

**University of California
Los Alamos National Laboratory**

**Compliance and Operational Analysis
LANL Budget Execution Processes
and Internal Controls**

April 15, 2003

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Ms. Anne C. Broome
Vice President-Financial Management
University of California
1111 Franklin Street
Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Budget Execution Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Budget Execution processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the budget execution processes. We recommend periodic follow-up to determine accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,



Brian F. Simmons
Central Region Director
Government Contract Services

Table of Contents

I.	Overview	1
	A. Background	1
	B. Summary of Observations.....	3
II.	Procedures Performed.....	3
	A. Scope of Analysis.....	3
	B. Objectives of Analysis.....	3
III.	Observations and Recommendations.....	4
	A. Budget Execution Process Observations.....	4
	1. Budget Adjustments.....	4
	2. Charging Incurred Costs to Project Codes	4
	3. G&A Rates.....	5
	4. Budget Analysis.....	6
	5. Budget Software	6
	6. Budget Processes	7
	7. Manual Budget Operations.....	7
	8. Budget Reconciliation	7

I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Budget Execution processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's budget execution processes and internal controls. The E&Y report is comprised of three (3) parts: (I) Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and do not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's budget execution processes and internal controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

“The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports;

and assures that accountability for the assets can be maintained.”

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation Supplement (DEARS). The DEARS implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL’s financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE’s standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: “Indirect Budget”, “Data Warehouse”, “Time & Effort”, “Accounting”, “Formal Budgeting”, and “Related Resources”.

Accounting policies that supplement the guidance contained in the Financial Management Handbook are contained in LANL’s Accounting Resource Manual. LANL accounting policies are implemented by specific desk instructions.

Each year, LANL submits a budget in accordance with applicable DOE, Office of Management and Budget, and other federal regulations. LANL’s total budget for FY 2003 is approximately \$2.7 billion that includes monies for operating, capital construction, and general plant projects.

With input from LANL, DOE develops an initial budget for Office of Management and Budget review. Ultimately, the DOE input becomes part of the President’s Budget which is addressed by Congress as part of the Energy and Water Development Appropriations Bill. Once the appropriations bill is signed by the President, DOE receives its portion and provides LANL an initial Approved Financial Plan (AFP), which allocates funds at the Estimated Cost & Obligation Reporting (ECOR) level.

At LANL, the Business Operations Division within the Administration Directorate performs budget planning and execution functions. BUS-3 (Budget and Planning) is responsible for the “core” budget development and execution, as well as development of LANL business policies and practices. As such, BUS-3 oversees the LANL wide budget process, including preparation of indirect budgets/rates. BUS-2 (Distributed Budget) budget analysts are assigned directly to assist program managers in administering the program managers’ budgets. The Program Integration Office (PIO) provides a link between the various program (BUS-2) and core (BUS-3) functions. Currently, there are 205 personnel authorized to perform

budget functions; 155 employees were assigned to BUS-2, 25 employees were assigned to BUS-3, and 25 employees were assigned to PIO.

B. Summary of Observations

As a result of our analysis, we identified eight (8) observations related to the strengthening of budget execution processes and internal controls. The observations related to budget adjustments, charging incurred costs to project codes, G&A rates, budget analysis, budget software, budget processes, manual budget operations, and budget reconciliation.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of budget execution processes and internal controls, included the following:

- Understand the process for LANL's budget execution activities.
- Assess written policies, procedures, and internal controls related to budget execution functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual and DOE requirements.

B. Objectives of Analysis

The objectives of the budget execution processes and internal controls were to:

- Document the LANL's key internal controls including the LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual provisions.
- Determine whether sampled items, in accordance with relevant contract and operational requirements were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

Based upon the procedures performed, we identified eight (8) items/control enhancement opportunities in the budget execution internal control processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the budget execution processes. In our view, the observations and recommendations are presented in the order of their importance. The items identified and the recommendations resulting from our procedures follow:

A. Budget Execution Process Observations

1. Budget Adjustments

a. Observation

Budget adjustments are periodically made for some programs, excluding all WFO's programs, to prevent actual costs from exceeding the budgeted amounts. Other reasons budgets may be adjusted include: (1) the identification of additional work scope, (2) identification of additional costs and, (3) a sponsor sends additional funding or cuts funding. A changing budget baseline precludes meaningful variance analysis to determine the nature and significance of deviations from budget. As a result, the budgeting function becomes a reactive tool to account for costs rather than a proactive tool to improve the overall planning and control process.

b. Recommendation

LANL should maintain the integrity of initially established budgets as a control and evaluation baseline for variance analyses. Adjustments to the original budget should be limited to changes in the scope of planned work authorized and documented by management.

