OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

AUDIT REPORT

DOE-OIG-21-25 April 2021

FISCAL YEAR 2018 EVALUATION OF INCURRED COST COVERAGE AT SANDIA NATIONAL LABORATORIES

Department of Energy
Washington, DC 20585

April 9, 2021

MEMORANDUM FOR THE MANAGER, SANDIA FIELD OFFICE

SUBJECT: Audit Report on "Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories"

The attached report discusses our review of incurred cost coverage during fiscal year 2018 for selected areas at Sandia National Laboratories. This report contains four recommendations. Management did not concur with three of our four recommendations.

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

Jennifer L. Quinones
Deputy Inspector General
Office of Inspector General

cc: Deputy Secretary
Chief of Staff

DOE-OIG-21-25

Department of Energy
Office of Inspector General

Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories
(DOE-OIG-21-25)

WHY OIG PERFORMED THIS REVIEW

In 1994, the Office of Inspector General (OIG), Department of Energy officials, and internal audit directors from selected sites with management and operating contractors implemented the Cooperative Audit Strategy, which allows management and operating contractors to audit their own incurred costs. Based on recent work conducted by the OIG and concerns expressed by external stakeholders, such as the Government Accountability Office, the OIG is evaluating the Cooperative Audit Strategy. As part of that effort, the OIG commenced six audits in fiscal year 2020 to review certain contractors' incurred cost coverage of selected areas. We initiated this audit to evaluate incurred cost coverage of selected areas during fiscal year 2018 at Sandia National Laboratories (SNL).

What Did OIG Find?

We found that SNL's allowable cost audits for fiscal year 2018 did not adequately evaluate incurred costs for allowability, allocability, and reasonableness. We noted weaknesses in SNL Internal Audit's design of the audit risk assessment, sampling approach, and incurred cost reconciliation process. We also identified issues with SNL's year-end indirect rate variance disposition practice.

What Is the Impact?

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

What Is the Path Forward?

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

BACKGROUND

Since May 1, 2017, National Technology and Engineering Solutions of Sandia, LLC, a wholly owned subsidiary of Honeywell International Inc., has managed and operated Sandia National Laboratories (SNL) under contract with the Department of Energy's National Nuclear Security Administration (NNSA). SNL is a multi-program laboratory with critical national security responsibilities, which include research and production to help ensure the safety, security, and reliability of the Nation's nuclear weapons stockpile. SNL incurred and claimed costs totaling approximately $3.28 billion from October 1, 2017, to September 30, 2018, which is fiscal year (FY) 2018.

As a management and operating contractor, SNL's financial accounts were required to be integrated with those of the Department, and the results of financial transactions were required to be reported monthly according to a reciprocal set of accounts. SNL was required by its contract to account for all funds advanced by the Department annually on its Statement of Costs Incurred and Claimed (SCIC), safeguard assets in its care, and claim only allowable costs. Allowable costs are incurred costs that are reasonable, allocable, and allowable in accordance with the terms of the contract, applicable cost principles, laws, and regulations.

In 1994, the Office of Inspector General (OIG), Department officials, and internal audit directors from selected sites with management and operating contractors implemented the Cooperative Audit Strategy. The Cooperative Audit Strategy places reliance on the contractors' internal audit function to provide operational and financial audits, including allowable cost audits, as well as assessing the adequacy of management control systems. The Cooperative Audit Strategy requires that audits performed internally must, at a minimum, meet the Institute of Internal Auditors *International Standards for the Professional Practice of Internal Auditing* (IIA Standards). The OIG relies upon the contractors' internal audit activities and provides guidance to cognizant Contracting Officers, Heads of Contracting Activity, Department site managers, and cognizant Chief Financial Officers on the sufficiency of the design and operation of internal audit activities, particularly as they support the SCIC. Consistent with the Cooperative Audit Strategy, SNL was required by its contract to maintain an internal audit activity with responsibility for conducting audits, including audits of the allowability of incurred costs. Rather than perform one comprehensive audit, SNL's practice was to complete a series of audits to address the allowability of incurred costs. For FY 2018, management told us SNL's Internal Audit (Internal Audit) completed a total of eight audits related to incurred cost allowability of which we reviewed five. To assist internal audit activities, the OIG provided a sample allowable cost audit program through its OIG Audit Manual with the expectation that internal auditors would exercise professional judgment when creating an audit program appropriate for its operating environment.

