



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

Audit Report

Washington Savannah River
Company, LLC, Internal Audit
Function




Department of Energy

Washington, DC 20585

January 14, 2009

MEMORANDUM FOR THE SECRETARY

FROM:


Gregory H. Friedman
Inspector General

SUBJECT:

INFORMATION: Audit Report on the "Washington Savannah River Company, LLC Internal Audit Function"

BACKGROUND

The Washington Savannah River Company, LLC (WSRC), served as the management and operating contractor for the Department of Energy's Savannah River Site (SRS) from April 1, 1989, to July 31, 2008. In accordance with the terms of its contract, WSRC expended Federal funds for the operation and maintenance of SRS. WSRC was required to account for all funds advanced by the Department and to safeguard Government assets in its care. Also, as required by its contract, WSRC was to annually prepare a *Statement of Costs Incurred and Claimed*, which it submitted to the Department for all Federal funds expended during the year. For Fiscal Year (FY) 2007, WSRC expended and claimed \$1,420,986,556.87.

The Office of Inspector General (OIG), in coordination with the Department and its Contractor Internal Audit Council, developed and implemented a *Cooperative Audit Strategy* in October 1992 to maximize audit coverage of facility contractors, such as WSRC. As part of that strategy and under the terms of its contract, WSRC was required to maintain an internal audit function that was acceptable to the Department, based on certain specific criteria. For example, WSRC was to conduct audits in accordance with professional audit standards. These audits were designed to ensure that costs charged were allowable, allocable to the Department, and reasonable in nature. These audits, in part, place the OIG in a position to rely on WSRC audit work in evaluating the adequacy of contractor internal controls over unallowable costs. Given the significance of WSRC expenditures and in response to quality concerns that surfaced during other reviews, we initiated this effort to determine whether audits completed by the WSRC Internal Audit Department (Internal Audit) during FY 2007 met both quality and professional auditing standards.

RESULTS OF AUDIT

Our review disclosed that work performed by WSRC Internal Audit during FY 2007 was not satisfactory in several material respects. Specifically, we found instances where:

- Auditors identified procurements that were not properly approved, but Internal Audit management permitted WSRC management to provide approvals three years after-the-fact. The WSRC auditors omitted the questioned costs associated with the procurements from the audit report;



- The WSRC Internal Audit manager encouraged WSRC management to omit information that confirmed improper labor cost allocations, an internal control weakness initially identified during audit testing; and,
- After the completion of audit testing, Internal Audit management directed a staff auditor to modify the testing attribute related to independent receipt of procured goods and services – an action that caused some of the questioned costs associated with this internal control weakness to be excluded from reporting.

Our review established that, through the inappropriate modification of audit findings, Internal Audit failed to follow International Standards for the Professional Practice of Internal Auditing, as promulgated by the Institute of Internal Auditors (IIA Standards). In spite of advice and, in some instances, the documented dissent of staff internal auditors, Internal Audit management directed inappropriate changes to valid audit results. Similarly, WSRC officials were permitted to provide after-the-fact justifications and approvals for violations of various internal control procedures designed to prevent or detect unallowable costs. These actions violated professional standards related to auditor independence and objectivity; proper performance of the audit engagement; and, appropriate communication of audit results.

These problems occurred, at least in part, due to the failure of the Savannah River Operations Office to require WSRC to comply with the provisions of a required 2004 internal audit contract clause and the associated Department-promulgated Acquisition Guide. This clause, part of Acquisition Letter AL-2005-04, issued on November 2, 2004, was designed to improve the practice of internal auditing across the Department by, among other things, strengthening reporting requirements and ensuring that Chief Audit Executives reported functionally to an independent governing body such as a Board of Directors, audit committee, or equivalent independent corporate governing body. Presumably, such a reporting arrangement may have prevented Internal Audit management from modifying results in favor of WSRC. An independent reporting arrangement may have also provided internal auditors who were directed to modify findings an opportunity to record and report their dissent to such an independent body without fear of reprisal from WSRC management.

