



OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

AUDIT REPORT

DOE-OIG-20-02

October 2019

**BATTELLE ENERGY ALLIANCE, LLC
COSTS CLAIMED UNDER DEPARTMENT
OF ENERGY CONTRACT NO. DE-AC07-
05ID14517 FOR FISCAL YEAR 2016**



Department of Energy
Washington, DC 20585

October 21, 2019

MEMORANDUM FOR THE DEPUTY CHIEF FINANCIAL OFFICER
MANAGER, IDAHO OPERATIONS OFFICE

A handwritten signature in cursive script, appearing to read "Teri L. Donaldson".

FROM: Teri L. Donaldson
Inspector General

SUBJECT: INFORMATION: Audit Report on "Battelle Energy Alliance, LLC
Costs Claimed under Department of Energy Contract No. DE-AC07-
05ID14517 for Fiscal Year 2016"

BACKGROUND

Since fiscal year (FY) 2005, Battelle Energy Alliance, LLC (BEA) has managed and operated the Idaho National Laboratory under a 20-year contract with the Department of Energy valued at \$17.18 billion. The Idaho National Laboratory is part of the Department's Office of Nuclear Energy.

As a management and operating contractor, BEA's financial accounts are integrated with those of the Department, and the results of transactions are reported monthly. BEA is required by contract to account for all net expenditures accrued annually on its Statement of Costs Incurred and Claimed, to safeguard assets in its care, and to claim only allowable costs. During FY 2016, BEA incurred costs totaling \$972,328,027.31. BEA is required to comply with the Department's Cooperative Audit Strategy, under which BEA internal auditors perform audits of the contractor, including the annual audit of costs claimed on the Statement of Costs Incurred and Claimed, also referred to as the annual incurred cost audit.

In recent years, the Office of Inspector General (OIG) began selecting one management and operating contractor to test the effectiveness of the internal audit group's annual incurred cost audit. This is accomplished by performing the annual audit in place of the internal audit group. For FY 2016, we selected BEA. The objectives of our audit were to determine if the FY 2016 incurred costs were allowable, allocable, and reasonable in accordance with the terms of the contract, applicable cost principles, laws, and regulations, and to assess BEA's internal audit work for the annual incurred cost audit.

RESULTS OF AUDIT

Based on our audit, we identified BEA practices that were not compliant with Cost Accounting Standards (CAS). We also identified other issues for which we were not always able to quantify

the full monetary impact, and weaknesses in BEA's Internal Audit (Internal Audit) audit procedures. For FY 2016, we questioned \$17.66 million of positive (over-recovered) funds and \$8.4 million of negative (under-recovered) funds from year-end indirect cost pool variances. We also questioned \$11,176 of Laboratory Directed Research and Development burdens. In particular, the CAS noncompliant practices and other issues we identified included:

- The disposition of year-end indirect cost pool rate variances – CAS 418 noncompliant;
- Charging year-end direct labor rate variances as indirect costs – CAS 402 noncompliant;
- Lack of indirect cost burden for unallowable costs – CAS 405 noncompliant;
- Allocation of travel and associated labor costs – BEA policy noncompliant; and
- Allocation of certain indirect rates – incorrect application.

These issues occurred because BEA did not properly follow contract terms and conditions, including the Federal Acquisition Regulation and CAS, and did not sufficiently adhere to internal policy.

Also, for areas where Internal Audit had provided audit coverage in FY 2016, e.g., subcontract costs, we reviewed a sampling of its work to determine whether we could rely on the audit work in lieu of performing our own testing. Based on our review, we determined Internal Audit's work could be relied upon in the select areas reviewed and identified minor additional questioned costs of \$8,013.

We identified areas that require improvement by Internal Audit. The audit procedures used by Internal Audit did not identify certain CAS noncompliant issues in BEA's cost accounting and management practices. We consider these areas to be fundamental for proper accounting of costs on government contracts. In particular, we noted that BEA's year-end variance distribution practices and use of direct labor variances were not compliant with CAS. When we discussed our concerns with Internal Audit, we learned that, in 2014, Internal Audit performed a "consulting engagement" related to BEA's draft Variance Distribution Guidelines (Guide) at the request of BEA management. We performed a review of this engagement and observed that Internal Audit's review of the Guide identified no concerns or weaknesses.

However, when we examined Internal Audit's "consulting engagement" in detail, we identified a number of concerns. First, we concluded that Internal Audit exhibited poor judgment by accepting the request as a "consulting engagement" rather than as an assurance engagement. Specifically, under guidelines promulgated by the Institute of Internal Auditors, a "consulting engagement" only involves two parties, Internal Audit and management. In contrast, an assurance engagement involves these two parties plus a third party – outside stakeholders who have an interest in and a need to rely upon the work of Internal Audit. Professional auditing standards suggest that when third party stakeholders have a need to rely upon Internal Audit's work, the work should be structured and planned as an assurance engagement. We concluded that, in this instance, Internal Audit should have known that the Guide could affect indirect cost

pools which, in turn, could impact allowability of incurred cost. The Internal Audit Director should have concluded that both the Contracting Officer and the OIG commonly rely upon all work performed by Internal Audit relating to issues affecting incurred costs, and therefore, should have taken the needs of these stakeholders into account when accepting the request to review the Guide and planning this review. Second, when we reviewed the “consulting engagement” work that Internal Audit performed on the Guide, we concluded that Internal Audit did not comply with its policies or with professional internal auditing standards in the following areas: Planning, Performing the Engagement, Supervision, Communication, Due Professional Care, and potentially Independence. Also, we note that Internal Audit’s shortcomings may have contributed to the material noncompliance associated with Finding 1 of this report. Accordingly, we are recommending certain corrective actions and additional oversight to ensure that these problems do not recur.

Finally, we identified concerns in our testing of BEA’s joint appointment agreements. Although we did not make a formal recommendation for this area, we suggested that BEA take steps to strengthen its formal policies and training procedures.

MANAGEMENT RESPONSE

Management partially concurred with the report’s findings and recommendations. Specifically, management concurred with Recommendations 3, 4, 5, 6, 7, and 8, and partially concurred with Recommendations 1, 2, and 9.

To address Recommendation 3, management stated that BEA had implemented policy changes related to cost pool variances. In addition, BEA adjusted cost pool variances that arose during FY 2018 and took similar interim actions to adjust several cost pool rates during FY 2019. To address Recommendation 4, management will require BEA to prepare program cost impact analyses for all recent fiscal years where indirect cost pool variances existed. To address Recommendation 5, management will ensure recovery of all questioned costs deemed unallowable. To address Recommendation 6, 7, and 8, management will direct BEA to modify policies and procedures to strengthen internal controls over indirect allocations, travel and labor costs, and material and subcontract handling costs.

Management partially concurred with Recommendation 1 because it stated the responsibility for oversight of contractors’ indirect cost management, and compliance with CAS, is inherent with the authorities of a Contracting Officer. In addition, Field Chief Financial Officers assist the Contracting Officer with CAS compliance, within the requirements of Department of Energy Order 520.1A, (*Chief Financial Officer Responsibilities*) and Department Order 523.1, (*Financial Management Oversight*). Management will provide Field Chief Financial Officers with this report and assess the adequacy of its policy for contractors’ CAS disclosure statements, including specific information on indirect rate variance management.

Management partially concurred with Recommendation 2 because it, along with BEA, determined that there would be no material cost impact to any one of the Idaho National Laboratory’s largest 30 programs, and concluded that the cost and effort necessary to make the adjustments exceeded any benefit. In addition, management acknowledged that BEA did not

reduce all indirect cost pool variances to zero by distributing them back to programs as originally allocated. Furthermore, management understands that several cost pools were, arguably, unreasonably out of balance, but accepted BEA's conclusion to make no adjustments because BEA's indirect cost pools are highly related. Moreover, management stated that BEA's decisions were not due to a misunderstanding of, or disregard for, CAS; nor inadequate oversight; and not due to any reason other than the determination that any impact to program costs was immaterial. Finally, at management's request, BEA implemented policy changes, which fully addressed the disposition of indirect cost pool variances; including adjusting its FY 2018 cost pool variances and several FY 2019 indirect cost pools.

