

U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF DEPARTMENT OF ENERGY'S
CONTRACTOR SALARY INCREASE FUND

MASTER

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

AUDIT OF DEPARTMENT OF ENERGY'S
CONTRACTOR SALARY INCREASE FUNDS

Audit Report Number CR-B-97-02

SUMMARY

The Department of Energy (Department) uses contractors to operate its facilities and compensates contractor employees based on their skills, complexity of jobs, and work performance. Thirty-one of the Department's major contractors reported a total payroll of \$4.3 billion and \$4.4 billion during 1994 and 1995, respectively. The 31 contractors also reported awarding salary increases of \$18 million for 1994 and \$200 million for 1995.

The purpose of the audit was to review the process used to determine and approve the amount of salary increases for contractor employees. Our specific audit objective was to determine whether salary increases received by contractor employees were in accordance with Departmental policies and procedures.

The Department of Energy Acquisition Regulation (DEAR) requires that contractor salary actions be within specific limitations, supportable, and approved prior to incurrence of costs. In addition, the Secretary of Energy imposed a 1-year salary freeze on the merit portion of management and operating contractor employee salaries for each contractor's Fiscal Year 1994 compensation year. However, a fund for promotions and adjustments was approved but limited to 0.5 percent of payroll for the year. A review of eight major contractors showed that six complied with the Department's policies on salary increases. The other two gave salary increases that were not always in accordance with Departmental policies. This resulted in both contractors not fully complying with the pay freeze in 1994 and exceeding their salary increase fund budgets in 1995. If these two contractors had implemented Department and contract requirements and contracting officers had properly performed their contract administrative responsibilities concerning salary increase funds, both contractors would have frozen salary increases and would not have exceeded their annual budgets.

We recommended that the Oakland Operations Office require (1) contracting officers and contractors to define which employees will be included in the salary increase fund, (2) contractors to implement contract terms, and (3) contracting officers to enforce contract terms and properly monitor salary increase funds. Further, we recommended the recoupment of unallowable costs of about \$1.1 million at Livermore and about \$267,000 at Berkeley in Fiscal Year 1994 and that a determination be made on the \$3.4 million of questionable costs for Fiscal Year 1995.

The Manager, Oakland Operations Office, disagreed with the amount of unallowable costs identified in the finding but agreed with two of the three recommendations. Although management agreed that there were unallowable costs for 1994, they did not agree to the amounts as stated in the report and did not agree that there were any unallowable costs for 1995.

Office of Inspector General
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PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Department of Energy (Department) uses contractors to operate its facilities and compensates contractor employees based on their skills, complexity of jobs, and work performance. The Department has established a process for authorizing and approving an annual salary increase fund for each contractor to enable them to retain a quality work force that is competitive with industry. In May 1993, the Secretary of Energy froze management and operating contractor employee salaries for each contractor's Fiscal Year 1994 compensation year. Also, the fund for promotions and adjustments was limited to a maximum of 0.5 percent of payroll for the 1-year period. Thirty-one of the Department's major contractors reported a total payroll (excluding overtime and benefits) of \$4.3 billion and \$4.4 billion during 1994 and 1995, respectively. The 31 contractors also reported awarding salary increases of \$18 million for 1994 and \$200 million for 1995.

We reviewed the process used to determine and approve the amount of salary increases for contractor employees. The audit objective was to determine whether salary increases received by contractor employees were in accordance with Departmental policies and procedures.

SCOPE AND METHODOLOGY

To accomplish our objective, we obtained and reviewed applicable Federal and Department regulations and correspondence related to contractor salary increases. We also reviewed related reports issued by the Office of Inspector General (Appendix A) and the General Accounting Office. Discussions were held with staff from the Office of Contractor Human Resource Management and cognizant operations/field officials at each site visited. These discussions covered the policies and procedures in effect to control salary increase funds.

