

Lawrence Livermore National Laboratory

Observations from Audit Procedures

September 30, 2006



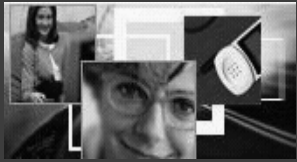
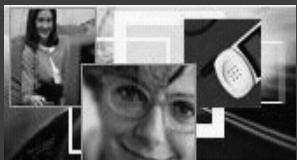


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This document is intended for use by the Regents' Committee on Audit and the management of the University of California and has been completed in the context of our audit of the University of California taken as a whole. The matters raised in this report are only those which have come to our attention that we believe need to be brought to you. They are not a complete listing of every potential matter arising from our procedures and we cannot be responsible for reporting all risks in your business or internal control weaknesses. This report should not be quoted in whole or in part without our prior written consent. No responsibility for any third party is accepted as the report has not been prepared for, and is not intended for, any other purpose.

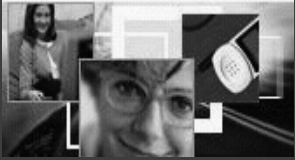


Your Needs and Expectations

We are committed to providing you with the highest level of professional service and committed to exceeding your expectations. Based on our discussions with you, we understand that your expectations are as follows:

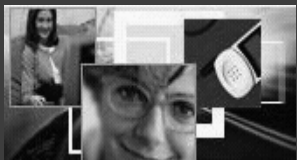
Needs/Expectations	PwC Actions
Provide the Audit Committee and UC management with an assessment of the Lab's financial accounting and reporting process. Prior to issuance to the UC management and Audit Committee, results of the assessments are to be provided to the Lab's finance management.	On this engagement we will complete analytics, internal controls review and substantive audit testing and ensure that a consistent level of quality and rigor is applied.
A final management letter with departmental responses is to be submitted to the UC Audit Committee.	Any recommendations for internal control improvements will be communicated to the Lab's finance management via the report of the results of our audit procedures and recommendations.
Keep management apprised of audit results and issues on a timely basis.	Ongoing.
Provide clear communication of the PwC expectations to the Lab's personnel.	PwC prepared a detailed listing of items required to be provided (PBC list). PwC monitored the listing and notified management of any issues that arose.

Because certain of the Lab's financial data is restricted, and since our procedures were limited to the March 31 and June 30, 2006 periods, we did not perform a complete audit of the Lab on a stand-alone basis. Had we conducted such an audit, additional matters may have arisen to report to you.



Background

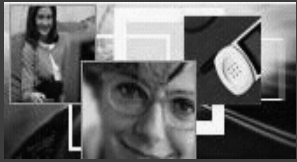
This year, we again conducted expanded audit procedures at all three UC operated national laboratories. While this report raises control and documentation issues, these should be viewed as recommendations for continuous improvement in the control environment.



Risk Assessment

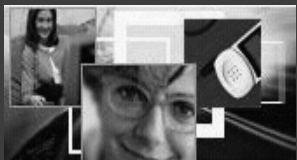
Our audit approach is risk-based. We identify and assess the implications of risks continuously throughout the performance of our audit procedures. We focus on the risks that have a potential impact on financial reporting and controls that mitigate those risks. The table below outlines our risk assessment and responses to those risks.

Risk Assessment	PwC Actions
<p>A preliminary assessment of the significant balance sheet accounts to identify significant variances and unusual items within the accounts as of March 31, 2006 and an update of that assessment as of June 30, 2006.</p>	<p>By performing various tests, as well as interviews with the Lab's management, we assessed and documented our understanding of the Lab's control environment during the interim phase of this year's audit and utilized that assessment as a preliminary basis for our procedures.</p>
<p>We obtained an understanding of the overall control environment including understanding of the key accounting cycles. The key accounting cycles addressed as part of this control risk assessment are:</p> <ul style="list-style-type: none"> • Cash/budgetary • Charges, purchasing, transfers and payables • Payroll • Receivables <p>Our assessment was complemented by substantive testing of the above areas.</p>	<p>We met with Lab's management to obtain an overall understanding of the Lab's control environment. We documented the process and control procedures as they relate to each of the four accounting cycles. In addition, we performed a monitoring controls review of each of the accounting cycles.</p>