As a consequence, Federal managers at SRS were not provided with information necessary to fully comprehend the materiality of nor address and resolve internal control weaknesses. For example, one audit identified significant questioned costs, yet the questioned costs which exceeded \$900,000, were omitted from the final audit report. In this and other cases, the changes were made without adequate rationale or justification. Exacerbating these issues, even when costs were questioned, Federal officials at SRS did not always furnish Internal Audit reports to applicable Federal Contracting Officers for adjudication of questioned cost issues.

Based on issues identified in this report, we concluded that the work performed by Internal Audit in FY 2007 could not be relied on. Until these deficiencies are corrected, we are unable to assess the allowability and allocability of the over \$1.4 billion in costs

incurred and claimed by WSRC. To aid in resolution, we made a number of recommendations designed to address Internal Audit deficiencies.

MANAGEMENT REACTION

Management disagreed with certain of our conclusions. Nonetheless, it acknowledged that there were problems with questionable practices by Internal Audit management, including lack of independence and material violations of professional standards. Management proposed corrective actions that are responsive to our recommendations. Management's comments and our responses are summarized in the body of our report.

Attachment

cc: Acting Deputy Secretary
Under Secretary of Energy
Administrator, National Nuclear Security Administration
Assistant Secretary for Environmental Management
Chief of Staff
Manager, Savannah River Operations Office
Team Leader, Audit Liaison Team, CF-1.2

**REPORT ON WASHINGTON SAVANNAH RIVER COMPANY, LLC,
INTERNAL AUDIT FUNCTION**

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COMPLIANCE WITH PROFESSIONAL AUDIT STANDARDS

WSRC's Internal Audit Work

Our review disclosed that work performed by Washington Savannah River Company, LLC's, Internal Audit Department (Internal Audit) during Fiscal Year (FY) 2007 did not always comply with quality or professional standards established by International Standards for the Professional Practice of Internal Auditing as promulgated by the Institute of Internal Auditors (IIA Standards). Prior to relying on work performed by Internal Audit, generally accepted government auditing standards require the Office of Inspector General (OIG) to evaluate such work to ensure it meets quality and professional standards. As such, we conducted a review of two of the five audits completed during FY 2007, namely the *Procurement Card Audit* and the *Accounting and Control of Labor Costs Audit*, to determine whether Internal Audit had – as asserted in each of its published audit reports – complied with IIA Standards. Based on that review, we identified several material instances in which Internal Audit did not adhere to established IIA Standards related to Independence and Objectivity, Performing the Engagement, and Communicating Results.

Independence and Objectivity

Several actions taken by Internal Audit management raise concerns regarding its independence and objectivity. According to IIA Standard 1100 – *Independence and Objectivity*, the internal audit activity should be independent, and internal auditors should be objective in performing their work. However, during our review of Internal Audit's working papers, we noted certain communications to Washington Savannah River Company, LLC (WSRC), management from Internal Audit management proposing methods to reduce the severity of audit findings. For example, Internal Audit management notified WSRC management that Internal Audit had identified a significant control deficiency in approving certain procurements that had been made in FY 2004. However, WSRC management could "remedy" these deficiencies by approving the sampled procurements nearly three years after the procurements had occurred. WSRC management complied with Internal Audit management's suggestion and the questionable costs associated with the control weakness were excluded from the final report.

In another audit, we noted that Internal Audit management advised WSRC management to reword its official response because it could result in the Department of Energy's (Department) contracting officer requesting WSRC to repay the questioned costs. In conducting an audit of labor adjustments, Internal Audit

identified and questioned \$919,000 of inappropriate labor adjustments. Internal auditors delineated each of the questioned costs on a spreadsheet and requested WSRC management's preliminary response to each of the questioned adjustments. In responding, WSRC management stated that based on its analysis, \$151,000 of labor hour adjustments were inappropriate and that they wanted to meet with Internal Audit to further discuss their response. During the course of the subsequent meeting, Internal Audit management proposed that management omit from its official response any reference to WSRC management's conclusion that inappropriate labor hour adjustments were made. Further, Internal Audit management suggested that WSRC management's response not identify the amount of questioned costs agreed with or even that management had completed its review of the questioned labor adjustments. By including this information in its official response, Internal Audit management postulated that the contracting officer could have a basis to request WSRC to reimburse the Department for the inappropriate labor charges. Based on this evidence, we believe that the Internal Audit activity was not independent or objective in performing its work and that its actions were designed to prevent the reporting of questioned costs.