Management partially concurred with Recommendation 9 because it considered our concern about how Internal Audit conducts an engagement to be a difference in professional opinion. To address the recommendation, management will direct BEA to modify policies and procedures to strengthen internal controls over Internal Audit functions after reviewing the results of an upcoming external peer review.

Management's comments are generally responsive to our concerns and we are pleased with the intended actions. However, in regards to management's partial concurrence with Recommendation 2, the comments were not responsive for several reasons. First, management did not address our recommendation to make a determination regarding the CAS noncompliant issues, related to the year-end indirect rate variances and average labor rates, identified in our report. Second, our report found that BEA did not adhere to the fundamental CAS 418 requirement to maintain the relationship of indirect cost variances at the pool level. In its response, management addressed our finding from the perspective that there was no material cost impact at the program level, which is different and distinct from our finding. Nonetheless, management acknowledged that because of Finding 1 in this report, BEA had adjusted its indirect cost variances at the pool level for FYs 2018 and 2019. This action indicates that BEA was noncompliant with CAS 418 and needed to make those changes to address the issue. Finally, management's response did not address the parts of the recommendation regarding legal issues associated with BEA's additional pension fund contribution and its use of LDRD funds for non-related LDRD work.

Regarding management's partial concurrence with Recommendation 9, we are pleased that management will direct BEA to strengthen its Internal Audit function. However, management's response did not address all areas of the recommendation. Specifically, our recommendation included requiring Internal Audit to implement a corrective action plan to address the CAS noncompliance issues identified in this report. In addition, we relied upon extensive criteria from professional standards and Internal Audit's policy to demonstrate our concern with Internal Audit's management of its "consulting engagements." Nonetheless, management did not state how it will address our recommendation to review Internal Audit's prior years "consulting engagements" where third parties would reasonably rely upon its work. Conversely, to address our recommendation, management plans to rely upon an external peer review to identify potential areas where Internal Audit could improve. However, an external peer review will not address the CAS noncompliance issues identified in this report. An external peer review's primary purpose is to ensure Internal Audit is adhering to the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing.

Finally, we discussed with management our concerns about its partial concurrence with Recommendations 2 and 9. Management stated it is fully committed to addressing the report's recommendations and ensuring BEA becomes more compliant with CAS as mentioned in this report. In addition, management stated that BEA now assesses rate variance materiality at the pool level. Furthermore, management stated that a legal analysis of the additional pension contribution and BEA's use of LDRD funds would occur. Management also stated it is concerned with Internal Audit's independence and that it intends to work with Internal Audit to make improvements to its processes.

Attachment

cc: Deputy Secretary
Chief of Staff
Under Secretary of Energy

**BATTELLE ENERGY ALLIANCE, LLC COSTS CLAIMED
UNDER DEPARTMENT OF ENERGY CONTRACT NO.
DE-AC07-05ID14517 FOR FISCAL YEAR 2016**

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BATTELLE ENERGY ALLIANCE, LLC COSTS CLAIMED UNDER DEPARTMENT OF ENERGY CONTRACT NO. DE-AC07-05ID14517 FOR FISCAL YEAR 2016

DETAILS OF FINDINGS

Based on our audit, we questioned funds remaining from fiscal year (FY) 2016 year-end indirect cost pool rate variances and average labor rate variances of \$17.66 million of positive (over-recovered) and \$8.4 million of negative (under-recovered) variances due to Battelle Energy Alliance, LLC (BEA) practices that were not compliant with Cost Accounting Standards (CAS). In particular, we found that BEA's disposition of year-end rate variances was not compliant with CAS 418, *Allocation of Direct and Indirect Costs*, and that its use of year-end direct labor rate variances was not compliant with CAS 402, *Consistency in Allocating Costs Incurred for the Same Purpose*. We also questioned \$11,176 of Laboratory Directed Research and Development (LDRD) burdens as noncompliant with CAS 405, *Accounting for Unallowable Costs*. In addition, we identified where BEA was noncompliant with its internal policy for properly allocating travel and associated labor costs, for which we were not able to quantify the full monetary impact. Furthermore, we identified areas where BEA improperly allocated certain indirect rates to legal and leased employee costs. BEA's Internal Audit (Internal Audit) had not previously reported on these issues.

Also, for areas where Internal Audit had provided audit coverage in FY 2016, we reviewed a sampling of its work to determine whether we could rely on the audit work in lieu of performing our own testing. Based on our review, we determined that Internal Audit's work could be relied upon in the select areas reviewed and identified minor additional questioned costs of \$8,013.

Furthermore, we identified areas that require improvement by Internal Audit. The audit procedures used by Internal Audit did not identify BEA's practices that we determined were noncompliant with CAS. We consider the correct application of these practices to be fundamental for proper accounting of costs on government contracts.

Finally, we identified concerns with BEA's management of joint appointment agreements. We found that BEA followed an inconsistent approach for validating work products, did not have sufficiently detailed invoices to validate associated labor and benefit charges, and had not properly reviewed travel costs. Although we did not make a formal recommendation for this area, we suggested that BEA take steps to strengthen its formal policies and procedures.

Finding 1: Disposition of Indirect Rate Variances

We found that BEA's disposition of indirect cost pool rate variances and average labor rate variances (rate variances) was not compliant with CAS 418. In particular, BEA managed rate variances in a manner that did not dispose of material rate variances by allocating the variances to cost objectives in proportion to its budgeted rates. Specifically, at year-end, five of BEA's

indirect cost pools showed a combined \$17.66 million positive (over-recovered) rate variance, as listed below. BEA used the accumulated positive variances to fund other unrelated indirect costs, such as BEA’s pension plan.

Rate	Variance	Actual Pool Costs	Variance Percentage of Pool Costs	Department Participation in Base ¹
Average Labor Rates	\$3.55M	\$338.3M	1%	75.68%
Leave	\$1.12M	\$55.77M	2%	75.68%
Organizational Management	\$2.08M	\$86.81M	2%	72.01%
Laboratory Directed Research and Development (LDRD)	\$4.99M	\$17.82M	28%	72.74%
Other Cost Pools	\$5.92M	\$122.12M	5%	Various
Total Variance	\$17.66M			

Rather than disposing of the positive rate variances within the related indirect cost pools, BEA chose to spend some of the over-recovered rate variances on unrelated Common Support and General and Administrative (G&A) cost pools. By doing so, the Common Support and G&A rates then showed under-recovered rate variances, as listed below.

Rate	Variance	Actual Pool Costs	Variance Percentage of Pool Costs	Department Participation in Base
Common Support	(\$6.77M)	\$148.28M	5%	71.51%
General and Administrative (G&A)	(\$1.63M)	\$155M	1%	71.50%
Total Variance	(\$8.4M)			

Additionally, BEA transferred \$9.26 million to the unrelated Fringe pool as a pension contribution. The pension contribution was in addition to the amount BEA had already factored into its Fringe rate for FY 2016 and represented a contribution above the required Employee Retirement Income Security Act minimum.

This practice did not comply with the beneficial or causal relationship between the final cost objective that contributed to the indirect cost and the final cost objective that benefitted from the actual costs, and was contrary to the practices described in BEA’s CAS Disclosure Statement. CAS 418-40, *Fundamental Requirements*, paragraph (c), requires pooled indirect costs to be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives.² CAS 418-50, *Techniques for Application*, paragraph (g)(4), requires that when variances are material, these variances are to be disposed of by allocating the cost to cost objectives in proportion to the costs previously allocated to the cost objectives using

¹ The percentages listed in this column reflect the amount of overall Department of Energy funding and not specific percentages by program offices.

² CAS 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 to processes, products, jobs, capitalized projects, etc.

the budgeted rates. In our opinion, a reasonable person would conclude that the absolute dollar value of BEA's year-end rate variances listed in this report are material. Accordingly, to comply with CAS 418, BEA was required to allocate the variances back to the cost objectives, rather than using the over-recovered funds to pay for other expenditures, such as contributing additional funds to the pension fund. Certainly, an extra contribution of \$9.26 million to the pension plan should be considered a material amount.