We obtained information on payroll costs, number of employees, and salary increases from the operations/field offices for 31 of the Department's major contractors for 1994 through 1996. The information included the percentage of payroll authorized for salary increases along with the dollar amounts for budget and actual salary increases. We judgmentally selected 8 of the 31 contractors for a more detailed review. These eight contractors had a total payroll of \$1.5 billion in 1994 and \$1.4 billion in 1995 and reported salary increases of \$5.8 million and \$54 million during 1994 and 1995, respectively.

Site visits were made to four of the eight contractors. These contractors and locations were: TRW Environmental Safety Systems, Inc. in Fairfax, Virginia; Lawrence

Berkeley National Laboratory in Berkeley, California; Lawrence Livermore National Laboratory in Livermore, California; and Westinghouse-Bettis in Pittsburgh, Pennsylvania.

Our analysis included:

- * Reviewing actions taken by the Department to monitor and approve contractor salary increase funds.
- * Verifying that management and operating contractors complied with the salary freeze imposed by the Secretary and determining whether any salaries were increased in the following years to negate the savings resulting from the freeze.
- * Verifying the accuracy of payroll, budget and salary increases, and the actual amount of the salary increase funds for 1994 and 1995.

The audit was made in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Accordingly, we assessed internal controls regarding salary increase expenditures. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed.

The audit was performed between May and December 1996. We used computer-processed data obtained from contractor personnel and payroll data bases. Although we did not fully examine the reliability of each data base, specific payroll data was traced to individual personnel records to test its validity.

An exit conference was held with representatives of the Oakland Operations Office on March 24, 1997.

BACKGROUND

Every year the Department approves a salary increase fund for each contractor to enable them to retain competent and productive employees. (For this report, salary increase fund is used in the same context as salary increase authorization.) To aid the Department in determining each contractors annual budget for their salary increase fund, contractors provide information such as hiring and turnover rates and survey data from reputable sources. The survey data includes salaries in the market for comparable industries, occupational responsibility, and geographic locations. The final budget amount is derived from a percentage of total payroll at a point in time.

In May 1993, the Secretary of Energy imposed a 1-year salary freeze on all management and operating contractor employees, which was in line with the Administration's goal for savings in Government funded operations. The freeze was effective for each contractor's Fiscal Year 1994 compensation year beginning any time

between October 1, 1993, and September 30, 1994. All employee salary increases, except those covered by collective bargaining agreements, employees hired during Fiscal Year 1994, and increases based on the attainment of an essential credential (e.g. reactor operator certification) were affected by the freeze. Any exception to the pay freeze required Headquarters approval and, in most cases, required approval by the Secretary. However, contracting officers were allowed to approve a fund for promotions and adjustments for Fiscal Year 1994. An adjustment is an increase that is not for merit or promotion. This fund was limited to a maximum of 0.5 percent of payroll for each contractor.

This report contains a finding that addresses controls for contractor salary increases that should be considered by management in preparing the yearend assurance memorandum on management controls. Part II of this report provides details on our finding and recommendations. Part III of this report includes detailed management and auditor comments.

PART II

FINDING AND RECOMMENDATIONS

Controls Over Salary Increases

FINDING

The Department of Energy Acquisition Regulation (DEAR) requires that contractor salary actions be within specific limitations, supportable, and approved prior to incurrence of costs. In addition, the Secretary of Energy imposed a 1-year salary freeze on the merit portion of management and operating contractor employee salaries for the Fiscal Year 1994 compensation year. Two of eight contractors gave salary increases that were not always in accordance with Departmental policies. Lawrence Livermore National Laboratory (Livermore) and Lawrence Berkeley National Laboratory (Berkeley) did not properly charge all salary increases to their increase funds. This occurred because these contractors did not implement and contracting officers did not enforce contract and Department requirements, and contracting officers did not properly monitor salary expenditures. As a result, both contractors did not fully comply with the Secretary's pay freeze in 1994, which resulted in unallowable costs of about \$1.1 million at Livermore and about \$267,000 at Berkeley. Also, both contractors incurred questionable costs in 1995, about \$2.6 million at Livermore and about \$831,000 at Berkeley, by exceeding their salary increase budgets.