Performing the Engagement

In evaluating the audit working papers, Internal Audit management's direction to resolve audit exceptions appeared inappropriate and minimized the extent of questioned costs identified. IIA Standard 2300 – *Performing the Engagement*, states that internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objective and that the audit should be properly supervised to ensure objectives are achieved and quality is assured. While we found that the auditors had conducted and documented a thorough analysis and evaluation of audit evidence, Internal Audit management's direction in dealing with the anomalies identified by staff auditors appeared to be inappropriate and unjustified.

In conducting its audit of procurement cards, Internal Audit selected a statistical sample of 68 requisitions from a universe of 12,455 to test whether WSRC's internal controls over procurement cards were in place and functioning. Among the various attributes tested was whether there was evidence of independent receipt of the procured item by someone other than the card holder. Out of the sample, Internal Audit identified 10 requisitions that did not meet the established attribute. Initially, the internal auditor

projected this error rate to the universe and noted the exceptions in the working papers. In conducting a supervisory review of the work, Internal Audit management directed the attribute be modified such that the internal auditor would accept any documentation of receipt regardless of independence. Therefore, the projection of questioned costs was reduced by over 50 percent and the significance and extent of errors related to the established internal control was inaccurately reported.

Another attribute tested was whether or not procurement card transactions had been approved by someone other than the cardholder. Initial testing by the internal auditor identified 11 transactions in which evidence of approval authority by someone other than the cardholder was not properly documented. The internal auditor projected the results of this error rate to the universe. After reviewing the audit working papers, Internal Audit management allowed WSRC management to retroactively approve the procurements in order to reduce the error rate of the sample even though the procurements had occurred three years earlier. The internal auditor was then directed to accept the subsequent approval as adequate documentation that the procurements had been properly approved. Ultimately, none of the projected questioned costs, statistically projected at approximately \$991,510, were included in the audit report. Such action impacted the quality of the audit in that the report did not provide information to Federal management that would have given them an understanding of the significance of the error.

Communicating Results

Internal Audit did not clearly communicate the results of work in its issued reports. IIA Standard 2400 – *Communicating Results*, states that final communication of engagement results should, where appropriate, contain the internal auditor's overall opinion and/or conclusions and that they should be accurate, objective, clear, concise, constructive, complete, and timely. However, the audit reports we reviewed did not completely and accurately disclose the audit results identified in the working papers.

In comparing audit evidence to reported results for the procurement card audit, we found that the internal auditor identified questioned costs associated with eight audit exceptions in the audit working papers, but only a portion of the questioned costs were disclosed in the audit report. According to the audit working papers, the internal auditor questioned costs of approximately \$2 million based primarily on Federal Acquisition

Regulations (FAR) 31.201. According to FAR, costs may be considered unallowable if there are significant deviations from the contractor's established practices. The audit working papers noted an expected error rate of 0.3 percent and a tolerable error of \$90,000. Because the noted projected errors of approximately \$2 million significantly exceeded the established tolerable error rate, we believe that the error was significant enough to warrant reporting the amount to Federal management. However, the final report only identified \$308,000 of questionable costs associated with two of the eight documented audit exceptions.

Also, Internal Audit did not clearly communicate the results of its audit work related to the labor cost audit. The audit was conducted to determine whether labor costs were properly accumulated, distributed and reported. After identifying 15,803 hours of questionable labor adjustments, Internal Audit provided WSRC management with a spreadsheet for its preliminary review and comment. WSRC management responded that 2,051 hours were inappropriately adjusted. In Internal Audit's subsequent report, there was no mention or quantification of the extent or magnitude of the inappropriateness of labor adjustments. Rather, the report simply noted that certain labor hour adjustments did not appear to comply with applicable Cost Accounting Standards, WSRC's Disclosure Statement, Department Accounting Handbook, and/or WSRC contract terms and conditions.