Furthermore, we are particularly concerned with \$4.99 million of over-recovered LDRD funds that BEA recovered under special legal authorities unique to the Department's LDRD program, but spent on costs other than their required purpose. Specifically, BEA recovered \$22.8 million of LDRD funds through an indirect charge to all BEA programs, both Department funded and non-Department funded. LDRD funds are authorized using special legal authorities that are administratively codified in Department Order 413.2C, *Laboratory Directed Research and Development*, which stipulates that these funds must be used for projects in the forefront areas of science and technology relevant to the Department's mission. Moreover, all projects receiving LDRD funding must receive concurrence from the Department. In its 2016 Annual Summary Report, BEA reported that it used \$17.8 million for 71 LDRD projects, but BEA did not report that it recovered \$22.8 million in its LDRD indirect cost pool and used \$4.99 million for other unrelated indirect costs, such as additional pension fund expenses or site infrastructure projects. We noted that Department Order 413.2C specifically forbids LDRD funds to be used to "fund general purpose capital expenditures." Further, we found no written concurrence from the Department to use LDRD funds in this manner.

Internal Control Weaknesses

This occurred because BEA and the Idaho Operations Office lacked sufficient internal controls to ensure adherence with CAS requirements. Specifically, BEA's Variance Distribution Guidelines (Guide) did not sufficiently adhere to CAS 418 requirements, and the Idaho Operations Office did not provide sufficient oversight of BEA's variance management practices to ensure compliance with CAS 418 requirements.

Variance Distribution Guidelines

We attributed this problem to weaknesses in BEA's Guide, which did not sufficiently adhere to CAS 418 requirements and did not reflect the practices described in BEA's Disclosure Statement. Specifically, the Guide did not address the fundamental requirement of CAS 418 to maintain the beneficial or causal relationship between the indirect cost pools and final cost objectives. For example, rather than disposing of year-end variances in a manner that maintains that relationship, the Guide promotes the disposal of variances by netting the unrelated pool costs with one another.

In addition, the Guide was inconsistent with BEA's disclosed indirect rate practices regarding the beneficial or causal relationship between the final cost objectives paying the indirect costs and the final cost objectives receiving the benefit. For example, BEA's CAS Disclosure Statement described its adherence with the CAS 418 requirement to establish homogenous indirect cost

rates that have an allocation base, which allocated costs to final cost objectives in proportion to the beneficial or causal relationship reflected by the pooled costs. Thus, BEA's CAS Disclosure Statement established an indirect rate structure that was intended to comply with the fundamental requirements of CAS 418. However, we found that BEA deviated from its disclosed CAS practices by netting over-recovered and under-recovered rate variances.

Dispositioning of rate variances within the pool maintains the integrity of the beneficial or causal relationship of each pool to its final cost objective base, ensuring that the final cost objectives pay only their proportionate share of BEA's indirect costs. It also "trues-up" or matches indirect costs recovered through pre-established indirect rates to the actual year-end indirect costs incurred.

Finally, as written, the Guide is focused on supporting rate stability for project management purposes and materiality at the final cost objective level. With a focus on rate stability, BEA overlooked the CAS 418 requirements for pre-established rates to be adjusted to reflect anticipated conditions. Instead, BEA held its rates at the same levels throughout the year, despite being aware that significant over-recoveries were accumulating. In addition, rates were not adjusted to reflect the significant under-recoveries that BEA anticipated would accumulate by year-end. The accumulation of significant variances, both positive and negative, was acceptable to BEA because it achieved rate stability.

While a focus on rate stability may be a valid business operating goal, such a focus does not justify deviations from the fundamental requirements of CAS 418.

Idaho Operations Office Oversight

We also attributed this problem to weaknesses in Federal oversight of BEA's rate variance management practice for CAS 418 compliance. In particular, the Idaho Operations Office had been aware of BEA's Guide but had not challenged its application. Furthermore, the Idaho Operations Office did not require that BEA demonstrate that the year-end rate variances were not material, as required in CAS 418-50, *Techniques for Application*, paragraph (g)(4).

When we spoke to the Idaho Operations Office regarding our concerns, Idaho Operations Office financial services personnel informed us that it was aware of BEA's practice of accumulating large rate variances before year-end. In addition, it was aware that BEA disposed of those variances by netting over-recovered and under-recovered variances together and costed any remaining positive variance as a pension contribution. Idaho Operations Office's acceptance of BEA's practices was also focused more on the aspects of rate stability and materiality as discussed in the Guide, rather than ensuring the beneficial or causal relationship within the indirect rates was maintained. Furthermore, the Idaho Operations Office valued the practice because it provided an opportunity to increase the stability of its pension obligations. According to Idaho Operations Office financial services personnel, the Department reasoned that, while BEA's rate variance management practice was not in strict compliance with CAS, it was sufficiently within the bounds of CAS, met the intent thereof, and was acceptable. However, augmenting pension fund contributions by knowingly accumulating over-recovered funds from

the indirect cost rates, including statutorily restricted LDRD funds, circumvented the requirements of contract terms and CAS, and did not reflect a prudent use of government funding.

Impact

As a result, we questioned \$17.66 million of positive (over-recovered) rate variances and \$8.4 million of negative (under-recovered) rate variances that had accumulated by the end of FY 2016 as misallocated and non-compliant with CAS. According to Federal Acquisition Regulation (FAR) 31.201-2, *Determining Allowability*, costs are only allowable when, among other items, they are compliant with CAS requirements. Of the \$17.66 million of positive rate variances, \$4.99 million was for LDRD funds, which has special legal authorities, and we concluded that this \$4.99 million was not used in an approved manner.

In addition, BEA's rate variance management practice could lead to a loss of customer confidence in its indirect rate structure and non-Department customers may have paid a disproportionate share of BEA's costs without receiving the associated benefit. Overall, non-Department customers funded about 27 percent of the work performed at the Idaho National Laboratory in FY 2016.

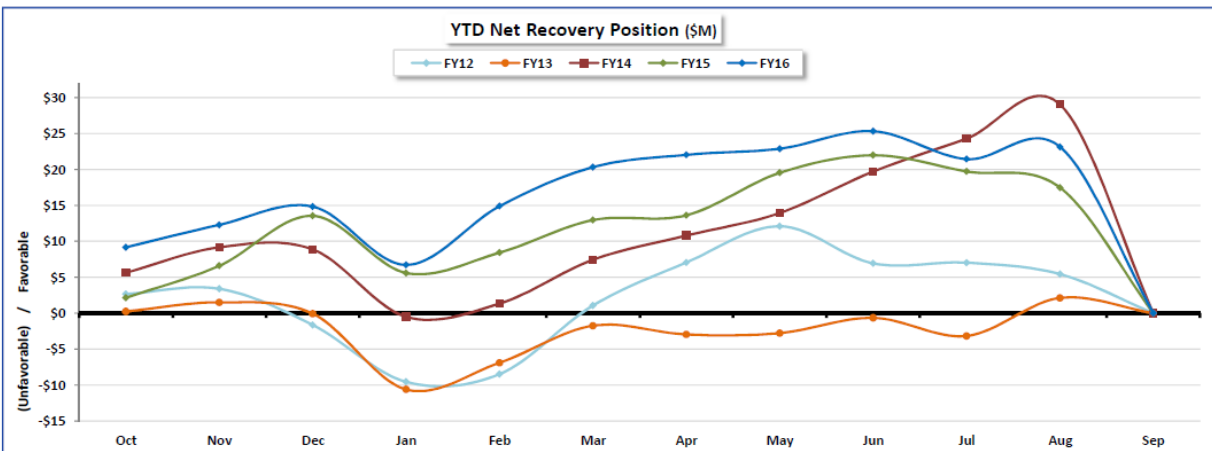
We discussed our concerns with Idaho Operations Office financial services personnel, who agreed that BEA did not strictly dispose of all rate variances by allocating them back to cost objectives in the same proportion to how they were originally allocated. Additionally, Idaho Operations Office financial services personnel informed us that BEA modified its Guide and practices in FY 2018 to substantially reduce the tolerable rate variance thresholds for individual indirect cost pools to address the auditor's concerns. Nonetheless, for FY 2016, the Idaho Operations Office concluded that there was *de minimus* net cost impact, about 0.3 percent, when compared to total program cost. Based on this, Idaho Operations Office concluded that pooled costs met the "reasonable proportions" requirement of CAS 418.

