



Department of Energy

Washington, DC 20585

June 30, 2006

Mr. Charles Montano
22 Monte Alto Road
Santa Fe, NM 87508

Re: Freedom of Information Act Request F2006-00185

Dear Mr. Montano:

This is the Office of Inspector General (OIG) final response to your request for information that you sent to the Department of Energy (DOE) under the Freedom of Information Act (FOIA), 5 U.S.C. 552. You asked for a copy of the 2004 Los Alamos National Laboratory (LANL) Statement of Cost Incurred and Claimed report, and any other reviews and related reports that were conducted in conjunction with the OIG Hotline Complaint you made.

The OIG Office of Audits Services has completed the search of its files for the documents responsive to your request. The search identified three documents responsive to your request. A review of the documents and a determination concerning their release has been made pursuant to the FOIA, 5 U.S.C. 552. Certain material has been withheld pursuant to subsection (b)(6) of the FOIA or Exemption 6, respectively.

Document 1 is released with material withheld to pursuant to Exemption 6.

Exemption 6 protects from disclosure "personnel and medical and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy. . . ."

Names and information that would tend to disclose the identity of certain individuals have been withheld pursuant to Exemption 6. In invoking Exemption 6, we have determined that it is not in the public interest to release the withheld material. In this request, we have determined that the public interest in the identity of individuals whose names appear in these files does not outweigh these individuals' privacy interests. Those interests include being free from intrusions into their professional and private lives.

To the extent permitted by law, the DOE, in accordance with Title 10, Code of Federal Regulations (C.F.R.), Section 1004.1, will make available records it is authorized to withhold pursuant to the FOIA unless it determines such disclosure is not in the public interest.

Documents 2 and 3 originated with the DOE's National Nuclear Security Administration (NNSA) or a contractor under the purview of that office. The documents have been forwarded to that office for a determination concerning their releasability. NNSA will




respond directly to you concerning those documents. One of the documents forwarded to NNSA contained OIG information that is exempt from mandatory disclosure under the FOIA. The OIG has withheld material from Document 2 pursuant to Exemption 6.

As required, all releasable information has been segregated from the material that is withheld and is provided to you. See 10 C.F.R. 1004.7(b)(3).

This decision may be appealed within 30 calendar days from your receipt of this letter pursuant to 10 C.F.R. 1004.8. Appeals should be addressed to the Director, Office of Hearings and Appeals, HG-1/L'Enfant Plaza Building, U.S. Department of Energy, 1000 Independence Avenue S.W., Washington, DC 20585-1615.

Thereafter, judicial review will be available to you in the Federal district court either (1) in the district where you reside, (2) where you have your principal place of business, (3) where the Department's records are situated or (4) in the District of Columbia.

Sincerely,


William S. Maharay
Deputy Inspector General
for Audit Services
Office of Inspector General

Enclosures

Memorandum

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DATE: December 23, 2005

REPLY TO:

ATTN OF: IG-32 (A04LA030)

SUBJECT: Audit Report on "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-36"

TO:

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] NA-66

Attached is the subject report. We initiated this audit to assess the changes to the internal control structure of Los Alamos National Laboratories (Los Alamos). The objectives of this assessment were to determine (1) if internal controls are adequate to assure that the cost claimed by Los Alamos are allowable under the Department of Energy (Department) contract; and (2) the extent to which the Office of Inspector General (OIG) may rely upon Los Alamos's internal audit's (Internal Audit) work.

Our assessment disclosed conditions in the internal control structure of Los Alamos in effect during Fiscal Year (FY) 2003 related to procurement and Just-In-Time (JIT) and freight processes, which in our opinion result in more than a relatively low risk that unallowable costs are claimed by and reimbursed to Los Alamos. Our review also disclosed that Los Alamos claimed and was reimbursed for unallowable costs incurred between FYs 1992 and 2003. Specifically, our assessment disclosed that:

- Internal Audit's Allowable Cost Audit of FY 2003 questioned claimed costs in the amount of \$935,765;
- Approximately \$4.8 million in questioned or unallowable subcontract costs for FYs 1992 to 2003 are unresolved; and,
- Self-Assessments and Procurement Reviews identified internal control weaknesses and questioned costs in freight and JIT procurements of \$2.2 million incurred in FYs 2000 through 2003.