Independence and Oversight of Internal Audit Function

Over the past two years, we have reported other weaknesses related to Internal Audit. Earlier this year, we reported that the Savannah River Operations Office (Savannah River) had not required WSRC to comply with provisions of Department Acquisition Letter AL-2005-04. Issued on November 2, 2004, the Acquisition Letter was designed to improve the practice of internal auditing across the Department. Among other things, it requires the internal audit activity to establish and report to an independent governing body such as a Board of Directors or audit committee in an effort to ensure its independence and objectivity. In this case, such an independent reporting arrangement may have prevented Internal Audit management from modifying results in favor of WSRC. An independent reporting arrangement may have also provided internal auditors who were directed to modify findings an opportunity to record and report their dissent to such an independent body without fear of reprisal from WSRC management.

The Acquisition Letter also provides assurance regarding adherence to professional standards while discussing such matters

as how WSRC will ensure that incurred contract costs are allowable under the cost principles of the contract. Our report recommended that the Department modify the WSRC contract to require Internal Audit to comply with the provisions of the Acquisition Letter. Initially, the Department concurred with the recommendation and proposed a modification to the WSRC contract. However, the Department did not incorporate this modification into the WSRC contract until August 8, 2008.

Also, in 2007, we reported that the Internal Audit function had not followed internal written procedures when performing and documenting its internal peer reviews and supervisory review of working papers. As a result, we recommended the Department direct Internal Audit to comply with established policies and procedures to ensure that supervisory review is thoroughly and sufficiently performed and documented. The Department concurred with the recommendation and indicated that corrective actions had been initiated.

Involvement of Contracting Officer

Finally, we found that Internal Audit's reports were not distributed to the Department's Contract Management Division for oversight and action. WSRC's contract requires that results of internal audits, including the working papers, shall be submitted or made available to the contracting officer. To ensure that questioned costs were resolved appropriately, Savannah River assigns responsibility for oversight of Internal Audit to both its Financial Evaluation Team and the Contracts Management Division. As such, Savannah River's *Integrated Performance Assurance Manual* notes that these organizations and other Savannah River personnel need to be cognizant of the costs being charged by the contractor and, if the costs appear to be unreasonable or otherwise questionable, the issue needs to be identified to the contracting officer for resolution.

In spite of the Savannah River policy, however, the contracting officer with cognizance over the WSRC contract told us that she had not been provided with audit reports issued by Internal Audit. Rather, the reports had only been provided to the Savannah River Financial Evaluation Team. Based on our inquiries, the Financial Evaluation Team indicated that it had not provided copies to the contracting officer. Further, we noted that Savannah River had no formalized process to ensure that those receiving Internal Audit's reports distributed them to appropriate Federal contract management personnel for action and follow-up. As a result, the Savannah River Contracts Management Division had not taken action to follow-up on questioned costs reported by Internal Audit.

Impact on Internal Controls and Allowability of Costs

As noted in the Acquisition Guide outlining the Cooperative Audit Strategy, an Internal Audit organization should provide independent, objective assurance and consulting activities. One of its primary duties is to conduct independent and objective reviews, in accordance with standards promulgated by the Institute of Internal Auditors, to assess the allowability of costs in accordance with the applicable cost principles of the contract. An independent, objective, and reliable internal audit function is therefore an essential part of the contractor's internal control function and is critical to the overall success of the Cooperative Audit Strategy. Failure to maintain an internal audit function that is satisfactory to the Department significantly increases the risk that unallowable costs will be incurred and not detected in a timely manner.

Based on issues identified in this report, we concluded that the work performed by Internal Audit in FY 2007 could not be relied on. Unless and until the deficiencies are corrected consistent with the terms of the WSRC contract, we will be unable to make an assessment of the allowability and allocability of the over \$1.4 billion in costs incurred and claimed by WSRC. To aid in resolution, we made a number of recommendations designed to address Internal Audit deficiencies, require determination of whether costs associated with the internal audit function are allowable, and whether questioned costs originally identified by WSRC internal audit, but not reported, are allowable.