The objective of this audit was to evaluate incurred cost coverage of selected areas during FY 2018 at SNL. Therefore, we did not specifically evaluate individual incurred costs for allowability, allocability, and reasonableness.[1]

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

INTERNAL AUDIT'S ALLOWABLE COST AUDITS WERE INADEQUATELY DESIGNED

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

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

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

- Internal Audit did not perform a reconciliation of the SCIC to SNL's books and records.

Costs Were Not Fully Considered in Assessing Risk and Transaction Testing

Internal Audit did not evaluate the substantial risks of indirect costs separate from direct costs in its allowable cost audits. At SNL, indirect costs of $1.45 billion accounted for about 44 percent of the $3.28 billion costs incurred during FY 2018, which was reported on the SCIC. The OIG Audit Manual, Chapter 14, *Guidelines for Contractor Internal Auditors*, includes procedures to evaluate the risks associated with direct and indirect costs. A direct cost is any cost that specifically supports a single cost objective.[2] On the other hand, an indirect cost is any cost that supports two or more cost objectives, is grouped with similar costs, and then allocated to multiple cost objectives based on relative benefits received or another equitable relationship. Accordingly, indirect costs are inherently riskier when compared to direct costs. The OIG Audit Manual, Chapter 14, also states that Internal Audit should evaluate changes in direct and indirect charging practices, changes in Cost Accounting Standards Disclosure Statements (Disclosure Statement), and fluctuations in direct and indirect labor charges, as well as verify that costs are properly classified by expense category, are consistently treated, and comply with Cost Accounting Standards. However, Internal Audit did not consider readily available indirect cost information when assessing risk or planning its transaction testing. SNL is one of the NNSA sites that had Federal Acquisition Regulation 52.216-7, *Allowable Cost and Payment*, incorporated into its contract, which required the submission of detailed indirect cost rate information. Despite the availability of this indirect cost information in FY 2018, Internal Audit stated that it was not used during planning for the cost allowability audits. In addition, Internal

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

Audit did not review adjusting entries/exception reports, review for advanced agreements, perform a comparative analysis of indirect costs with prior years and budgets, review labor mix and sensitive labor amounts, consider changes in charging direct/indirect costs, or perform testing to payment in its FY 2018 incurred cost allowability audits.

Further, Internal Audit's allowable cost audits transaction testing did not always differentiate between direct and indirect costs. For example, Internal Audit's transaction testing was at the account level (e.g., travel, accounts payable, or labor) and did not break down costs to "auditable entities," such as indirect cost pools. Internal Audit did not always perform substantive testing to ensure that indirect costs were accumulated in indirect cost pools that were homogeneous, or that pooled costs were allocated to cost objectives in a reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives, as required by Cost Accounting Standards. For instance, Internal Audit generally did not differentiate questioned costs between direct or indirect costs, evaluate whether the costs were properly burdened, or determine whether questioned costs were included in the proper allocation bases in any of the five audits related to FY 2018 incurred cost allowability.

These issues occurred for a couple of reasons. When questioned about these issues, Internal Audit stated that it followed the methodologies contained in the OIG Audit Manual. However, the OIG Audit Manual does not set forth detailed procedures for the allowable cost audit. Instead, the OIG Audit Manual makes it clear that internal auditors must exercise professional judgment and ensure procedures are applicable to their operating environment. Internal Audit also stated that it considered the risks regarding indirect costs during its annual audit planning and the individual allowable cost audits, as applicable. In FY 2018, only one of the five cost allowability audits considered indirect costs and was limited to business development costs. We do not consider that to be sufficient coverage given that indirect costs represented a significant portion of SNL's costs for FY 2018 or 44 percent of the $3.28 billion total costs incurred. As for the other items that we noted that Internal Audit did not specifically address when performing preliminary procedures to identify allowable cost audit risks, Internal Audit told us that those areas would be part of each auditable entity and were therefore considered in the annual planning risk analysis. However, we could not find documentation in Internal Audit's allowable cost audit workpapers where those items were specifically considered.