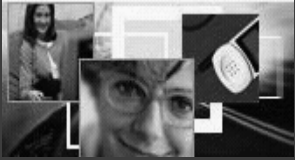
Risk Assessments *(continued)*

Risk Assessments	PwC Actions
<p>Financial statement assertions (Completeness, Accuracy, Validity, Existence) of the significant financial statement accounts are addressed.</p>	<p>We performed the appropriate substantive detail testing of significant balance sheet and expense accounts. The details and the results of the work performed are documented herein.</p>
<p>Fraud review procedures and internal audit reports review.</p>	<p>We obtained and reviewed all internal audit reports issued in fiscal 2006. In addition, we inquired with Lab's management and internal audit of their awareness of any known instances of fraud.</p>



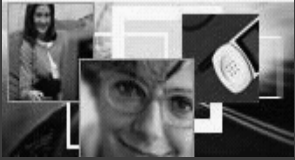
Audit Strategy

Audit Strategy	Audit Procedure
Cash and cash equivalents	Assess and test monitoring controls over the cash cycle Review and test bank account reconciliations Confirm bank account balances with Bank of America Perform analytical reviews
Accounts receivable	Assess and test monitoring controls over the receivables cycle Perform analytical reviews Review accounts receivable reconciliations Perform subsequent receipts testing Evaluate the allowance for doubtful accounts
Prepaid expenses	Perform review of prepaid account reconciliations Perform analytical reviews Perform testing of support
Inventory	Review inventory reconciliations Perform analytical reviews
Buildings and equipment and accumulated depreciation	Review account reconciliations Perform disposal and addition testing Perform analytical reviews Review repairs and maintenance accounts
Accounts payable, accrued liabilities and fund held for others	Assess and test monitoring controls Review account reconciliations Perform search for unrecorded liabilities Perform substantive testing Perform analytical reviews



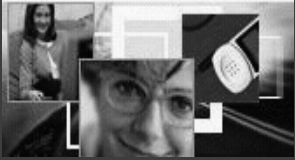
Audit Strategy *(continued)*

Audit Strategy	Audit Procedure
Pension and post-retirement medical	Perform review of account reconciliations Perform analytical reviews Balances agreed to actuarial report
Deferred revenue	Assess and test monitoring controls Review account reconciliations Perform analytical reviews Perform substantive testing
Commitments and contingencies	Discuss any commitments/contingencies with management Consider results of other audit tests for additional commitments/contingencies
Equity (contributed capital and retained earnings)	Confirm transfer of funds Detailed analytical procedures
Payroll	Assess and test monitoring controls Perform substantive testing
Cost allowability	Review of internal audit reports Substantive testing to re-perform testing performed by internal audit during the year.



Cash

- Assessed and tested monitoring controls over the cash cycle
 - Obtained an updated overview of controls over the cash cycle
 - Assessed and tested monitoring controls over the cash cycle for the following accounts:
 - 1) Payroll account
 - 2) Vendor account
 - 3) Lab controlled bank Accounts
 - Non-statistically selected a sample of three monthly bank reconciliations from each of the largest payroll and vendor accounts and ensured they were prepared timely on a regular basis by examining the date prepared and comparing to the period being reconciled. No exceptions noted.
 - Examined and reviewed the list of outstanding checks as of March 31, 2006. In addition, we selected a sample of 30 outstanding checks to ensure that follow-up was performed. No exceptions noted.
 - Examined and reviewed the monitoring controls over check generation by reviewing three batch reports. No exceptions noted.



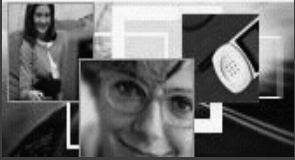
Cash *(continued)*

- Non-statistically selected a sample of thirty “Positive Pay Detail Report” and reviewed the report for Lab’s follow-up and supervisory approvals. No exceptions noted.

-- Assessed and tested monitoring controls over the Lab controlled bank accounts

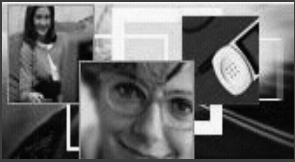
- Obtained a sample of three monthly bank reconciliations for all fund types and ensured they were prepared and reviewed by the appropriate supervisor. No exceptions noted.

- Performed analytical reviews
- Confirmed all bank account balances with Bank of America (“*BofA*”)
 - No exceptions noted.