RECOMMENDATIONS

We recommended that the Manager, Oakland Operations Office, require the contracting officers at Livermore and Berkeley to:

1. Implement DOE Order 350.1, Chapter 5, by working with the contractors to mutually define and document which employees will be required to be included in the salary increase fund.
2. Enforce contract terms and properly monitor salary increase funds to ensure budgets are not exceeded and all required employees are included in the fund.
3. Take appropriate action at Livermore and Berkeley to recoup the \$1.1 million and \$267,000, respectively, of unallowable costs for 1994. Also, review the questioned costs for 1995 and, based on this determination, recoup any amount that is determined to be unallowable.

MANAGEMENT REACTION

The Manager, Oakland Operations Office, agreed with recommendations 1 and 2 and partially agreed with recommendation 3, but disagreed with the determination of the amount of unallowable costs. Although management agreed to begin the process to recoup the unallowable costs for 1994, it did not agree with the amounts as stated in the report. Also, management did not agree that the 1995 questioned costs were unallowable.

DETAILS OF FINDING

SALARY INCREASE POLICIES

To ensure that contractors' salaries are kept at competitive levels, the Department authorizes and approves an annual salary increase fund. The fund is calculated as a percentage of the contractors payroll and, when approved, becomes the budget for the contractors annual salary increases. For Fiscal Year 1994, the Secretary of Energy froze the merit increases for management and operating contractor employees and limited the salary increase fund to 0.5 percent of payroll for promotions and adjustments. Employees covered by collective bargaining agreements, employees hired during the pay freeze, and increases based on the attainment of an essential credential were excluded from the freeze. Because of the freeze, a salary increase merit submission was not required in 1994; however, each contractor was required to provide detailed reports to the Department, on a quarterly basis, showing the promotion and adjustment expenditures.

DEAR 942.002 states the Department shall monitor its contractors to ensure compliance with the terms and conditions of the contract. This would also ensure that all applicable promotion, merit increases, and adjustments are charged against the salary increase fund. The DEAR also states that labor policies of the Department's contractors should be designed so that contractors salaries are competitive with industry practices and reasonable for the work performed.

DOE Order 350.1, Contractor Human Resource Management Programs, issued September 30, 1996, requires that the Heads of Contracting Activities have procedures in place to verify the accuracy of the contractors' annual report on salary increase expenditures prior to reimbursement by the Department. Each contractor is required to track its expenditures of the salary increase fund and prepare an annual report of the expenditures for the contracting officer. Also, the specific groups of employees to be included in the salary increase fund are to be defined by mutual agreement between the contracting officer and contractor.

SALARY INCREASE FUND

Contractor employees received salary increases that were not always in accordance with Departmental policies and procedures. Although, six of eight contractors reviewed were in compliance with the established policies and procedures, problems existed at two contractors who did not charge all salary increases to their increase funds.

Salary Increase Fund Requirements

Livermore and Berkeley did not properly charge all employee salary increases to their increase funds. Headquarters personnel informed us that all salary increases should be charged to the fund unless the increase was for an employee in a step progression program, an indeterminate employee, or employees covered under collective bargaining agreements. An employee in a step progression program receives increases as skills are learned. Indeterminate employees are those whose employment normally will not exceed 2 years. These types of employees are usually excluded from the increase fund. However, for 1994 the Secretary imposed a pay freeze and only collective bargaining unit employees, employees hired during the freeze, and increases based on the attainment of an essential credential (e.g. reactor operator certification) were excluded.