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

Internal Audit did not always perform adequate sampling in its allowable cost audits to determine whether incurred costs were allowable, allocable, and reasonable. OIG Audit Manual, Chapter 14, states that it is expected that a recognized statistical sampling methodology will be used to sufficiently reach a conclusion on the allowability of costs and permit the projection of unallowable costs. If not statistical, it states that the rationale for using judgmental sampling should be clearly documented in the auditor's workpapers. However, we noted concerns with Internal Audit's sampling methods. For example, in the five FY 2018 incurred cost allowability audits, Internal Audit did not perform statistical sampling and did not always adequately document its rationale for using other sampling methodologies. For example, in several instances, Internal Audit's sampling workpapers noted that the populations were not homogenous, but they did not explain why the data was dissimilar nor explain why homogenous populations could not be developed. We also found that Internal Audit did not always provide adequate detail in its sampling methodology workpapers. To illustrate, in one of the five audits, Internal Audit reviewed a population of 64,109 transactions totaling $71.9 million where it elected to perform a nonstatistical sample of 30 transactions or 0.05 percent of the transaction population. For that audit, Internal Audit did not identify the dollar amount of the transactions tested in the summary workpaper, and we also identified an instance where Internal Audit did not clarify the error level when sampling would be expanded. Further, for two out of the five audits, Internal Audit's transaction testing focused primarily on internal control attributes rather than cost allowability.

This occurred because Internal Audit did not follow the OIG Audit Manual when selecting and documenting its sampling approach. As mentioned previously, per the OIG Audit Manual, Chapter 14, a recognized statistical sampling methodology should be used to sufficiently reach a conclusion on the allowability of costs and permit the projection of unallowable costs; if statistical sampling is not used, the rationale for using another approach should be clearly documented in the auditor's workpapers. Internal Audit stated that it did not perform statistical sampling because it considered the sampling methodologies it used to be appropriate given the populations were not homogenous. Internal Audit also said it used data analytics to target higher risk transactions, which it considered to be more powerful than statistical sampling. However, Internal Audit did not document why it did not develop homogenous populations that would allow the use of statistical sampling nor describe its data analytics methodologies in any of the five FY 2018 incurred cost allowability audits.

Internal Audit Did Not Reconcile the Statement of Costs Incurred and Claimed to Books and Records

Internal Audit did not perform a complete reconciliation of the FY 2018 SCIC to SNL's books and records as instructed by Cooperative Audit Strategy guidance and the OIG Audit Manual. Per the Cooperative Audit Strategy, the risk assessment to determine the scope of the allowable cost audit should cover all contractor incurred costs for the year. In addition, the Cooperative Audit Strategy states that the audit should be comprehensive and performed in accordance with the audit program approved by the OIG. A sample audit program is included in the OIG Audit Manual, Chapter 14, along with additional guidance for contractor internal audit departments. In particular, Exhibit B provides a sample audit program for allowable cost reviews. Step 3a of the program states that Internal Audit should reconcile the amounts on the SCIC to the general ledger, subsidiary ledger, or trial balance. Furthermore, IIA Standards require documentation of relevant information to support conclusions and engagement results. The SCIC reconciliation would provide written evidence to support Internal Audit's representation that it covered all of the FY 2018 costs incurred and claimed.

Internal Audit stated that it did not reconcile the SCIC to books and records because it relied on another group at SNL that performed that analysis. According to the SNL Internal Audit Manager, the SNL accounting group reconciles the SCIC to books and records. However, we noted that Internal Audit did not perform any procedures to determine whether the SNL accounting group's reconciliation was reliable. Per IIA Standards, procedures evaluating competency, objectivity, and due professional care must be performed to rely on the work of others.

SANDIA NATIONAL LABORATORIES' YEAR-END VARIANCE DISPOSITION PRACTICE WAS NONCOMPLIANT WITH CAS 418

In FY 2018, SNL dispositioned its year-end indirect rate variances in a manner contrary to the requirements in Cost Accounting Standard 418, *Allocation of Direct and Indirect Costs* (CAS 418). Per CAS 418, when pre-established indirect rates are used, the costs must be allocated in reasonable proportion to the beneficial or causal relationship of the pooled costs to the cost objectives. Under CAS 418, contractors must distribute material variances to each cost objective in proportion to how the contractor previously charged those objectives. For example, if actual costs were materially more than initially recovered using the pre-established rates, each cost objective should be charged its proportionate share of the additional costs. On the other hand, if actual costs were materially less than initially recovered using the pre-established rates, then each cost objective should be repaid its proportionate share of the overpayment. In FY 2018, SNL did not review year-end variances with respect to each cost objective. Instead, SNL grouped all year-end cost variances together and determined that the costs were $5.15 million more than initially estimated. SNL then distributed the total year-end variance across open Department projects instead of allocating the costs to the initial objectives, as required by CAS 418. Therefore, closed Department projects and non-Department-funded projects, such as Strategic Partnership Projects (SPP), did not receive their proportionate share of the variance. The table below depicts the FY 2018 indirect rate variances by individual cost pool.