RECOMMENDATIONS

We recommend that the Manager, Savannah River Operations Office:

1. Require that all contractor internal audit reports be provided to the applicable Federal Contracting official for resolution of all questioned costs;
2. Make a determination on whether questioned costs identified by Internal Audit, but not reported, are allowable;
3. Perform a review of the WSRC Allowability of Cost Audit for 2007, in accordance with generally accepted government auditing standards, to ensure that the work of Internal Audit can be relied on; and,
4. Determine whether WSRC's fee should be reduced due to deficient performance by Internal Audit during FY 2007.

**MANAGEMENT
AND AUDITOR
COMMENTS**

Overall, Management disagreed with our audit conclusion that the work performed by Internal Audit in FY 2007 could not be relied on. This opinion was based on the results of two reviews conducted by parties external to Savannah River. However, Management acknowledged that weaknesses existed within Internal Audit and provided planned actions to address these weaknesses. Specifically, Management concurred with recommendation 1 and stated that Internal Audit will be required to include distribution of all reports to the Federal Contracting official. Further, in response to recommendation 2, Management stated that the Savannah River Chief Financial Office will obtain and provide to the Federal Contracting official, all information deemed necessary to provide full disclosure and assist in the determination of allowability of costs. Additionally, in response to recommendation 3, Management stated that the Savannah River Financial Evaluation Team Leader will perform a review of the Allowability of Cost Audit for 2007 to include a general working paper review and a reconciliation of the final report to the supporting working papers. Finally, in response to recommendation 4, Management stated that the Federal Contracting official will make a determination if a fee reduction is required due to deficient performance by Internal Audit during FY 2007.

Despite Management's position that the work of Internal Audit could be relied upon, we believe that our work adequately supports our opinion. Further, the two external reviews cited by Savannah River appear to support our conclusions. For example, the review conducted by the Office of Environmental Management Consolidated Business Center determined that serious weaknesses exist with Internal Audit including questionable practices by the Internal Audit manager, lack of independence of the Internal Audit manager, appropriateness of audit reporting and the length of time it takes to complete some internal audits. A review by a Certified Public Accountant retained by WSRC to evaluate our results also concluded that certain IIA standards were not followed.

We consider Management's planned actions related to our recommendations to be responsive. The review activities contemplated by Management in response to recommendation 3 should be performed in accordance with generally accepted government auditing standards and sufficient documentation should be maintained to enable the Office of Inspector General to make an assessment of the allowability and allocability of costs incurred and claimed by WSRC during FY 2007.

Appendix 1

OBJECTIVE

The objective of this audit was to determine whether audits completed by the Washington Savannah River Company, LLC's, (WSRC) Internal Audit Department (Internal Audit) during Fiscal Year (FY) 2007 met both quality and professional auditing standards.

SCOPE

The audit was performed from March 2008 to August 2008 at the Savannah River Operations Office (Savannah River) and the offices of WSRC in Aiken, South Carolina. The scope of the audit was limited to a review of a representative sample of reports and associated working papers for audits issued by the WSRC Internal Audit during FY 2007.

METHODOLOGY

To accomplish the audit objective, we:

- Obtained and reviewed Department of Energy guidance and requirements for contractor internal audit functions, including specific WSRC contract requirements;
- Reviewed applicable standards for the professional practice of internal auditing;
- Interviewed key personnel at Savannah River; and,
- Obtained and reviewed WSRC Internal Audit reports and associated working papers.

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 work. Specifically, we reviewed the work of WSRC Internal Audit for FY 2007 to determine the extent to which the Office of Inspector General could rely upon the work and thereby avoid duplicate efforts. 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. Finally, we did not rely on computer processed data to accomplish our audit objective.

An exit conference was held with Savannah River Operations Office management on December 11, 2008.

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