Livermore

At Livermore, employees were categorized into two groups--accountable and nonaccountable. The accountable category of employees consisted of scientists, engineers, technical and administrative support. The nonaccountable category consisted of apprentices, trainees, summer hires, graduate students, and any employee who received an adjustment for a change of status or conversion of workweek. When Livermore submitted data for the approval of its annual salary increase budget, only the accountable group's payroll was used. When asked why employees were categorized into these two groups, Livermore informed us that historically it had always been done this way and was shown this way in its internal salary program guidelines. However, neither the contractor nor contracting officer could provide written documentation to show that the Department had approved this categorizing of employees that were excluded from the salary increase fund.

Based on Livermore's salary increase fund listings, 317 employees in 1994 and 519 employees in 1995 were categorized as nonaccountable and received increases. However, these increases were not charged against the salary increase fund. Therefore, Livermore exceeded its approved budgets for the salary increase fund in 1994 and 1995. We did not determine whether Livermore would have been within its budget if these nonaccountable employees had been included in the calculations submitted for budget approval because the necessary data was not readily available.

Berkeley

Berkeley categorized its employees into two groups--represented and nonrepresented. The represented category was union employees including service workers, clerical, and skilled craftsmen. The nonrepresented category consisted of temporary employees, student assistants, graduate students, engineers, and scientists. Berkeley stated that only the nonrepresented group of employees payroll was used when data was submitted for the approval of its annual salary increase budget.

Based on Berkeley's 1994 salary increase data, 94 nonrepresented employees' salary increases were not included in the budget or charged against its fund. This also occurred in 1995; and because Berkeley compiled salary increase data differently in 1994 due to the pay freeze, the number of employees excluded from its fund in 1995 could not be determined. We did not determine whether Berkeley would have been within its budget if these nonrepresented employees had been included in the calculations submitted for budget approval because the necessary data was not readily available. Also, neither the contractor nor contracting officer could provide written documentation to show that the Department had approved excluding some of the nonrepresented employees from the salary increase fund.

Secretary's Pay Freeze Requirements

By not charging all employee increases to its salary increase fund, Livermore and Berkeley also did not fully comply with all the requirements of the Secretary's pay freeze. Livermore and Berkeley did not limit the promotion and adjustment portion of their funds to 0.5 percent for all required employees and paid 317 and 94 employees, respectively, promotions and adjustments that were not included and approved in their budgets. These employees should not have been excluded from the freeze because they were not covered by collective bargaining agreements, new hires, or the increases were not based on the attainment of an essential credential. For example, although the Oakland Operations Office had given Livermore written approval to exclude six Oracle Programmers from the freeze, the Secretary's guidance explicitly stated that any exceptions to the freeze required Headquarters and, in most cases, the Secretary's approval. Headquarters personnel informed us that neither contractor received an exception to the pay freeze for any of its employees. In addition to not fully complying with the pay freeze, Livermore and Berkeley exceeded their salary increase budgets.

IMPLEMENTATION AND CONTRACT ADMINISTRATION

The contractors at Livermore and Berkeley did not implement and contracting officers did not enforce contract and Departmental requirements for salary increases. In addition, contracting officers did not properly perform their contract administration responsibilities concerning salary expenditures.

Contractor Implementation of Requirements

Under the requirements of both contracts, Livermore and Berkeley were required to submit salary increase fund proposals based on a percentage of their September 30 base payroll and to report on salary increase expenditures annually. For 1994, the Secretary modified the requirement to quarterly reports. However, none of the quarterly reports required during the pay freeze were submitted by either contractor.

Contract Administration

The Department did not fulfill all its contract administration responsibilities concerning salary increase fund expenditures. Although DEAR 942.002 requires the Department to ensure all salary increases are charged to the salary increase fund, Livermore was allowed to decide which employees would be included in the salary increase fund from year to year. Prior to the beginning of each compensation year, Livermore prepared internal guidelines on the type of employees that would be included and excluded in the salary increase fund. Livermore sent a copy of its internal guidelines to the Oakland Operations Office but did not ask for nor received approval. Berkeley also prepared internal guidelines, however, they only explained the categories of employees and the payroll codes. They did not describe which employees would be included in the salary increase fund.