Accounts Receivable

- Assessed and tested monitoring controls over the receivables cycle
 - Obtained an updated overview of the receivables cycle
 - Tested monitoring controls over the receivables cycle
 - Tested monitoring of contracts by selecting a sample of four monthly “ENG 48 Contract Modification Report” and examined the Lab’s review of the current status of all contracts outstanding and their respective funding amounts. No exceptions noted.
 - Non-statistically selected a sample of 30 daily check receipt logs and reviewed the logs preparation and evidence of sign-offs. No exceptions noted. In addition, we traced the total amounts of deposit to deposit ticket and Accounts Receivable subledger. Exceptions noted. Refer to comments following.
 - Obtained a sample of four monthly “Summary of Collections” and reviewed the reconciliations of the Lab’s total cash receipts to DOE fund balances. No exceptions noted.



Accounts Receivable *(continued)*

Observation

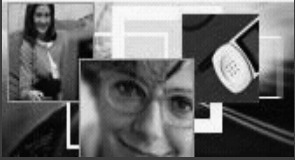
During our review of the cash deposit receipt logs, we noted a number of instances in which the daily receipts did not agree to the deposit detail report. In each occurrence, advance checks were received on work-for-others projects and not deposited in accordance with Labs policy. Per discussion with management, we understand that this issue was related to the STARS conversion. When an advance check is received prior to the receipt of the Work-For-Others (“WFO”) number, the Lab cannot deposit the funds into the DOE bank account. Therefore, it must be deposited into the Bank of America bank account which creates additional work when it must later be transferred. Therefore, there were checks that were held pending the receipt of the WFO number.

Recommendation

We recommend that the process for the receipt of advance checks be refined to require timely depositing of those checks into the appropriate bank accounts. This will provide for increased control over all cash receipts of the Lab.

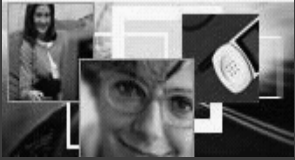
Management’s Response

Management agrees that, at times in the past, advance checks were held for a few days while awaiting the issuance of an advance invoice. Now invoices are generated timely so that, when advance checks are received, they can be applied against an invoice and timely deposited. In part, the hold of generating invoices was due to the processing time required for the DOE to issue a WFO number. That processing time has now been shortened. The Lab no longer holds checks awaiting invoices for longer than two days. After two days without an invoice, the deposit is made to the Bank of America account.



Accounts Receivable (continued)

- Selected a sample of four monthly “Billing Procedures Checklist” to review completion of the checklists. No exceptions noted.
- Selected a sample of four monthly AR Agings (“*Financial Operations and Revenue Management Group Monthly Internal Report*”) and reviewed the reconciliations of the reports by MARS balance sheet code to the AR trade receivable balances. In addition, we reviewed for evidence of supervisory sign-offs. Exceptions noted. Refer to comments following.
- Selected a sample of two monthly “Summary of Debt Due from Public” reports to examine evidence of management’s reviews and sign-offs. On a quarterly basis, the reports are due to DOE. No exceptions noted.
- Examined and reviewed the Allowance for Uncollectible A/R calculations and A/R aging reports sent to DOE. Exceptions noted. Refer to comments following.



Accounts Receivable *(continued)*

Observation

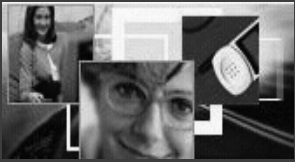
During the test of control of the Accounts Receivable (“A/R”) cycle in which we verify that all receivables are aged and reconciled on a monthly basis, no signatures were noted on the A/R reconciliation indicating review. Based upon our discussion with management, the review is done via electronic copies of the report. However, there is no log or electronic signature on the soft copy to provide evidence of review. Furthermore, there was no signature to document management’s review of the allowance for the uncollectible accounts receivable calculations or the accounts receivable aging report sent to the DOE.

Recommendation

We recommend that the control process be amended to require the retention of evidence of the review. This can include a hard copy of A/R reconciliation with the proper signature evidencing review. Furthermore, we recommend that management ensure review and sign-off of the allowance for uncollectible accounts receivable calculations and accounts receivable aging report that is sent to the DOE.