However, we disagree with the materiality position. Specifically, the Idaho Operations Office's analysis considered the cost impact compared to total program costs only after BEA's decision to spend over-recovered rate variances on unrelated indirect cost pools, which is inappropriate. Also, additional legal analysis is needed to ensure that BEA's use of rate variance over-recoveries were appropriate when BEA funded its pension obligation with some of the over-recoveries. Furthermore, additional legal analysis is needed to ensure that use of the \$4.99 million of LDRD funds, which has special legal restrictions, was appropriate. This report makes recommendations to address these concerns.

Finally, we determined that the variance issue was not isolated to FY 2016. Although we have not audited BEA's variance management practices from the previous years, we observed data to indicate that similar weaknesses may have occurred in prior years.

Indirect Cost and Recovery

September FY16 Elapsed Time = 100.0%



Source: BEA's Laboratory Financial Report: FY 2016

As the graph indicates, a similar trend line existed for FYs 2014 through 2016, with large over-recovered rate variances accumulating right before year-end, followed by a sharp decline to zero rate variances at year-end. Based on these trend lines, we concluded that there is a high probability that similar CAS noncompliant situations occurred in FY 2014 and FY 2015, and possibly occurred in prior years as well. The cost impact of the disposal of these large positive variances being noncompliant with CAS 418 over that span of time is likely substantial; however, we did not quantify the full impact of this practice on prior years. We concluded that, once the issues identified in this report for FY 2016 are resolved, the Contracting Officer should request BEA to determine the cost impact in years prior to FY 2016.

Finding 2: Average Direct and Indirect Labor Rates

We found that BEA's disposition of its average labor rates variance, both for direct labor and indirect labor, known as average charge-out rates, was not compliant with CAS 402 because BEA co-mingled direct costs and indirect costs. Specifically, we found that BEA used \$2.19 million of over-recovered direct labor variances to augment costs in other indirect cost pools, such as an additional pension contribution to the Fringe pool. This amount is part of the \$17.66 million we questioned in Finding 1 of this report. We address this amount separately here because it reflects a separate CAS 402 noncompliance and illustrates how a CAS noncompliance can impact multiple areas.

CAS 402-40, *Fundamental Requirement*, states that all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives.

BEA's disposition of its direct labor variance did not comply with the fundamental requirements of CAS 402 when BEA used it to augment costs in unrelated indirect pools – in essence, BEA recast direct labor costs over-recoveries as an indirect cost. For FY 2016, BEA used pre-established average charge-out rates to recover labor costs for both direct and indirect labor.

These rates are a combination of salary, escalation, merit pay, and reserve. By year-end, labor costs recovered through the average charge-out rates were higher than the actual labor costs, creating a total variance over-recovery of \$3.55 million. BEA changed the nature of the over-recovered direct labor costs when it disposed of the average charge-out rates variance by incurring indirect costs in unrelated indirect cost pools. Under this practice, BEA converted about \$2.19 million of direct labor costs to indirect costs with respect to final cost objectives.

This occurred because BEA's variance management practices promote the disposal of variances by netting the unrelated variances of one indirect rate against another. BEA's Guide also allowed management to treat any over-recovered rate variances, including direct labor rate variances, as funds that are available to fund indirect costs for the Idaho National Laboratory as a whole, at management's discretion.

As a result, BEA may have overcharged its customers for direct labor costs by about \$2.19 million. Furthermore, BEA used the over-recoveries for costs in unrelated indirect cost pools for which these customers may not have received a direct benefit.

Finding 3: Indirect Cost Burden for Unallowable Costs

We identified a CAS 405 noncompliance insofar as BEA did not correctly apply an indirect cost burden to all of its unallowable costs. Specifically, BEA did not include all unallowable costs in the LDRD allocation base, which understated the LDRD base by \$624,344.

CAS 405.40, *Fundamental Requirement*, paragraph (e), states that all unallowable costs are subject to the same cost accounting principles governing cost allocability as allowable costs. In circumstances where these unallowable costs normally would be part of a regular indirect-cost allocation base or bases, they shall remain in such base or bases.

This issue occurred because BEA's cost accounting system did not have adequate controls to ensure that unallowable costs received their appropriate burdens. We found that unallowable costs incurred are predominantly indirect costs of a G&A nature. However, BEA did not classify these costs to G&A projects; rather, they were classified as unallowable projects, some of which were not coded to receive LDRD burdens.

As a result, G&A unallowable costs did not receive the appropriate allocation of LDRD costs, and the LDRD allocation base was incomplete. Applying the LDRD allocation of 1.79 percent to the \$624,344 of unallowable costs nets \$11,176 of costs that should be charged to the unallowable accounts. Accordingly, we questioned \$11,176.

Finding 4: Travel Cost Charging

We identified a noncompliance where BEA did not always adhere to contract requirements and internal policy to properly allocate travel and associated labor costs to the same project(s). Specifically, in 9 of the 57 (about 16 percent) travel transactions tested, travel and associated labor costs were not appropriately allocated.

CAS 402-40, *Fundamental Requirement*, states that all costs incurred for the same purpose are either direct or indirect costs only with respect to the customer. Also, FAR 31.201-4, *Determining Allocability*, states that a cost is allocable if it is assignable or chargeable to one or more customers on the basis of relative benefits received. Finally, BEA's policy required that all travel and associated labor efforts incurred for the same purpose be charged to the same project.

BEA's process required that once travel is complete, an employee submits a final expense report that documents the allocation of travel costs to the appropriate project(s) for which travel was taken. In addition, travel labor is required to be allocated through the employee's timecard to the appropriate project(s).

However, we found that for the nine transactions identified, employees did not appropriately allocate travel charges, such as transportation and per diem costs, to the appropriate project(s) to correspond with labor charged on the timecard. For example, two employees charged travel to a direct project and labor to an indirect project, while a separate employee charged travel to an indirect project and labor to a direct project. The remaining six employees charged all travel costs to various direct or indirect projects and charged labor to various different direct and indirect projects.

This occurred because employees did not follow proper procedures for charging travel and associated labor costs. As a result, BEA had misallocated travel and associated labor costs and was not able to properly track project costs.

Finding 5: Allocation of Certain Indirect Rates

During our audit, we identified where BEA had improperly allocated certain indirect rate burdens. Specifically, BEA inappropriately allocated the material handling burden to some legal costs and inconsistently allocated its subcontract handling burden to leased employee costs.

Legal Costs

We identified a situation where BEA did not always use the proper indirect rate when burdening its legal costs. Specifically, we found that BEA misallocated \$113,989 of material handling burden to unrelated G&A legal costs.

CAS 418-40, *Fundamental Requirements*, paragraph (c), requires that indirect pooled costs be allocated to final cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to the final cost objectives. BEA did not comply with this standard when it applied material handling burdens to G&A legal costs. In BEA's rate structure, material handling pool costs did not provide benefit or cause to the G&A legal costs incurred.

This occurred because BEA lacked sufficient procedures to ensure that G&A legal costs were assigned to the proper expenditure type. An expenditure type is an expense account that classifies costs entered in the accounting system and directs how burdens are applied to costs. When BEA assigned G&A legal costs to expenditure types for materials, the legal costs

prompted the corresponding material handling burden. When we discussed our finding with BEA, a Business Management official agreed that the material handling burden had been inappropriately allocated to the legal costs.

As a result, BEA inappropriately allocated \$113,989 of material handling burden to the G&A pool.

Subcontract Handling Costs

We identified that BEA incorrectly allocated its subcontract handling burden to leased employee costs. Specifically, we noted an inconsistent application of the subcontract handling burden in all of the 223 transactions tested. For example, 89 of the 223 transactions received the burden and 134 did not.

CAS 418-40, *Fundamental Requirements*, paragraph (c), requires pooled costs to be allocated to final cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to the final cost objectives.

This occurred because BEA lacked sufficient procedures to ensure the consistent application of its subcontract handling burden when assigning expenditure types to leased employee costs. When we spoke to BEA about our concerns, Business Management officials agreed that the subcontract handling burden had been inconsistently applied.