In addition, the Field Director of Procurement (FDP) had not signed the FY 2003 SCIC, as required by the Department's Accounting Handbook. The Department's Accounting Handbook states that the Contracting Officer will obtain the FDP's signature, which attests that the contractor has established a system of procurement controls intended to minimize the risk of incurring unallowable or unreasonable costs. Because of the items discussed, we are qualifying our opinion on the FY 2003 SCIC.

Based on our assessment of the internal auditor's qualifications, independence, and audit workpapers, and tests of the work performed by the internal auditors, we determined that the work of the internal auditors met Government auditing standards, as well as Institute of Internal Auditors Standards, and thus their work could be relied upon.

Finally, Los Alamos and the Department continue to hold discussions, but have not resolved about \$14.7 million in questioned costs previously reported by the Office of Inspector General for costs claimed in FYs 1996 through 2002.

Management agreed with our recommendations. We appreciate the cooperation of your staff during our review.

George W. Collard
Assistant Inspector General
for Performance Audits
Office of Inspector General

Attachment

cc: Manager, Los Alamos Site Office
[] Audit Liaison Team, CF-1.2

**AUDIT
REPORT**

**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-36**



**U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES**

DECEMBER 2005

**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-36**

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES
NATIONAL NUCLEAR SECURITY ADMINISTRATION AUDITS DIVISION

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-36

Audit Report Number: OAS-V-06-07

December 23, 2005

ASSESSMENT OBJECTIVES, SCOPE, AND METHODOLOGY

We have assessed the changes to the internal control structure of Los Alamos National Laboratory (Los Alamos) for Fiscal Year (FY) 2003 to assure that costs claimed by Los Alamos, and reimbursed by the Department of Energy (Department) are allowable under the contract. We also reviewed the Los Alamos' internal audit function (Internal Audit) as of January 24, 2005, to determine the extent to which the Office of Inspector General (OIG) may rely upon the work they have performed and thereby avoid duplicative audit efforts. Our review, conducted in accordance with generally accepted Government auditing standards for financial related audits, included tests of compliance with those laws and regulations which could, if not observed, have a direct and material effect on the internal control structure.

Our assessment included an evaluation of Internal Audit and the following internal control elements:

- Contract terms;
- Contractor internal control changes;
- Audit reports by the OIG and other entities; and,
- Other information determined to be relevant and necessary to satisfy the assessment objectives.

The Department's Accounting Handbook requires the OIG to periodically assess the reliability of the internal control structure used by the contractor and the affected field element to assure that only allowable costs are claimed and reimbursed. Each fiscal year, the OIG will determine if the Statement of Costs Incurred and Claimed (SCIC) can be signed based on this assessment.

Because of inherent limitations in any control structure, unallowable costs may be incurred and not detected. Also, projection of any review of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate. The results of our audit work were discussed with Los Alamos and Los Alamos Site Office officials on December 15, 2005.

BACKGROUND

Los Alamos' financial accounts are integrated with those of the Department, and the results of financial transactions are reported monthly according to a uniform set of accounts. Further, Los Alamos is required to account for all funds advanced by the Department, and to safeguard the Department's assets in its care.

The management of Los Alamos is responsible for establishing and maintaining an internal control structure, including an internal audit function that will ensure costs billed and reimbursed are allowable under the contract. According to contract terms, the contractor is required either annually, or at such other times as may be mutually agreed upon, to conduct an internal audit satisfactory to the Department of the records, operations, expenses, and transactions of the cost claimed to be allowable under the contract.

In October 1992, the Department initiated a tiered audit strategy for its contractors to improve communications and enhance the efficiency of existing audit resources. The new audit strategy uses risk assessment methodologies as the basis for audit plans within the Department. This cooperative strategy incorporates the audit work performed by contractor internal audit staff (provided the audits comply with professional audit standards), OIG audits, and reviews conducted by Operations offices. Specific internal audit requirements are identified in the Department Acquisition Regulation and the Department's Acquisition Guide.