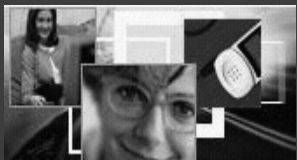
Management’s Response

Management concurs with the observation. This recommendation was made internally as part of the internal control review (SOX Program) which was performed for LLNL’s OMB assurance. The process will be changed such that individuals who perform reconciliations obtain evidence of the preparation and review. Until such time as an electronic signature process can be implemented, hard copies of all documents are to be retained.



Accounts Receivable *(continued)*

- Performed a fluctuation analysis of significant receivable accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts
 - Obtained explanations and assessed reasonableness of significant and material variances
- Reviewed accounts receivable account reconciliations
 - Reviewed a sample of five accounts receivable reconciliations totaling \$38M or 98% of the accounts receivable balance as of March 31, 2006. We tested significant reconciling items to supporting documentation and the client's supervisory reviews. Refer to observation following.
- Performed subsequent receipts testing
 - Selected a sample of 30 large subsequent payments and vouched to their related AR to ensure validity of the receivables. No exceptions noted.
- Evaluated the allowance for doubtful accounts
 - Obtained supporting documentation for the allowance for bad debt calculation and reviewed journal entry based on the calculation and evidence of supervisory approval. No exceptions noted.



Accounts Receivable *(continued)*

Observation

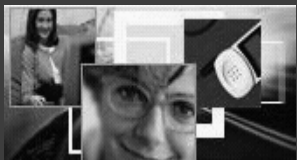
During the review of the reconciliation between the accounts receivable (“A/R”) aging detail and the general ledger, we noted a difference of \$2.48M between the A/R Aging report and the sub-ledger general ledger balance. This difference relates to costs incurred for projects that have been approved by the Contract Officer but not yet funded in the DOE system. These costs cannot be billed to the DOE until the online funding has been completed. Such costs are recorded to an unbilled accounts receivable general ledger account until such time as the online funding is complete and the costs can be invoiced. At that time, the amounts are transferred out of the unbilled account and reflected in the accounts receivable account. These amounts are properly reported to UC as receivables, payables and are included in both expenses and revenues.

Recommendation

We understand that this has been a general practice that has been agreed by the DOE & Labs management. We understand that there are rigorous controls around the activity that is recorded to the unbilled A/R account and follow up once billing has been approved. We recommend that management continue to monitor the costs that are incurred prior to formal billing approval.

Management’s Response

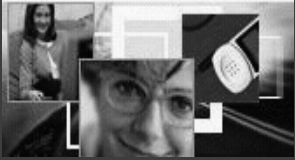
Management concurs with the observation noted above and the fact that this is a generally accepted practice between the UC run Labs and the DOE. Further, there are rigorous controls in place by which the amounts recorded to the suspense account are monitored and reconciled on a monthly basis. Management does not believe that further action is required at this time related to this matter.



Prepays

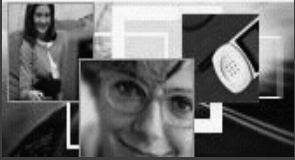
- Performed a fluctuation analysis of prepaid accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts
 - Obtained explanations and assessed reasonableness of significant and material variances

- Reviewed prepaid account reconciliations
 - Reviewed a sample of two general ledger account reconciliations totaling \$366M or 99% of the prepaid balance as of March 31, 2006. The accounts we reviewed were as follows:
 - **Suspense Debits** (\$1million): This account is used to record unbilled charges that will be analyzed and billed in a subsequent period.
 - **Pension Plan Asset** (\$365 million): This account is used to record UC Employees Pension Plan.



Prepays (continued)

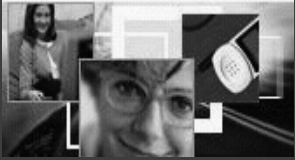
- Performed Substantive Testing on Prepaid Expenses:
 - Detail tested Pension Plan Asset which represented \$365,263,112 (99%) of the prepaid balance as of March 31, 2006 by agreeing amounts to the quarterly Financial Accounting Standards Board Statement No. 87, *Employer's Accounting for Pensions* Statement that is provided to the Lab by the DOE. No exceptions noted.
 - Detail tested the Suspense Debits – MARS adjustment account in the amount of \$1.3 million through review of invoices and accrual calculations as of March 31, 2006. No exceptions noted.
 - Detail tested \$1.1M or 77% of the Unbilled and Multi-location Suspense balance as of March 31, 2006. Through review of credit memos and reconciliations. No exceptions noted.
 - Detail tested \$465K or 88% of the Russian Subcontracts by selecting 29 samples and reviewed their related invoices as of March 31, 2006. Reviewed journal entries which reclassified the Subcontracts to prepaids. No exceptions noted.



