NSTec's Internal Audit Function. The objective of the review was to determine whether NSTec Internal Audit met both quality and professional auditing standards. OFFM reviewed four audits that were not included in our review. OFFM identified no significant weaknesses and concluded that Internal Audit met both quality and professional auditing standards.

Given that our findings appear to relate to isolated exceptions, the recently completed NNSA review confirmed that internal audits met auditing standards, and actions were taken by NSTec to improve internal audit quality, we are not making any formal recommendations. However, we suggest that the Nevada Site Office Manager:

- Determine whether the $35,000 in mischarges identified in the original NSTec *Livermore Operations Charging Practices* report were appropriately managed; and,

- Ensure that the NSTec Internal Audit Manager has sufficient interaction and participation with senior management and the Board of Managers to carry out his responsibilities.

Since no recommendations are being made in this report, a formal response is not required. We appreciate the cooperation of your staff during the audit.

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

Attachment

cc: Director, Office of Internal Controls, NA-66
Assistant 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
Audit Liaison, Nevada Site Office

SCOPE AND METHODOLOGY

We performed the audit between October 2009 and March 2010, and between September 2010 and February 2011. We conducted our work at the Nevada Site Office and National Security Technologies, LLC (NSTec) offices in Las Vegas, Nevada.

To accomplish the audit objective, we reviewed Department of Energy (Department) guidance and requirements for contractor internal audit functions as well as applicable standards for the professional practice of internal auditing. We interviewed key personnel at the Department, NSTec, and Northrop Grumman Corporation; reviewed 7 of 39 NSTec Internal Audit reports, the associated workpapers, and supporting documentation; and, obtained information from selected Department contractor's internal audit departments regarding their participation in senior management and board level meetings.

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 that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. 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 assessed performance measures in accordance with the Government Performance and Results Act of 1993 and found that the Department had established performance measures related to internal audit activities. We did not rely on computer-processed data to satisfy our audit objective.

Management waived an exit conference.

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