SNL Indirect Costs Pool Recoveries (Under)/Over* for FY 2018

Indirect Rate	Variance	Actual Pool Costs	Pool Percentage
Fringe	$ (2.03)M	$ 473.09M	0.43%
ALD 1000	$ .24M	$ 59.47M	0.42%
ALD 2000	$ .67M	$ 80.52M	0.83%
ALD 5000	$ (1.49)M	$ 74.77M	1.99%
ALD 6000	$ 0M	$ 54.00M	0.00%
ALD 8000	$ (.75)M	$ 62.79M	1.19%
Operational Overhead	$ (1.73)M	$ 753.40M	0.23%
Management Fee — Department	$ 1.14M	$ 20.37M	5.60%
Management Fee — Non-Department	$ .48M	$ 9.43M	5.12%
SPP	$ (.29)M	$ 16.80M	1.75%
General and Administrative	$ 1.45M	$ 217.26M	0.67%
LDRD	$ (1.44)M	$ 162.73M	0.89%
Legacy Allocations**	$ (1.41)M		
Total***	$ (5.15)M		

*Under-recovered indirect costs are indicated by parentheses
**Legacy allocations due to change in indirect rates
***Immaterial rounding

Per SNL's *Year-End Variance Management* policy, if an indirect rate change is needed during the year, SNL will make rate changes according to the Retro Rate Change Schedule to minimize the year-end variance. During the final week of the year-end close process, SNL performs a Year-End Variance analysis daily and sends the report to the Year-End coordinator. At year end, the spread of variance is confirmed with accounting and information technology personnel. Approval of the spread of variance is obtained from the Budget Officer, and information technology personnel run a program to spread the confirmed overall year-end indirect rate variance proportionate to open Department projects. This practice was consistent with SNL's FY 2018 Disclosure Statement, which stated that at year end, any remaining variance between costs and recoveries will be distributed through a spread of variation process to all open Department-funded projects.

According to SNL officials, this situation occurred due to accounting deadlines and materiality considerations. SNL officials agreed that the way SNL handled the disposition of the year-end rate variances was not compliant with CAS 418. The SNL officials said that SNL and NNSA had evaluated concerns regarding the indirect rate variance disposition process and suggestions for improvement in FY 2011. The SNL officials explained that due to NNSA's year-end accounting closing deadline, SNL implemented intermediate indirect rate adjustments to help mitigate the overall year-end variances starting in FY 2012. The SNL officials further stated that SNL considered the overall year-end indirect rate variance immaterial when compared to the total costs claimed. However, by focusing on materiality at the total costs claimed level, SNL did not maintain the integrity of the beneficial or causal relationship of each cost pool to its base ensuring that the final cost objectives pay only their proportionate share of indirect costs. This practice undermines the central objective of the indirect cost pool. For example, SNL netted the Department and non-Department fee pools against each other and then allocated the difference to all projects as if they benefited the same projects. Per CAS 418, SNL should have allocated the variances back to each cost objective rather than netting the variances together.

THE DEPARTMENT APPROVED A NONCOMPLIANT PRACTICE

The Department approved SNL's FY 2018 Disclosure Statement despite it containing a practice noncompliant with CAS 418. SNL's FY 2018 Disclosure Statement described its practice of netting the year-end indirect rate variances and allocating the overall year-end variance to open Department-funded projects, which did not comply with CAS 418. Yet, the Sandia Field Office Contracting Officer approved the Disclosure Statement without questioning this practice that, according to SNL officials, had been in place since 2012, or for over 8 years.

This situation occurred because the Disclosure Statement review process missed the noncompliant practice. The Sandia Field Office Contracting Officer stated that the field and NNSA Management and Budget review SNL's Disclosure Statement, identify areas of concern that must be addressed, discuss concerns with SNL, and agree on a resolution for identified areas of concern. Once resolution is complete, the Contracting Officer approves the Disclosure Statement. However, the Contracting Officer stated that the review missed this noncompliant practice.

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

As a result of the issues identified above, there is an increased risk that SNL charged unallowable costs to the Department, and SNL's FY 2018 incurred costs were improperly allocated to some of its cost objectives. Weaknesses in the design of the allowable cost audits increased the risk that SNL claimed unallowable costs because the level of testing and substantive procedures performed were adversely impacted, particularly regarding indirect costs. This is significant because SNL's indirect costs totaled $1.45 billion, or 44 percent of the total $3.28 billion costs incurred during FY 2018. Overall, the weaknesses we identified in Internal Audit's allowable cost audits design lessened the value of Internal Audit's determination that incurred costs were allowable, allocable, and reasonable.