Contracting officers also did not enforce all the requirements of the pay freeze or contract terms. In a memorandum, dated May 21, 1993, Headquarters informed the Oakland Operations Office that contractors would be required to provide detailed reports, on a quarterly basis, showing the promotion and adjustment expenditures for the year contractor salaries were frozen. However, the Director, Human Resources Management Division at the Oakland Operations Office, only advised Livermore and Berkeley that a report was due on November 15, 1994. As discussed above, neither contractor submitted reports tracking expenditures during the freeze, and the contracting officers did not question the contractors when the reports were not received. In addition, contract terms required both contractors to submit annual salary expenditure reports. Although both contractors submitted the required annual expenditure reports, we were informed by the contracting officers that the annual reports were not reviewed.

IMPACT OF CURRENT CONTRACT ADMINISTRATION

Of the eight contractors reviewed, two exceeded their approved salary increase funds in 1994 and 1995. By exceeding their budgets in 1994, Livermore and Berkeley did not fully comply with the Secretary's pay freeze by limiting promotion and adjustment increases to 0.5 percent of payroll. Therefore, in 1994 both contractors incurred unallowable costs, Livermore about \$1.1 million and Berkeley about \$267,000 because 317 and 94 employees, respectively, who were not included in the freeze, received promotion and adjustment increases not charged against the salary increase funds.

Further, by excluding the increases for 519 employees from its salary increase fund in 1995, Livermore exceeded its authorized budget by about \$2.6 million. Berkeley exceeded its authorized budget by about \$831,000 in 1995.

PART III

MANAGEMENT AND AUDITOR COMMENTS

In response to this report, the Manager, Oakland Operations Office, generally disagreed with the finding and determination of the amount of unallowable costs. Management believes that the majority of increases given at both Lawrence Livermore National Laboratory and Lawrence Berkeley National Laboratory fall under the umbrella of exceptions allowed in the Secretary's 1994 pay freeze directive. Management agreed with recommendations 1 and 2 and partially agreed with recommendation 3. A summary of management's comments and our response follows.

General Comments. Management stated that four categories of increases should have been constrained by the parameters of the freeze directive. These categories were students that were not officially terminated from the payroll at the end of their session, executives, step structure employee groups to merit structure positions, and technicians from the 500 to 200 series at Livermore. Management also agreed that post-doctoral students who simply received routine step increases did not fall under the categories of exceptions to the freeze. However, management stated that although Headquarters approval was not given for these increases because Oakland had given approval to grant increases to these employees, Berkeley had acted in good faith. Therefore, management does not plan to recover these unallowable costs from the contractor. With regard to the 1995 pay practices, management stated that the exclusion of certain categories of employees from the fund is consistent with its intent, which is to provide a fund for the merit increases of the consistent labor force as determined by anticipated market movement. Management referred to a Task Group Report for Interim Guidance on Industrial Relations Functions issued by Headquarters in 1982. It states that the fund is a pool of money approved annually by the Department against which the costs of all pay increases ... for permanent, non-bargaining unit personnel during the year are charged.

Auditor Comments. The Oakland Operations Office was advised of the salary freeze by letter on May 21, 1993. The letter outlined the specific requirements and effective dates of the freeze. In the "Questions and Answers" dated May 25, 1993, exceptions to the freeze were discussed along with special approvals required for exceptions. Question 8 specifically answered that there would be very few exceptions to the freeze and that all exceptions would require Headquarters approval with approval by the Secretary in most cases. Therefore, even though the Oakland Operations Office knew in advance that they did not have the authority to approve any exceptions to the freeze, approval was given to the laboratories for certain salary increases in 1994. The Oakland Operations Office should have requested the required approval and, until it was received, should not have allowed the contractors to pay certain increases in 1994. The Secretary's guidance was very specific, and if the contracting officers had been adequately administering the contracts, these unauthorized increases would not have occurred. With regard to the salary increases for 1995, the Oakland Operations Office did not provide any

documentation to show that certain categories of employees were approved to be excluded from the salary increase fund. Instead, we were told it was a long-standing practice at the laboratories that has just been accepted by the Oakland Operations Office over the years. However, just because it has been a long-standing practice does not make it correct or allowable. Also, the Task Group Report for Interim Guidance for Industrial Relations mentioned that the field industrial relations staff should discuss with Headquarters any types of increases excluded from the salary increase fund to ensure consistent treatment of employees by different field offices.