2. Charging Incurred Costs to Project Codes

a. Observation

Charging of incurred costs to project codes is suspended when incurred costs reach 95 or 99 percent of budget authorization for "regular" and Work For Others (WFO), respectively. Nevertheless, actual costs will, on occasion, exceed the budget authority. When actual costs incurred exceed budgeted/authorized amounts, the excess costs are charged to a suspense account. Costs are analyzed pending receipt of additional budget to determine whether or not the excess costs are potentially

beneficial/assignable to another program. If neither result occurs, the amounts remain as a suspense and are ultimately charged against the UC Management fee.

b. Recommendation

Costs should be charged to the project for which they are incurred irrespective of the funding status. Costs exceeding budgets should not be: (1) suspended pending possible reclassification; or (2) left in a suspense account. LANL should consider developing a system generated warning report that would be sent to the responsible Budget Analyst informing the Budget Analyst that the project order is approaching 75 percent of the obligation threshold.

3. G&A Rates

a. Observation

LANL has five different General and Administrative (G&A) rates that are applied to: (1) on-site, (2) off-site program, (3) capital and construction program, (4) construction (over \$50 million), and (5) commercial work. LANL uses a modified total cost input base that excludes procurement costs over \$100 thousand, as well as costs for student and post-doctoral status workers, and university contracts. (LANL's Disclosure Statement only describes three major rates--on-site, off-site program, and capital and construction program.) LANL also uses numerous indirect rates (approximately 400). Although DOE has approved LANL's Disclosure Statement, the practice of using multiple G&A rates may not meet the intent of FAR 31.203(c) or Cost Accounting Standard (CAS) 410.

b. Recommendation

LANL should consider implementing a single G&A rate. LANL should consider simplifying the overall indirect rate structure to reduce the cost and effort associated with budgeting, tracking, and adjusting numerous individual rates. Simplification would also enhance control by focusing management attention on fewer areas of greater significance.

4. Budget Analysis

a. Observation

Budget analysts from both the program and Division levels perform periodic analyses to assist technical program managers in tracking program progress. The program and Divisional personnel use financial reports based on data recorded in the Financial Management Information System (FMIS). Technical program management however, (whether from the Program Management Division or “in-house”) use the data recorded in FMIS adjusted for unrecorded transactions (e.g., material accruals and outstanding commitments). Consequently, there are often multiple measures of “actual” costs at any point in time.

b. Recommendation

LANL should implement a standard reporting format depicting the reconciliation for authorized adjustments to raw financial data. All parties should provide management analyses based on a single measure of cost/schedule control information through use of a standard reporting format completed on a periodic basis.

5. Budget Software

a. Observation

LANL employees use several different types of computer software for budget estimating, monitoring, and project management. Reasons for the variations include customer and user preferences, program functionality, and lack of prescribed standards. These differences result in reduced systems compatibility, increased system/software maintenance, and variability in management reports.

b. Recommendation

LANL should prescribe the use of standardized, preferably off-the-shelf, computer software to reduce maintenance cost and increase consistency in performance and control activities. All activities should use the same application software for a given function.

6. Budget Processes

a. Observation

A number of LANL budget processes have not been documented either formally or informally by way of flowcharts and/or desktop procedures. To assist in achieving consistency with management direction and policy requirements, all significant processes (and particularly the control features of those processes) should be documented.

b. Recommendation

LANL should provide the resources to institutionalize standard operating practices within the budget function through proper documentation. Desk instructions should include cross-references to policies and other desk instructions, author, origination and effective dates, approvals and date, revision date, and log of revisions in a standard format.

7. Manual Budget Operations

a. Observation

There are a number of manual operations within the budget function that could be automated. For example, due to system limitations, budget personnel generate a budget allocation matrix in EXCEL format for each program. The matrix must then be manually input into FMIS by program. BUS-3 personnel also perform several time-consuming reconciliations on EXCEL spreadsheets (e.g., calculating organizational support on capital and construction, Work for Others, LANL Directed Research and Development adjustment, and Central Maintenance Management System G&A rebate).

b. Recommendation

LANL should provide the resources to automate manual processes to the maximum extent possible. Through increased automation, LANL can improve operating efficiency and decrease the potential for human error.

8. Budget Reconciliation

a. Observation

Approved Funding Plans should be reconciled with Work Authorization Statements before funds are allocated to provide assurance that LANL has the approval to spend monies received. BUS-3 has recognized this as an

important control function as part of their control risk self-assessment and is implementing a reconciliation procedure.

b. Recommendation

LANL should include validation of the reconciliation control procedure in the current validation cycle.