Further, due to SNL's CAS 418 noncompliant year-end indirect rate variance disposition practice, SNL's FY 2018 incurred costs were improperly allocated to some of its cost objectives. In particular, SNL's closed Department-funded projects and non-Department-funded projects, such as SPP, did not fully receive the correct allocation of indirect costs. At the end of FY 2018, there were closed Department projects totaling $127.12 million, or 4 percent of SNL's $3.28 billion total incurred costs that did not receive the variance allocation. More concerning was that non-Department-funded projects did not receive an allocation of the variance, which accounted for $1.03 billion, or 31 percent of the total $3.28 billion SNL incurred during FY 2018. Because the Department did not identify this noncompliant practice during its review of SNL's Disclosure Statement, this practice has continued for over 8 years. Due to our limited audit scope, we did not attempt to quantify the overall impact of this practice. Finally, SNL's noncompliant practice did not recognize the requirements provided by congressional controls and SPP. Specifically, 31 U.S. § 1301(a), the purpose statute, which can be applied to indirect and direct activities, prohibits the use of appropriations for purposes other than those for which they were appropriated. Additionally, Department policies strictly regulate cost allocation for Laboratory Directed Research and Development and SPP programs.

RECOMMENDATIONS

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

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

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

3. Ensure Internal Audit completes an appropriate reconciliation, or verification of reconciliation, of the SCIC submission to books and records; and

4. Revise policies, procedures, and disclosures related to the process of year-end indirect rate variance disposition to be consistent with Cost Accounting Standards and ensure procedures recognize the individuality of congressional controls.

MANAGEMENT RESPONSE

Management nonconcurred with three of our four recommendations and disagreed with our findings. The disagreement focused on past practices that management considered acceptable and were not previously questioned by the OIG.

Management comments are included in Appendix 3.

AUDITOR COMMENTS

While management nonconcurred with three of our four recommendations, the OIG stands by its findings and has significant concerns with the manner in which Internal Audit performed its cost allowability audit risk assessment, sampling approach, and incurred cost reconciliation process. The relevance of the OIG's findings to allowability and allocability of incurred costs is clearly described in the report. In addition, the possibility of significant unallowable costs being incurred and paid by the Department is plausible given the amount of costs SNL incurred in FY 2018 ($3.28 billion) and the issues identified in the report. Therefore, the OIG continues to assert that it is necessary the recommendations in this report be implemented.

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

Where management disputes the finding regarding indirect costs by asserting it performed other reviews of indirect costs, the OIG notes that those other reviews do not necessarily test transactions for allowability, allocability, and reasonableness. Also, as discussed on page 2, Internal Audit did not differentiate indirect costs from direct costs when planning the transaction testing in its allowable cost audits.

Management disputes the finding about inadequate sampling by stating that SNL recently consulted with its Statistical Science Group, which considered Internal Audit's current sampling processes to be adequate. Since the OIG was not provided this information, the OIG cannot discern how that determination was made or whether the processes evaluated were the same as those used in the FY 2018 cost allowability audits. The OIG continues to assert that Internal Audit did not perform statistical sampling or adequately document its rationale for using other sampling methodologies during the performance of the 2018 cost allowability audits, as required by the OIG Audit Manual.

While management disputes the finding regarding the reconciliation of the SCIC by asserting that Internal Audit conducts its work against SNL's official systems of record, the OIG contends that Internal Audit must confirm that SNL's systems of record reconcile to the incurred costs claimed on the submitted SCIC.

Management agreed to develop a materiality threshold regarding the year-end rate variance. However, the OIG cautions that a materiality threshold may not be appropriate for all circumstances because every cost pool and allocation base has unique risk factors that impact materiality decisions.

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

OBJECTIVE

We conducted this audit to evaluate incurred cost coverage of selected areas during fiscal year (FY) 2018 at Sandia National Laboratories (SNL).

SCOPE

The audit was performed from October 2019 through October 2020 at SNL and the National Nuclear Security Administration's Sandia Field Office in Albuquerque, New Mexico. The audit scope included costs incurred and claimed by SNL for FY 2018. The audit was conducted under Office of Inspector General project number A20CH006.

METHODOLOGY

To accomplish our audit objective, we:

- Reviewed applicable Federal laws and regulations, United States Code, Cost Accounting Standards, Department of Energy and SNL policies and procedures, SNL contract provisions, and other legal requirements related to the audit objective.

- Interviewed Department officials and SNL personnel, including SNL's Internal Audit (Internal Audit), responsible for management and oversight of incurred costs.