Recommendation 1. Implement DOE Order 350.1, Chapter 5, by working with the contractors to mutually define and document which employees will be required to be included in the salary increase fund.

Management Comments. Concur. Contracting officers at Livermore and Berkeley will work with the contractors to mutually define and document which employees will be required to be included in the salary increase fund. Anticipated date of completion is June 1, 1997.

Auditor Comments. Management's comments are responsive to the recommendation.

Recommendation 2. Enforce contract terms and properly monitor salary increase funds to ensure budgets are not exceeded and all required employees are included in the fund.

Management Comments. Concur. Contractors will be required to submit annual reports of salary increase fund expenditures for all employees included in the fund as required by the contract. These reports will be reviewed by the Oakland Operations Office to determine that the salary increase fund budgets have not been exceeded. Anticipated date of completion is December 1, 1997.

Auditor Comments. Management's comments are responsive to the recommendation.

Recommendation 3. Take appropriate action at Livermore and Berkeley to recoup the \$1.1 million and \$267,000, respectively, of unallowable costs for 1994. Also, review the questioned costs for 1995 and, based on this determination, recoup any amount that is determined to be unallowable.

Management Comments. Management agreed that there were some unallowable costs for 1994, but did not agree to the dollar amounts as stated in the report or that the questionable costs for 1995 were unallowable. Management previously stated that some information provided to us for Berkeley was incorrect and would change the amount of unallowables. Based on a management review, the unallowable costs agreed to for 1994 were attributed to the increases given to executives, employees going from the step to merit structure, technicians going from the 500 to 200 series at Livermore, and employees within student accounts. Management plans to identify the specific unallowable costs and

begin the process to recoup them. Management also stated that they have reviewed the questionable costs for 1995 and determined that all such costs were allowable.

Auditor Comments. The 1-year salary freeze imposed by the Secretary of Energy was very restrictive and specific on any exceptions to the freeze. Any exceptions to the freeze required Headquarters approval and, in most cases, approval by the Secretary. All employee salary increases, except those covered by collective bargaining agreements, employees hired during the freeze, and increases based on the attainment of an essential credential were frozen in 1994. Therefore, any employee that did not fall into one of these three categories should have had their salaries frozen in 1994. Any exception should have received approval from Headquarters, not the Oakland Operations Office. We acknowledge management's previous comment that they provided us with incorrect information for 18 clerical employees that will reduce the amount of unallowables at Berkeley. However, taking this into account, all other employee salary increases identified in the report for 1994, unless they fall into one of the three categories of exceptions, should be considered unallowable.

The questioned costs for 1995 were for costs incurred in excess of the approved budget for salary increases. Retroactive approval of increases does not encourage contractors to use the budget to contain costs.

APPENDIX A

PART IV

Reports Issued by the Department of Energy's
Office of Inspector General

<u>Report Number</u>	<u>Report Title</u>
DOE/IG-0332	Inspection of the Department of Energy's Procedures for Administering Contractors' Executive Employees' Compensation
DOE/IG-0266	Salary Administration Practices Sandia National Laboratories, Albuquerque, New Mexico
WR-OC-89-04	Nevada Operations Office's Oversight of Reynolds Electrical and Engineering Company Administration Practices
ER-OC-88-12	Review of the Salary Increase Fund at the Brookhaven National Laboratory
ER-OC-88-11	Chicago Operations Office Management of Salary Increase Funds
ER-OC-88-04	Review of the Salary Increase Fund at the Argonne National Laboratory

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