As a result, BEA was not able to fully track and monitor the correct burdening of leased employee costs. We did not perform procedures to determine whether a beneficial or causal relationship existed between leased employee costs and the subcontract handling burden. However, if the burden should have been applied to all leased employees, then about \$97,000 was misallocated. Conversely, if the burden did not apply to leased employees, then about \$36,000 was misallocated.

Finding 6: Validation of Cooperative Audit Strategy

Internal Audit Reliance Testing of Relocation, Travel, and Cost-Type Subcontracts

For specific areas where Internal Audit had provided audit coverage in FY 2016, we reviewed a sampling of its work to determine whether we could rely on the audit work in lieu of performing our own testing. Based on our review, we determined that Internal Audit's work could be relied upon in the areas reviewed, and we questioned \$8,031 in additional costs, which we considered minor and non-systemic. We reviewed audits in the areas of travel, cost-type subcontracts, and relocation. Specifically, from our review of Internal Audit's "Relocation Audit," report IR16006, we questioned \$8,031 of relocation costs for the purchase of a home. The General Services Administration Federal Travel Regulation states that broker fees or commissions paid in connection with the purchase of a home are not allowable. The commission fee we questioned was \$6,000 for the purchase of a home and the associated \$2,031 of taxes. These costs were identified during our retesting of Internal Audit tested transactions, and we determined that they

were not identified due to an oversight. We considered this oversight to be minor and non-systemic. BEA concurred that the \$8,031 was unallowable and took steps to reimburse the Department.

Cooperative Audit Strategy Validation

We identified CAS noncompliant issues in BEA's cost accounting and management practices that Internal Audit had not previously identified. These are areas that require improvement by Internal Audit. The OIG, in consultation with the Department and the Contractor Internal Audit Council, developed and implemented the Cooperative Audit Strategy to maximize the overall audit coverage of management and operating contractors and fulfill its responsibility for auditing the costs incurred by the Department's major facilities contractors. The Department requires contractors to maintain an internal audit activity that is responsible for (1) performing operational and financial audits, including incurred cost audits; and (2) assessing the adequacy of management control systems to support the OIG as part of the Cooperative Audit Strategy.

We are able to rely on Internal Audit's audit and assurance engagement work that was performed under professional auditing and assurance standards and found that Internal Audit was generally in compliance with its policies and procedures.

However, we identified one instance where Internal Audit performed a "consulting engagement" related to BEA's draft Guide in which Internal Audit's review of the Guide did not comply with professional standards for "consulting engagements" or with BEA's policies and procedures. This review occurred prior to FY 2016 and was not in the initial scope of our audit. We noted that Internal Audit's review of the Guide identified no concerns or weaknesses. However, when we examined this review in detail, we identified a number of concerns. First, we concluded that Internal Audit exhibited poor judgment by accepting this management request as a "consulting engagement" rather than as an assurance engagement.

Specifically, under guidelines promulgated by the Institute of Internal Auditors, a "consulting engagement" only involves two parties, Internal Audit and management. In contrast, an assurance engagement involves these two parties plus a third party – outside stakeholders who have an interest in and a need to rely upon the work of Internal Audit. When third party stakeholders have a need to rely upon Internal Audit's work, the work should be structured and planned as an assurance engagement. We concluded that, in this instance, Internal Audit management should have known that the Guide could affect indirect cost pools which, in turn, would impact allowability of incurred cost. In addition, Internal Audit management should have concluded that both the Contracting Officer and the OIG rely upon its work relating to issues affecting incurred costs, and therefore, should have taken their needs into account when accepting a request to review the Guide. We discussed this concern with the Internal Audit Director, who told us that he considered the request to be a simple review and that it was appropriately considered a "consulting engagement." He stated that he did not consider this to be an area in which incurred costs would be a consideration.

Second, when we reviewed the “consulting engagement” work that Internal Audit performed on the Guide, we concluded that Internal Audit did not comply with its policies or with professional auditing standards in the following areas: Planning, Performing the Engagement, Supervision, Communication, Due Professional Care, and potentially Independence. Specifically:

- Planning: Neither BEA management nor Internal Audit was able to provide documentation of BEA’s request for a review of the Guide, the objective of the review, or planning or scoping considerations. We discussed this concern with the Internal Audit Director, who stated that there was an email with the request and appropriate scoping; however, he stated that this email could not be found.
- Performing the Engagement: We found that Internal Audit’s documentation and analysis were inadequate on a number of counts. First, there was no written objective or scope, so we could not judge whether work was sufficient to address the objective. Second, there was no documented analysis to judge whether the Guide maintained the beneficial or causal relationships between pools and bases. Third, Internal Audit did not document its analysis regarding its conclusions on materiality of the pool variances. Without such documentation of work performed, Internal Audit lacked a reasonable basis for concluding that the Guide had no CAS compliance issues. When we discussed this concern with the Internal Audit Director, he stated that the issues were simple enough not to warrant formal working papers with documented analysis. Further, he said, some of the analysis may be on the email communicating the results of the review; however, this email could not be found.
- Supervision: We found that the Internal Audit Director performed all work on this engagement alone and without supervision. When we discussed this concern, the Internal Audit Director stated that standards allow for cases where one person may constitute the entire Internal Audit Department, such as in the case of small companies. However, we observed that BEA is not a small company and does business in excess of \$1 billion annually.
- Communicating and Disseminating Results: We found that the Internal Audit Director was unable to provide documentation showing the communications that took place between it and BEA management, including the dissemination of engagement results. We discussed this concern with the Internal Audit Director, who stated that this was in fact documented in an email, which could not be found.
- Proficiency and Due Professional Care: Given the nature of Internal Audit’s noncompliance with professional auditing standards dealing with Planning, Performing the Engagement, Supervision, and Communication, we concluded that it did not meet the auditing standard associated with Due Professional Care for both planning and execution. The Internal Audit Director stated that the review was appropriate to the simple and narrow nature of the request.
- Independence: Given the facts and circumstances surrounding Internal Audit’s performance of the Guide “consulting engagement,” we are concerned that Internal Audit

may appear to have been engaged in a management process to help develop the Guide. In so doing, we are concerned that Internal Audit's independence may appear to be compromised should it review the Guide in the future because Internal Audit may be seen to have contributed to its development. In particular, rather than performing a review in accordance with normal procedures and professional auditing standards, we noted that Internal Audit held meetings, reviewed CAS criteria (CAS 418 and 305), and considered various simulations on spreadsheets before informally communicating to BEA management that it did not identify any concerns. When Internal Audit was asked to review and comment upon the Guide, and did so outside the normal applicable professional auditing standards, it may be construed that Internal Audit was part of the management review and approval process. To maintain proper independence, Internal Audit should not participate in what may be seen as a management role. Maintaining independence will strengthen Internal Audit's credibility, as weaknesses in the Guide may be identified during the normal course of audit. Finally, we find it concerning that while vetting these issues with Internal Audit, the Director appeared to argue on behalf of BEA's position in support of the Guide and BEA's position on materiality, rather than maintaining an independent perspective on these matters, as we would expect, and as professional auditing standards require. The Internal Audit Director disagreed that independence was impaired in any way and stated that their "consulting engagement" was an appropriate service for Internal Audit to perform.

Finally, we noted that Internal Audit's shortcomings may have contributed to the material noncompliance associated with Finding 1 of this report, which we consider to represent fundamental areas for proper accounting and management of costs on government contracts. In Finding 1 of this report, we found that BEA's disposition of indirect cost rate variances was not compliant with CAS and its disclosed practices. We attributed this noncompliance to weaknesses in the Guide. Accordingly, we are recommending certain corrective actions and additional oversight to ensure that these problems do not recur.

Other Matters

Joint Appointments

We identified concerns in our testing of 13 selected invoices from 4 of BEA's 18 joint appointment agreements. Specifically, we noted potential weaknesses in BEA's invoice review process and validation of work performed, and salary and benefit costs. For example,

- BEA's invoice review group only reviewed invoices to ensure costs are within the contractual limit;
- BEA followed an inconsistent approach for validating work products; and
- BEA lacked timesheets to validate associated labor and benefits charges for all invoices reviewed. Three of the four joint appointment contracts reviewed required the subcontractor to separately identify hours expended by category/individual.