- Reconciled SNL's underlying accounting system data to the amounts contained in the Statement of Costs Incurred and Claimed and compared the information to the Letter of Credit.

- Identified related-party disclosure procedures and determined whether SNL was properly disclosing related parties and following applicable procedures.

- Reviewed SNL's Cost Accounting Standards Disclosure Statements for significant cost accounting changes and assessed the adequacy of the Department's review process.

- Reviewed monthly indirect rate variance reports and evaluated disposition of the variances.

- Reviewed project cost over- and underruns, and evaluated whether direct and indirect costs were consistently charged to projects.

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

- Evaluated whether beneficial and causal pool/base relationships existed within SNL's indirect rate structure.

- Reviewed and evaluated Internal Audit's risk assessment process for preparing its annual audit plan and conducting its cost allowability audits.

- Reviewed five of the eight Internal Audit files that supported FY 2018 allowable cost audits to determine if all questioned costs had been reported.

- Reviewed and evaluated Internal Audit's performance regarding sampling, workpaper documentation, and supervisory review.

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

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We assessed internal controls and compliance with laws and regulations necessary to satisfy the audit objective. In particular, we assessed the internal control components and underlying principles significant to the audit objective. Specifically, we assessed the control environment and the underlying principles regarding establishing structure, responsibility, and authority and oversight responsibility. We also assessed monitoring and the underlying principle of performing monitoring activities. Further, we assessed control activities and the underlying principles of design control activities, design activities for information systems, and implementation of control activities. Finally, we assessed the risk assessment and the underlying principle of identifying, analyzing, and responding to risk. However, because our review was limited to these internal control components and underlying principles, it may not have disclosed all internal control deficiencies that may have existed at the time of this audit.

We assessed the reliability of SNL's FY 2018 financial cost data by reconciling underlying database information to the Statement of Costs Incurred and Claimed. We validated a portion of the database transactions by reviewing documentation supporting the data and the system that produced the data and interviewing SNL officials knowledgeable about the data. We determined that the data was sufficiently reliable for the purposes of this report.

Management officials waived an exit conference on April 2, 2021.

- Assessment Report on *Audit Coverage of Cost Allowability for Sandia Corporation, from October 1, 2015, through April 30, 2017, under the Department of Energy Contract No. DE-AC04-94AL85000* (DOE-OIG-20-48, July 2020). The assessment[3] determined that the allowable cost-related audit work performed by Sandia Corporation's (SNL), and now National Technology and Engineering Solutions of Sandia, LLC's Internal Audit for costs incurred from October 1, 2015, to April 30, 2017, could be relied upon. Based on its limited sampling, the Office of Inspector General (OIG) did not identify any material internal control weakness with allowable cost audits, which generally met the *Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing* prescribed by the Institute of Internal Auditors. Further, SNL's Contract Audit Department had conducted or arranged for audits of subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor. The OIG observed that SNL's Internal Audit identified $372,311 in questioned costs in audits performed from October 1, 2015, to April 30, 2017, which had been resolved and reimbursed to the Department of Energy. While the OIG did not identify any material internal control weaknesses with either cost allowability or subcontract audit, the OIG questioned $6,755,738 in unresolved questioned costs identified by SNL's Contract Audit Department. The OIG made three recommendations to address the issues identified.

- Assessment Report on *Audit Coverage of Cost Allowability for Sandia Corporation During Fiscal Years 2014 and 2015 Under Department of Energy Contract No. DE-AC04-94AL85000* (DOE-OIG-19-24, March 2019). The assessment[4] determined that, SNL's Internal Audit allowable cost-related audit work from fiscal years (FY) 2014 through 2015 could be relied upon. Further, SNL's Contract Audit Department had conducted or arranged for audits of subcontractors when costs incurred were a factor in determining the amount payable to a subcontractor. SNL Internal Audit identified $127,636 in questioned costs in FY 2014 and $4,802 in FY 2015, which had been resolved and reimbursed to the Department. While the OIG did not identify any material internal control weaknesses with either cost allowability or subcontract audit, it questioned $183,928 of unresolved questioned costs identified by SNL's Contract Audit Department in FY 2014 and $211,285 in FY 2015, which remained unresolved as of February 2018. The OIG reported these unresolved costs in FY 2014 and 2015 as absolute values, while in previous years it reported those costs as a net amount. The OIG chose to use absolute values instead of a net amount because it gave a more accurate picture of all costs that were questioned by SNL. In addition, the OIG reported $2,459,152 in FY 2014 and $2,728,702 in FY 2015 in home office expenses, which remained unresolved as of February 2018 because these costs were pending Defense Contract Audit Agency's audit of the parent corporation, Lockheed Martin Corporation. Further, the OIG reported on prior questioned and unresolved costs. Specifically:

    - $16,487,033 in unresolved potential overpayments of New Mexico gross receipts tax, which remained unresolved at the time of the OIG's review;

---

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

[4] Ibid.