Inventory

- Performed a fluctuation analysis of significant inventory accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts
 - Obtained explanations and assessed reasonableness of significant and material variances

- Reviewed inventory account reconciliations
 - The largest account balance, Material & Supplies-Nuclear Material Control Account, in the amount of \$23M as of March 31, 2006 was not available to review due to security issues.
 - We were able to review the remaining inventory account reconciliations in the amount of \$2.5M or 10% of the total inventory asset. No exceptions noted.

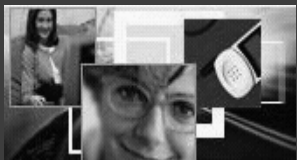


Property, Plant & Equipment

- Performed a fluctuation analysis of significant Property, Plant & Equipment (“PP&E”) accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts
 - Obtained explanations and assessed reasonableness of significant and material variances

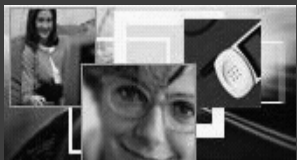
- Reviewed PP&E account reconciliations
 - Reviewed all five reconciliations totaling \$2.8B or 100% of the PP&E account balance as of March 31, 2006. No exceptions noted.

- Performed disposal and additional testing
 - Non-statistically selected and tested a sample of 92 transactions that occurred during the year. Those included additions, disposals and transfers from account 2130 and 2311. No exceptions noted.



Accounts Payable

- Assessed and tested monitoring controls over the purchases and payables cycle
 - Obtained an updated overview of the purchases and payables cycle
 - Tested monitoring controls over the purchases and payables cycle
 - Reviewed the A/P Detail Listing dated June 12, 2006 and ensured that the report had been reviewed by the appropriate personnel. No exceptions noted.
 - In addition, we obtained a sample of ten weekly “Vendor Code Site Change” edit reports for review. No exceptions noted.
 - Selected a sample of 45 invoices and matched them with correct POs and receiving documents, if applicable. No exceptions noted.
 - Judgmentally selected a sample of 45 invoices greater than \$50k and ensured that the invoices were properly authorized by the appropriate signers for payments.
One exception noted. Refer to comment following.
 - Judgmentally selected a sample of four monthly AP Trial Balance Reconciliations and examined for reconciling items and supervisory reviews. In addition, we observed whether the reconciliations were done in a timely fashion. No exceptions noted.



Accounts Payable *(continued)*

Observation

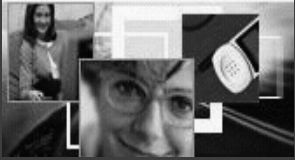
During our testing of controls over the processing and payment of invoices, we noted an invoice in excess of \$50,000 that had not been signed to evidence the review by an authorized accounts payable (“A/P”) staff member. Lab policy requires invoices that exceed \$50,000 a secondary review and approval by an authorized member of the A/P department. For one invoice out of our sample of 45, there was no evidence of that secondary review.

Recommendation

We recommend that management ensure that all members of the A/P staff are educated on the policies of the Lab to ensure appropriate procedures are performed. In addition, we recommend that the Lab explore automating the approval process to require the additional approval prior to payment of an invoice.

Management’s Response

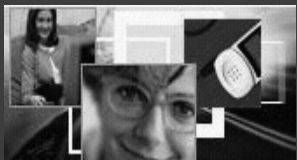
Management concurs with the finding. The Lab’s policy is such that an authorized member of the A/P staff review and approve invoices that exceed \$50K. With regards to the above recommendation, it is agreeable that management should ensure that all invoices are signed by authorized approvers. In addition to this policy, it is LLNL procedure to have a group independent of Accounts Payable (Disbursement Operations Group) verify that all invoices over \$100K have an authorized approver initial. Additionally, the authorized bank signer reviews all invoices over \$100K, verifying the sign-off of the invoice, as indicated by the initials on the payment register.