We noted that this occurred because BEA lacked consistent internal controls to ensure joint appointment invoices were properly reviewed according to contract requirements.

As a result, the potential weaknesses identified introduced vulnerabilities in BEA's ability to adequately monitor and validate work performed and determine whether labor costs were properly invoiced. In addition, travel costs included on joint appointment invoices were not always reviewed.

Although we will not make a formal recommendation for this minor area, we suggest that BEA strengthen its formal policies and training procedures over joint appointments to ensure invoiced costs and work performed can be adequately validated.

RECOMMENDATIONS

To ensure the consistent application of indirect rate variances practices, we recommend that the Deputy Chief Financial Officer:

1. Perform a review of the Department's management and operating contractor disclosed practices, and related policies and procedures for indirect rate variance management to ensure that they are compliant with CAS 418.

We recommend that the Manager, Idaho Operations Office, direct the Contracting Officer to:

2. Make a determination regarding the CAS noncompliant issues identified in this report, in particular for:
 - a. Disposition of year-end indirect rate variances.
 - b. Average labor rates.
 - c. Legal issues associated with the additional pension fund contribution.
 - d. Legal issues associated with the use of LDRD funds.
3. Require BEA to develop and implement a corrective action plan to address the CAS noncompliance issues identified in this report.
4. Require BEA to prepare a detailed Cost Impact Proposal for those CAS noncompliant issues determined to be significant for FY 2016 and for all prior and subsequent contract years where similar CAS compliance issues occurred.
5. Make a determination regarding the allowability of costs questioned in this report and recover any amounts deemed unallowable.
6. Ensure BEA modifies its internal policies and procedures for including direct unallowable costs in the applicable indirect allocation bases consistent with CAS requirements.
7. Ensure that BEA adequately addresses the improper charging of travel and labor costs when employees travel.
8. Require BEA to address the incorrect application of certain indirect rates identified in this report and strengthen the associated internal controls, to include:
 - a. Inappropriate allocation of the material handling burden to legal costs.
 - b. Inconsistent allocation of the subcontract handling burden to leased employee costs.
9. Require Internal Audit to develop and implement a corrective action plan to address issues identified in this report. Because these issues concern incurred costs, the closure

of these corrective actions should be overseen by the Contracting Officer. The corrective actions should include, at a minimum:

- a. The CAS noncompliance issues identified in this report and what steps Internal Audit will take to increase its consideration of these risks in its risk assessment.
- b. Review prior years' work to ensure that Internal Audit's "consulting engagements" were not performed in areas where third parties would reasonably need to rely upon the work. If it is determined that their services should have been assurance engagements, identify and mitigate the possible impacts on third parties.
- c. Review prior years' "consulting engagements" for compliance with professional auditing standards and internal policies and procedures.
- d. Additional scrutiny of Internal Audit during the independent peer review process.

MANAGEMENT RESPONSE

Management partially concurred with the report's findings and recommendations. Specifically, management concurred with Recommendations 3, 4, 5, 6, 7, and 8, and partially concurred with Recommendations 1, 2, and 9.

To address Recommendation 3, management stated that BEA had implemented policy changes related to cost pool variances. In addition, BEA adjusted cost pool variances that arose during FY 2018 and took similar interim actions to adjust several cost pool rates during FY 2019. To address Recommendation 4, management will require BEA to prepare program cost impact analyses for all recent fiscal years where indirect cost pool variances existed. To address Recommendation 5, management will ensure recovery of all questioned costs deemed unallowable. To address Recommendation 6, 7, and 8, management will direct BEA to modify policies and procedures to strengthen internal controls over indirect allocations, travel and labor costs, and material and subcontract handling costs.

Management partially concurred with Recommendation 1 because it stated the responsibility for oversight of contractors' indirect cost management, and compliance with CAS, is inherent with the authorities of a Contracting Officer. In addition, Field Chief Financial Officers assist the Contracting Officer with CAS compliance, within the requirements of Department of Energy Order 520.1A, (*Chief Financial Officer Responsibilities*) and Department Order 523.1, (*Financial Management Oversight*). Management will provide Field Chief Financial Officers with this report and assess the adequacy of its policy for contractors' CAS disclosure statements, including specific information on indirect rate variance management.

Management partially concurred with Recommendation 2 because it, along with BEA, determined that there would be no material cost impact to any one of the Idaho National Laboratory's largest 30 programs, and concluded that the cost and effort necessary to make the adjustments exceeded any benefit. In addition, management acknowledged that BEA did not reduce all indirect cost pool variances to zero by distributing them back to programs as originally allocated. Furthermore, management understands that several cost pools were, arguably, unreasonably out of balance, but accepted BEA's conclusion to make no adjustments because BEA's indirect cost pools are highly related. Moreover, management stated that BEA's decisions were not due to a misunderstanding of, or disregard for, CAS; nor inadequate oversight; and not due to any reason other than the determination that any impact to program costs were immaterial. Finally, at management's request, BEA implemented policy changes, which fully address the disposition of indirect cost pool variances; including adjusting its FY 2018 cost pool variances and several 2019 indirect cost pools.

Management partially concurred with Recommendation 9 because it considered our concern about how Internal Audit conducts an engagement to be a difference in professional opinion. To address the recommendation, management will direct BEA to modify policies and procedures to strengthen internal controls over Internal Audit functions after reviewing the results of an upcoming external peer review.

AUDITOR COMMENTS

Management's comments are generally responsive to our concerns and we are pleased with the intended actions. However, in regards to management's partial concurrence with Recommendation 2, the comments were not responsive for several reasons. First, management did not address our recommendation to make a determination regarding the CAS noncompliant issues, related to the year-end indirect rate variances and average labor rates, identified in our report. Second, our report found that BEA did not adhere to the fundamental CAS 418 requirement to maintain the relationship of indirect cost variances at the "pool" level. In its response, management addressed our finding from the perspective that there was no material cost impact at the "program" level, which is different and distinct from our finding. Nonetheless, management acknowledged that because of Finding 1 in this report, BEA had adjusted its indirect cost variances at the "pool" level for FY 2018 and 2019. This action indicates that BEA was noncompliant with CAS 418 and needed to make those changes to address the issue. Finally, management's response did not address the parts of the recommendation regarding legal issues associated with BEA's additional pension fund contribution and its use of LDRD funds for non-related LDRD work.

Regarding management's partial concurrence with Recommendation 9, we are pleased that management will direct BEA to strengthen its Internal Audit function. However, management's response did not address all areas of the recommendation. Specifically, our recommendation included requiring Internal Audit to implement a corrective action plan to address the CAS noncompliance issues identified in this report. In addition, we relied upon extensive criteria from professional standards and Internal Audit's policy to demonstrate our concern with Internal Audit's management of its "consulting engagements." Nonetheless, management did not state how it will address our recommendation to review Internal Audit's prior year "consulting engagements" where third parties would reasonably rely upon its work. Conversely, to address our recommendation, management plans to rely upon an external peer review to identify potential areas where Internal Audit could improve. However, an external peer review will not address the CAS noncompliance issues identified in this report. An external peer review's primary purpose is to ensure Internal Audit is adhering to the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing.

Finally, we discussed with management our concerns about its partial concurrence with Recommendations 2 and 9. Management stated it is fully committed to addressing the report's recommendations and ensuring BEA becomes more compliant with CAS as mentioned in this report. In addition, management stated that BEA now assesses rate variance materiality at the pool level. Furthermore, management stated that a legal analysis of the additional pension contribution and BEA's use of LDRD funds would occur. Management also stated it is concerned with Internal Audit's independence and that it intends to work with Internal Audit to make improvements to its processes.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

We conducted this audit to determine if fiscal year 2016 incurred costs were allowable, allocable, and reasonable, in accordance with the terms of the contract, applicable cost principles, laws, and regulations, and to assess Battelle Energy Alliance, LLC's (BEA) internal audit work for the annual incurred costs audit.