- $20,852 in unresolved SNL Contract Audit Department findings from FY 2012 through FY 2013, which remained unresolved as of February 2018; and

- $6,982,097 in unresolved home office expenses from FY 2011 through FY 2013 that were included in the OIG's previously issued audit report (OAS-V-15-03, September 2015) and remained unresolved as of September 2018 while either undergoing or pending the Defense Contract Audit Agency's audit.

The OIG made two recommendations to address the issues identified.

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

April 05, 2021

MEMORANDUM FOR TERI L. DONALDSON
INSPECTOR GENERAL

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

SUBJECT: Response to the Office of Inspector General Draft Report *Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories* (A20CH006)

Thank you for the opportunity to review and comment on the subject draft report. The Office of Inspector General (OIG), implemented the Cooperative Audit Strategy in October 1992, which shifted significant cost and responsibility to the Department of Energy and its Management and Operating Contractors (M&Os) to assist the OIG in fulfilling its responsibility for auditing the costs incurred by the Department's major facilities contractors. Since that time, Sandia National Laboratories (SNL) and our other M&Os have consistently demonstrated compliance with Institute of Internal Auditors (IIA) standards and a unique understanding by their internal audit teams of operations, risk, and materiality, in designing and implementing audit programs to effectively and efficiently evaluate the allowability, allocability, and reasonableness of costs paid by the Government. We respectfully disagree with the report's conclusion that SNL's allowable cost audits for fiscal year 2018 did not adequately evaluate incurred costs, potentially resulting in significant amounts of unallowable costs being charged to the Department and going undetected.

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

Finally, in sharp contrast to the current report's conclusion, OIG work conducted over the past 28 years (with the most recent report issued in July 2020) and independent peer reviews, have consistently confirmed that SNL Internal Audit adheres to appropriate professional standards when conducting audits, as required by their contract. SNL's 2018 incurred cost audits followed substantially the same rigorous audit program as in prior years. The current draft report generally reflects subjective conclusions about audit methods that are contradictory to SNL's formal risk assessment and not required by IIA Standards. The conclusions are also not supported by a structured risk assessment by the OIG auditors, or sufficient audit work to demonstrate a deficiency in the effectiveness of the SNL's audit program. Further, the issues raised in the report generally lack materiality or relevance to overall allowability and allocability of costs, and there is no credible, objective evidence of any non-compliance with IIA Standards or other validated risks, to warrant this sudden change in evaluation of SNL's 2018 audit program as inadequate.

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

Attachment

Attachment

NATIONAL NUCLEAR SECURITY ADMINISTRATION
Management Decision

Fiscal Year 2018 Evaluation of Incurred Cost Coverage at Sandia National Laboratories (A20CH006)

The Office of Inspector General (OIG) recommended that the Manager, Sandia Field Office (NA-SN), work with the Department and Sandia National Laboratories to address the following:

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

Management Response: Non-concur. As noted in the cover memorandum for this decision, this recommendation is overly broad and linked to the general unsupported conclusion that Sandia National Laboratories' (SNL) allowable cost audits for fiscal year (FY) 2018 did not adequately evaluate incurred costs, potentially resulting in significant amounts of unallowable costs being charged to the Department and going undetected. To support this conclusion, the report takes exception to two primary audit activities relating to: a) consideration of indirect costs in the testing program; and b) selected use of non-statistical sampling techniques. As these approaches have been transparent to the OIG in their prior reviews, which have not previously questioned these practices, it is clear that this represents a new proposed or preferred approach by the OIG, and not a deficiency or unaddressed risk in the audit program. Further, the report provides no analysis or additional audit work to support the claim that significant unallowable cost may go undetected under the current approach, nor that there is a potential cost benefit to the suggested additional audit work. All evidence supports a conclusion that SNL's audit program is adequate and complies with applicable professional audit standards. Should requirements change, or if future audit work by the OIG validates that their preferred method would be effective and cost beneficial in identifying additional unallowable costs, NNSA will re-evaluate the recommendation.