RESULTS OF ASSESSMENT

Our assessment disclosed conditions in the internal control structure of Los Alamos in effect during FY 2003 related to procurement and Just-In-Time (JIT) and freight processes, which in our opinion resulted in a more than a relatively low risk that unallowable costs were claimed by and reimbursed to Los Alamos. Our review also disclosed that Los Alamos claimed and was reimbursed for unallowable costs incurred between FYs 1992 and 2003. Specifically, our assessment disclosed that:

- Internal Audit's Allowable Cost Audit of FY 2003 questioned claimed costs in the amount of \$935,765;
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- Self-Assessments and Procurement Reviews identified internal control weaknesses and questioned costs in freight and JIT procurements of \$2.2 million incurred in FYs 2000 through 2003.

In addition, the Field Director of Procurement (FDP) had not signed the FY 2003 SCIC, as required by the Department's Accounting Handbook. The Department's Accounting Handbook states that the Contracting Officer will obtain the FDP's signature, which attests that the contractor has established a system of procurement controls adequate to minimize the risk of incurring unallowable or unreasonable costs. Because of the items discussed, we are qualifying our opinion on the FY 2003 SCIC.

Based on our assessment of the internal auditor's qualifications, independence, and audit work papers, and tests of the work performed by the internal auditors, we determined that the work of the internal auditors met Government auditing standards, as well as the Institute of Internal Auditors Standards, and thus their audit work could be relied upon.

Finally, Los Alamos and the Department continue to hold discussions, but have not resolved about \$14.7 million in questioned costs previously reported by the OIG for costs claimed in FYs 1996 through 2002.

Allowable Cost Audit

Internal Audit completed the FY 2003 Allowable Cost Audit and questioned \$198,684 pertaining to meals; \$55,761 in travel; \$14,167 for JTT freight; \$4,214 in payroll overpayments; and \$662,939 in subcontracted support service costs.

Meal costs were questioned because (1) the business purpose of the meal was not documented; (2) meal cost limits were exceeded; and (3) the scheduled meetings did not last at least two hours. Travel costs were questioned because (1) supporting documentation could not be located; and (2) per diem exceeded Federal Travel Regulation limits. JTT questioned costs for freight charges were the result of inadequate supporting business justification. Finally, payroll contained overpayments.

In addition, Internal Audit questioned \$662,939 of claimed costs by Kellogg Brown & Root, Shaw, Lata (KSL); Los Alamos' support service contractor. Examples of the questioned costs pertained to contingencies, relocation expenses, and safety awards.

Internal Audit also noted several internal control weaknesses in the areas of (1) reconciliation of disbursements to the SCIC; (2) tracking of recruiting fees; and (3) compliance with meal, travel, and freight policies.

Internal Audit recommended that the Los Alamos Chief Financial Officer (CFO) refund amounts determined by the Department to be unallowable and also seek reimbursement from KSL for their portion of the questioned costs. In addition, the report indicated that the CFO (1) would review policy requirements for meals, travel, and JTT freight; (2) issue updated policies and/or policy reinforcement memoranda; and (3) follow-up to ensure effectiveness.

Subcontract Cost Audits

Internal Audit performed audits of Los Alamos' subcontractors and identified about \$58.5 million in questioned costs. These costs were claimed between FY 1992 through FY 2003. As of January 2005, Los Alamos' Procurement Team had resolved about \$56.1 million of the questioned costs, leaving about \$2.4 million still unresolved.

In addition, Los Alamos also retained an independent accounting firm to review costs claimed by and reimbursed to a furniture subcontractor for the period October 1995 through

December 2001. The accounting firm's report of May 17, 2004 which was subsequently amended by a report dated April 22, 2005, identified \$2.4 million in questioned costs. Los Alamos is currently pursuing litigation to recover these costs.

Self-Assessments and Procurement Reviews

Los Alamos' internal self-assessments also identified questioned costs. A Self-Assessment and Procurement Review (SAPR) Team was established by Los Alamos in April 2003 to implement a more comprehensive approach to conducting assessment activity within the Supply Chain Management (SUP) division. The SAPR Team's mission was to provide reasonable assurance that the procurement organization was functioning as intended in areas including (1) annual self-assessment of procurement activities; (2) internal control reviews; (3) transaction testing; and, (4) subcontract audits.