Scope

This audit was performed from March 2017 to April 2019 at Idaho National Laboratory in Idaho Falls, Idaho. The audit scope was limited to costs incurred for fiscal year 2016. We did not evaluate the technical aspects of BEA's performance. The audit was conducted under Office of Inspector General project number A17ID010.

Methodology

To accomplish our objectives, we:

- Reviewed applicable laws, regulations, policies, and procedures.
- Reviewed relevant reports issued by the Office of Inspector General, Government Accountability Office, BEA's Internal Audit, Department of Energy, Idaho Operations Office, and other entities.
- Conducted interviews with Federal and contractor personnel.
- Statistically sampled 50 of 6,249 purchase card transactions and judgmentally sampled 3 transactions from those not included in our statistical sample universe. There were no findings to project to the transaction universe.
- Statistically sampled 50 of 12,468 direct material purchase transactions and judgmentally sampled 3 transactions from those not included in our statistical sample universe. There were no findings to project to the transaction universe.
- Judgmentally sampled 27 out of 118 direct material accruals. 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.
- Judgmentally sampled 21 of 492 strategic partnership projects. 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.

- Judgmentally sampled selected invoices from 4 of 18 joint appointments. 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.
- Judgmentally sampled 40 of 3,345 cost transfer journal entries. 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.
- Tested salaries and bonuses for 100 percent of key personnel.
- Judgmentally sampled selected invoices from 4 of 16 leased employees. Testing was expanded to look at the burdening of all leased employee transactions.
- Analyzed indirect rates by evaluating how indirect rates were determined and assessed whether they were appropriately and consistently applied to allocation base costs.
- Evaluated indirect rate variance management practices by determining whether indirect rate variances were monitored, adjusted, and disposed of properly.
- Tested transactions using the requirements contained in Federal Acquisition Regulation and in contract terms and conditions by tracing transactions to books of original entry, supporting records, and documentation.
- Reviewed policies and procedures for identifying subcontracts that require audits and arranging such audits.

In order to perform our reliance assessment on the allowable cost audit work conducted by BEA's Internal Audit, we reviewed allowable cost audit reports, workpapers, and audit planning, including risk assessments; auditor qualifications and independence; and BEA's overall Internal Audit strategy and compliance with applicable professional auditing standards. For our retest of fiscal year 2016 incurred cost transactions reviewed by BEA's Internal Audit, we judgmentally selected transactions associated with four subcontracts, relocation, and travel.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Accordingly, we assessed significant internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objectives. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. Finally, we relied on computer-processed data to accomplish our audit objectives. We assessed this data by tracing it to source documents and determined the data to be sufficiently reliable to provide a basis for our conclusions.

This report is intended for the use of the Department contracting officers and field offices in the management of their contracts and is not intended to be used for and should not be used by anyone other than these specified parties.

Management officials waived an exit conference on August 27, 2019.

PRIOR REPORTS

- Audit Report on the [*Lawrence Livermore National Security, LLC, Costs Claimed Under Department of Energy Contract No. DE-AC52-07NA27344 for Fiscal Year 2015*](#) (DOE-OIG-18-12, December 2017) Based on our audit, we questioned costs totaling \$1,262,454.77, identified weaknesses in internal controls, and identified weaknesses in Lawrence Livermore National Security, LLC's (LLNS) Internal Audit procedures. Except for the reported questioned costs and internal control weaknesses, nothing came to our attention to indicate that the other costs incurred by LLNS were not allowable. Also, based on our review of Internal Audit's work, we determined that it could be relied upon in the select areas reviewed and identified minor questioned costs of \$725.68. We did, however, identify internal control weaknesses in LLNS' accounting system that had not previously been reported by Internal Audit. Those weaknesses included LLNS' management of its strategic partnership project cost overruns and underruns and unallowable costs. This occurred because LLNS did not properly follow contract terms and conditions, including the Federal Acquisition Regulation and Cost Accounting Standards. In addition, we identified two minor internal control weaknesses where LLNS did not maintain its own complete records of supplemental labor costs and demonstrated an incomplete understanding of supplemental labor cost documents. Further, LLNS did not always adhere to internal policy and contract requirements to properly allocate travel and associated labor costs to the same project(s). Finally, we identified areas that require improvement by Internal Audit in order for the Office of Inspector General to continue to rely upon its work for future fiscal years under the Cooperative Audit Strategy. In our opinion, the audit procedures used by Internal Audit did not identify certain internal control weaknesses in LLNS' cost accounting and management practices. As a result, we recommend that the contracting officer request an improvement plan from Internal Audit to ensure that unallowable costs and internal control weaknesses identified in the report are properly audited in future incurred cost audits.
- Assessment Report on the "*Assessment of Audit Coverage of Cost Allowability for Battelle Energy Alliance, LLC under Department of Energy Contract No. DE-AC07-05ID14517 during Fiscal Year 2013*" (OAS-V-14-16, September 2014). Based on our assessment, nothing came to our attention to indicate that the allowable cost-related audit work performed by Battelle Energy Alliance, LLC's Internal Audit could not be relied upon. We did not identify any material internal control weaknesses with Internal Audit's cost allowability audits, which generally met International Standards for the Professional Practice of Internal Auditing. Internal Audit identified \$190,891 in expressly unallowable and questioned costs, of which \$174,804 has been resolved. We are questioning the remaining \$16,087, which has yet to be resolved. We identified no other audits or reviews that reported internal control weaknesses impacting the allowability of costs claimed for fiscal year 2013. We also found that Battelle Energy Alliance, LLC provided audit coverage of its cost reimbursable subcontracts. In particular, Internal Audit selected subcontractors for review based on a risk-based approach applied to the entire cost reimbursable subcontract population. For each subcontractor selected, a statistical sample of invoices was reviewed to determine whether costs claimed by and reimbursed to subcontractors were allowable, allocable, reasonable, and consistent with

contract terms and conditions. From the subcontracts audited, Internal Audit identified \$2,461 in questioned costs and \$18,256 in unallowable costs, which have all been resolved.

MANAGEMENT COMMENTS

United States Government

Department of Energy

memorandum

Idaho Operations Office

Date: JUN 27 2019

Subject: Draft Audit Report "Battelle Energy Alliance, LLC Costs Claimed under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016" (CLN191347)

To: IG-30 (A17ID010)

Thank you for providing a draft copy of the Office of Inspector General (OIG) report "Battelle Energy Alliance, LLC Costs Claimed under Department of Energy Contract No. DE-AC07-05ID14517 for Fiscal Year 2016." The Department of Energy, Idaho Operations Office (DOE-ID) and the Acting Chief Financial Officer, CF-1, have reviewed the draft report and provide the enclosed responses to the recommendations.

If you have any questions, please contact Amy Grose, DOE-ID Chief Financial Officer, at 208-526-5711, or Kelly Lemons, DOE-ID Director Financial Services and Resources Management Division, at 208-526-5453.



Robert Boston
Manager

Attachment

cc: NE-20, Chief Operating Officer (Miotla)
CF-1, Acting Chief Financial Officer

Responses to Report Recommendations

For the Acting Chief Financial Officer (CFO)

Recommendation 1: Perform a review of the Department’s management and operating contractor disclosed practices, and related policies and procedures for indirect rate variance management to ensure that they are compliant with Cost Accounting Standards (CAS) 418.

Management Response: Partially Concur

Contractors are contractually required to be compliant with the requirements of CAS, including CAS 418, and approved, disclosed practices. The responsibility for oversight of contractors’ indirect cost management, and compliance with CAS, is inherent with the authorities of a Contracting Officer. Field CFOs assist the Contracting Officer with CAS compliance, within the requirements of Department of Energy (DOE) Orders 520.1A and 523.1. For Field CFOs, Order 523.1 responsibilities include reviewing CAS Disclosure Statements, and advising the contracting officers regarding adequacy of those disclosure statements. CFO will provide DOE Field CFOs with the Office of Inspector General’s (OIG) findings from this incident, relating to indirect rate variance management, at the Idaho National Laboratory (INL). CFO will also assess DOE policy adequacy for contractors’ CAS disclosure statements, including specific information on indirect rate variance management.