Regarding indirect costs, the report's statement that Internal Audit did not evaluate the risks of indirect costs separate from direct costs in its allowable cost audit is inaccurate. Internal Audit considers all costs, including direct and indirect, during its annual planning risk assessment. "Indirect Rates" is an auditable area in SNL's audit universe and is part of the annual risk assessment. Although not always part of the incurred cost audit for a specific year, Internal Audit has audited this area 3 of the past 4 years. For example, in FY 2018 Internal Audit performed an audit titled "Charging Accuracy: Financial Model Simplification" because Sandia changed their entire indirect burden model. The purpose of the audit was to determine whether Sandia's financial model simplification was being adhered to for charging accuracy. Appropriate design and execution of allowable cost audits are dependent on each individual audit risk assessment and based on auditor professional planning and evaluation. SNL will continue to perform audits of indirect costs when appropriate based on risk assessment. The next audit in the indirect rate area will be conducted in FY 2021.

Attachment

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

Management Response: Non-concur. NNSA disagrees with the report's conclusion that Internal Audit did not always perform adequate sampling. Most of the OIG observations regarding sampling represent the auditors' preferences on how the audit may have been conducted, not deficiencies in the applied methodology. The guidance suggested in the OIG Audit Manual recognizes and addresses both statistical and other sampling methods to sufficiently reach a conclusion on the allowability of costs, noting that if statistical sampling is not used, the rationale for using another approach should be clearly documented in the auditor's workpapers. Internal Audit met with Sandia's Statistical Science Group in February and March 2020 to review Internal Audit's sampling approach. The Statistical Science group confirmed that current processes and methodologies were adequate to ensure the reliability of audit results. While we agree that documentation can be further enhanced in some instances, the level of occurrence and overall impact on reliability of the audit work are minimal. To support easier auditability, the Internal Audit Group did update sampling methodology documents and forms to ensure all required documentation is included in one workpaper. These documents are currently in review and expected to be finalized by June 30, 2021.

Recommendation 3: Ensure Internal Audit completes an appropriate reconciliation, or verification of reconciliation, of the Statement of Costs Incurred and Claimed (SCIC) submission to books and records.

Management Response: Non-concur. The primary purpose of the SCIC is to provide a high level presentation of the costs incurred and claimed by the contractor for the year, and provide a place to capture required signatures and certifications regarding those costs. Internal Audit conducts its audit work against the contractor's official systems of record – Not the SCIC. There is no requirement that Internal Audit perform a reconciliation of the SCIC submission to books and records. The OIG's non-mandatory guidance includes a suggested step to reconcile the amounts on the SCIC to the general ledger, subsidiary ledger, or trial balance, and also explicitly emphasizes that the suggested steps are general guidance and should be expanded or eliminated as necessary to fit the contractor's audit environment and risk assessment. At SNL, a reconciliation has historically been performed by the accounting department when submitting the SCIC. Additionally, Internal Audit periodically performs additional audit work on SCIC reconciliation based on assessed risk. For example, Internal Audit performed a SCIC reconciliation audit for costs incurred in FY 2017, the results of which did not support the need for an additional review in FY 2018. Internal Audit will continue to evaluate the business and risk case and perform annual SCIC reconciliations when appropriate. NNSA considers this recommendation closed.

Recommendation 4: Revise policies, procedures, and disclosures related to the process of year-end indirect rate variance disposition to be consistent with Cost Accounting Standards and ensure procedures recognize the individuality of Congressional controls.

Attachment

Management Response: Concur. While this issue has no material impact on the overall reliability of the incurred cost audits, in collaboration with NNSA, SNL will initiate discussions to develop a reasonable materiality threshold for year-end indirect variance and, once agreed upon, determine appropriate timing for necessary practice changes. This will include benchmarking peers to identify best practices in year-end rate variance disposition; studying and developing options for rate variance spreads by pool and projects; and developing and testing identified practice enhancements. Policies, procedures, and disclosure relating to the process of indirect rate variance disposition will be revised and implemented for fiscal year end 2022.

Estimated Completion Date: September 30, 2022

FEEDBACK

The Office of Inspector General has a continuing interest in improving the usefulness of its products. We aim to make our reports as responsive as possible and ask you to consider sharing your thoughts with us.

Please send your comments, suggestions, and feedback to OIG.Reports@hq.doe.gov and include your name, contact information, and the report number. You may also mail comments to us:

Office of Inspector General (IG-12)
Department of Energy
Washington, DC 20585

If you want to discuss this report or your comments with a member of the Office of Inspector General staff, please contact our office at 202–586–1818. For media-related inquiries, please call 202–586–7406.