The SAPR Team identified questioned costs of about \$2.2 million claimed in FYs 2000 through 2003. These costs include standard and premium freight for FYs 2000 through 2003 of \$1.4 million and estimated overpayments made by Los Alamos to its vendors through the JIT system for FYs 2001 and 2002 of \$800,000. [

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Freight

The SAPR Team questioned \$728,035 in standard freight and \$696,978 in premium freight incurred in FYs 2000 to 2003. To validate the freight amounts the SAPR Team questioned, we selected a statistical sample of freight charges to determine whether premium freight was required and included supported documentation. After discussions with several employees to obtain additional support documentation, we noted that we could not rely or quantify our sample because Los Alamos released a questionnaire to employees identified in our sample that pre-empted our interviews concerning the freight costs. Subsequently, we then selected a judgmental sample of 28 and independently asked employees if they had documentation to support additional freight charges incurred from FYs 2000 through 2003. Of the 28 interviewed, only one employee could produce documentation to support additional freight required. We concluded that the questioned freight costs the SAPR Team identified have merit because (1) Los Alamos acknowledged that internal control weaknesses existed in FYs 2000 through 2003 regarding freight; and (2) Los Alamos did not have documentation to support the items in our judgmental sample.

Just In Time

The SAPR Team also questioned an estimated \$800,000 of overpayments Los Alamos made to its vendors through the JIT system. Specifically, we retested the SAPR Team's Five Compliance Reviews (Review), which tested the JIT system for over payments. The SAPR team completed each Review using an Excel spreadsheet as the review tool. The spreadsheet

calculated the discrepancies for price, quantity, and special variances such as freight, returns, and restocking fee to determine if the vendor overcharged Los Alamos. Our test results revealed discrepancies consistent with the results of the SAPR Team's Reviews. Therefore, we concluded that the results of the SAPR Team reviews had merit because our results were similar and Los Alamos officials acknowledged that internal control weaknesses existed in the JIT area.

Internal Control Weaknesses

The SAPR Team's Reviews also identified internal control weaknesses related to Procurement and other areas:

Procurement Internal Control Weaknesses

- The inability to routinely monitor cost corrections at the procurement level.
- Procurement's JIT Cost Compliance "Audits" were ineffective in ensuring that JIT vendors accurately invoiced Los Alamos.
- Failure of Procurement to ensure continued performance of JIT cost compliance reviews.

Other Internal Control Weaknesses

- Transactions could not be validated because of the lack of documentation to support the JIT vendor invoice.
- Prohibited items (exclusions lists) were being purchased.
- No evidence was found that Los Alamos was adhering to *JIT Cost Compliance Review Procedures*.

Los Alamos has not addressed the issues outlined in the self-assessment reviews because of disagreements with the SAPR Team's findings. Therefore, the questioned costs and internal control weaknesses are still outstanding.

Previous Matters Not Resolved

Questioned costs previously reported by the OIG have not been resolved. Specifically, about \$14.7 million previously questioned is still outstanding but Los Alamos and the Department are currently holding discussions to resolve the costs.

- | | |
|------------------------|-----------------|
| • Audit Report IG-0596 | \$14,599,874.00 |
| • OIG Audit WR-V-02-07 | \$126,202.78 |
| • OIG Audit WR-V-97-05 | \$2,030.00 |

Los Alamos has made proposals to the Department to resolve approximately \$14.6 million of the costs previously questioned. According to the Contracting Officer, a final determination on the questioned costs is pending guidance from the National Nuclear Security Administration's Office of Financial Management.

RECOMMENDATIONS

We recommend that the Manager, Los Alamos Site Office:

1. Make a determination regarding the allowability of questioned costs, including unresolved questioned subcontract costs and those questioned by the SAPR Team;
2. Seek recovery of those costs determined to be unallowable;
3. Direct Los Alamos to provide a corrective action plan to address internal control weaknesses identified by the SAPR Team; and,
4. Resolve outstanding questioned costs previously identified by the OIG.

MANAGEMENT COMMENTS

Management generally concurred with our findings and recommendations and will review the report and make cost determinations as appropriate. Management's comments are included as Attachment B.

AUDITOR COMMENTS

Management's comments were responsive to the recommendations. Where appropriate, minor changes were made to the report.

Office of Inspector General
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