CFO will provide communication of the findings to Field CFO offices no later than 90 days after issuance of the final OIG report, and will complete assessment of potential policy changes by December 31, 2019.

For the Manager, Department of Energy Idaho Operations Office (DOE-ID)

Recommendation 2: Make a determination regarding the CAS noncompliant issues identified in this report, in particular for: a) disposition of year-end indirect rate variances; b) average labor rates; c) legal issues associated with the additional pension fund contribution; and d) legal issues associated with the use of Laboratory-Directed Research and Development (LDRD) funds.

Management Response: Partially Concur

Significant consideration and discussion of the issues identified in this report occurred throughout the course of the audit. DOE-ID will continue to pursue all information available to close these issues through policy changes or other means, as deemed appropriate, no later than 180 days after issuance of the final OIG report.

DOE-ID agrees that Battelle Energy Alliance, LLC (BEA) did not reduce all indirect cost pool variances to zero by distributing them back to programs as originally allocated. BEA determined that if no adjustments were made, there would be no material cost impact to any one of INL’s largest 30 programs (85% of all spending), and concluded that the cost and effort necessary to make the adjustments exceeded any benefit.

DOE-ID understands that several cost pools were, arguably, unreasonably out of balance as noted in the report, but DOE-ID accepted BEA’s determination and conclusion to make no adjustments based on DOE-ID’s knowledge that BEA’s indirect cost pools were highly related with regard to how they were allocated to programs. The adjustments would have been very small per program and relatively balanced across all programs.

In response to the concerns identified, several subsequent analyses, performed both by BEA and DOE-ID, confirmed that all significant individual program costs would have been essentially unchanged had all

Responses to Report Recommendations

indirect cost pool variances been reduced to zero. For instance, during Fiscal Year (FY) 2016, DOE's Office of Nuclear Energy's largest 11 programs funded nearly \$500M or roughly 50% of all work performed at the INL, and those programs would have paid about \$200,000 (0.04%) more had all cost pool variances been reduced to zero by distributing them back to programs as originally allocated. DOE-ID's position is that this demonstrates compliance with CAS. CAS 305 recognizes that tolerable differences will occur and provides the concept of materiality as a way to dismiss tolerable differences and still maintain compliance.

DOE-ID's acceptance of BEA's decision to not adjust all cost pool variances at the end of FY 2016 was not due to a misunderstanding of, or disregard for, CAS; not due to inadequate oversight; and not due to any reason other than the determination and conclusion that if no adjustments were made, there would be no material cost impact to any of the programs that paid a significant portion of BEA's overhead costs.

DOE-ID encouraged BEA to modify their indirect cost pool variance policy. In response, BEA implemented policy changes, which fully address the disposition of indirect cost pool variances. Those changes were reflected in BEA's actions to adjust cost pool variances that arose during FY 2018. Further, as a result of their mid-year review of indirect rates, BEA is taking similar interim actions to adjust several indirect cost pools during FY 2019.

Recommendation 3: Require BEA to develop and implement a corrective action plan to address the CAS noncompliance issues identified in this report.

Management Response: Concur

Throughout the course of the audit, issues identified in this report were discussed between DOE-ID and BEA. BEA has implemented policy changes that appear to fully address the OIG's concerns related to cost pool variances. Those changes were reflected in BEA's actions to adjust cost pool variances that arose during FY 2018, as suggested in the report. BEA has taken similar interim actions to adjust several cost pool rates during FY 2019.

Recommendation 4: Require BEA to prepare a detailed Cost Impact Proposal for those CAS noncompliant issues determined to be significant for FY 2016 and for all prior and subsequent contract years where similar CAS compliance issues occurred as deemed necessary.

Management Response: Concur

DOE-ID will require BEA to prepare program cost impact analyses for all recent fiscal years where indirect cost pool variances similar to those identified in the report existed, as deemed necessary, no later than 180 days after issuance of the final OIG report.

Recommendation 5: Make a determination regarding the allowability of costs questioned in this report and recover any amounts deemed unallowable.

Management Response: Concur

DOE-ID will ensure recovery of all costs deemed to be unallowable no later than 180 days after issuance of the final OIG report.

Responses to Report Recommendations

Recommendation 6: Ensure BEA modifies its internal policies and procedures for including direct unallowable costs in the applicable indirect allocation bases consistent with CAS requirements.

Management Response: Concur

DOE-ID will direct BEA to modify policies and procedures to strengthen internal controls over indirect allocations, as deemed necessary, no later than 180 days after issuance of the final OIG report.

DOE-ID agrees that LDRD costs of approximately \$11,000 should have been allocated to unallowable G&A costs. The unallowable costs in question were incurred for activities funded through the G&A pool, which was part of the LDRD cost allocation base during FY 2016. BEA corrected the error by charging \$11,000 to their corporate unallowable cost account.

BEA employs a complex cost accounting system that provides for hundreds of unique cost combinations and exceptions. Such complexity creates opportunity for human error. BEA continues to evaluate their systems and controls in an effort to minimize these errors. DOE-ID will continue to perform annual reviews to provide assurance that the indirect rates approved by DOE-ID are applied by BEA in accordance with disclosed charging practices.

Recommendation 7: Ensure that BEA adequately addresses the improper charging of travel and labor costs when employees travel.

Management Response: Concur

DOE-ID will direct BEA to modify policies and procedures to strengthen internal controls over travel and labor costs, as deemed necessary, no later than 180 days after issuance of the final OIG report.

DOE-ID agrees that all travel costs should be charged to the benefitting project or program. The bulk of these mischarges were to related projects under the same broad direct program or overhead. Although, the dollar value of the errors extrapolated to the entire population would be insignificant to BEA costs as a whole, DOE-ID agrees that improvements to the process for ensuring travel cost allocation could be made.

Recommendation 8: Require BEA to address the incorrect application of certain indirect rates identified in this report and strengthen the associated internal controls, to include: a) inappropriate allocation of the material handling burden to legal costs and b) inconsistent allocation of the subcontract handling burden to leased employee costs.

Management Response: Concur

DOE-ID will direct BEA to modify policies and procedures to strengthen internal controls over material and subcontract handling costs, as deemed necessary, no later than 180 days after issuance of the final OIG report.

DOE-ID agrees that the outside legal costs identified in the report were burdened incorrectly with the material handling adder, rather than the subcontract handling adder. DOE-ID agrees BEA inconsistently applied certain subcontract handling burdens to leased employees.

BEA employs a complex cost accounting system that provides for hundreds of unique cost combinations and exceptions. Such complexity creates opportunity for human error. BEA continues to evaluate their systems and controls in an effort to minimize these errors. DOE-ID will continue to perform annual

Responses to Report Recommendations

reviews to provide assurance that the indirect rates approved by DOE-ID are applied by BEA in accordance with disclosed charging practices.

Recommendation 9: Require Internal Audit to develop and implement a corrective action plan to address issues identified in this report. Because these issues concern incurred costs, the closure of these corrective actions should be overseen by the Contracting Officer. The corrective actions should include, at a minimum: a) the CAS noncompliance issues identified in this report and what steps Internal Audit will take to increase its consideration of these risks in its risk assessment; b) review prior years' work to ensure that Internal Audit's "consulting services" were not performed in areas where third parties would reasonably need to rely upon the work. If it is determined that their services should have been assurance engagements, identify and mitigate the possible impacts on third parties; c) review prior years' "consulting services" for compliance with professional auditing standards and internal policies and procedures; and d) additional scrutiny of Internal Audit during the independent peer review process.

Management Response: Partially Concur

DOE-ID will direct BEA to modify policies and procedures to strengthen internal controls over Internal Audit functions, as deemed necessary, after reviewing the results of the upcoming external peer review of Internal Audit.

DOE-ID agrees with the OIG's position and conclusion to continue to rely on BEA's Internal Audit performance of audit and assurance engagement work.

DOE-ID's interpretation is that the review of BEA's draft internal indirect cost pool variance policy by BEA's Internal Audit was, and should have been, performed as a consulting service.

The OIG's conclusion that the engagement should have been performed as an assurance service is a matter of professional judgement and, in this case, there is a difference in professional opinion.

FEEDBACK

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