Accounts Payable *(continued)*

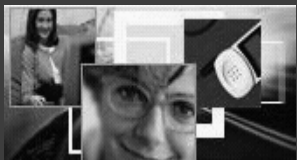
- Reviewed A/P account reconciliations
 - Reviewed a sample of four general ledger account reconciliations totaling \$37M or 100% of the balance as of March 31, 2006. No exceptions noted.

- Performed substantive testing on search for unrecorded liabilities
 - Selected a sample of 34 expenses paid from 7/1/06-8/31/06 and verified validity and accuracy of the expense through review of supporting documentation (i.e. invoice and check copy) and vouched to AP. No exceptions noted.



Accrued Liabilities

- Performed a fluctuation analysis of significant accrued accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts.
 - Obtained explanations and assessed reasonableness of significant and material variances.
- Reviewed accrued account reconciliations
 - Reviewed a sample of 13 reconciliations totaling \$910M or 99% of the accrued liabilities balance as of March 31, 2006. No exceptions noted.
- Performed substantive analytics and detailed testing
 - Performed substantive analytics on 97% of the Accrued Expenses and Other Liabilities Lead Schedule. Exception Noted. Refer to comment following.
 - Selected samples of 30 employee vacation amounts and verified against the payroll registers and years of service with the vacation accrual policy. No exceptions noted. No exceptions noted.



Accrued Liabilities *(continued)*

Observation

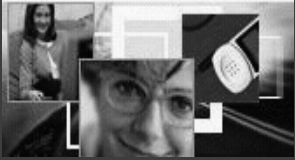
During review of the accrued expenses account, we noted the litigation reserve liability had a debit balance rather than a credit balance. The accrual adjustment to the litigation reserve in June in the amount of \$619k was entered as a debit rather than a credit in error. Therefore, the liability was understated by \$1.2 M at June 30, 2006.

Recommendation

We recommend that management make an adjusting journal entry to correct the liability.

Management's Response

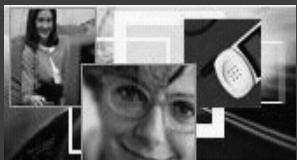
Management was aware of the error prior to the performance of the audit procedures and had recorded a correcting journal entry in August 2006. Further, Management communicated the error to UC and an adjusting journal entry has been recorded to correct this on the UC financial statements as of June 30, 2006.



Pension and Post-retirement

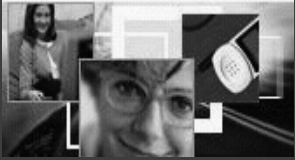
- Performed analytical reviews
 - Obtained a thorough understanding and documented the composition and description of the accounts
 - Obtained explanations and assessed reasonableness of significant and material variances

- Reviewed 100% pension and post-retirement account reconciliations as of March 31, 2006. No exceptions noted.



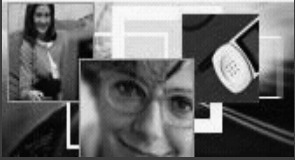
Deferred Revenue

- Assessed and tested monitoring controls over the revenue cycle
 - Obtained an updated overview of the revenue cycle.
 - Tested monitoring controls over the revenue cycle (refer to AR section for controls testing on deferred revenue). No exceptions noted.
- Performed a fluctuation analysis of significant deferred revenue accounts
 - Obtained a thorough understanding and documented the composition and description of the accounts.
 - Obtained explanations and assessed reasonableness of significant and material variances.
- Reviewed 99% of the deferred revenue account reconciliations as of March 31, 2006
 - No exceptions noted.
- Performed substantive testing of 78% of the deferred revenue balance
 - Selected a sample of 32 items to the deferred revenue balance and agreed to check copy or contracts for validity. No exceptions noted.



Payroll

- Assessed and tested monitoring controls over the cash cycle
 - Obtained an updated overview of the payroll cycle
 - Tested monitoring controls over the payroll cycle
 - Non-statistically selected a sample of 10 payroll edit reports and reviewed for evidence of timely generation, supervisory review, and whether the exceptions were followed up by the appropriate accounting personnel. No exceptions noted.
 - Selected a sample of three Consolidated Billing Summary for benefits and examined for timely generation of the report and evidence of Payroll Supervisor reviews (e.g., sign-offs). In addition, we reviewed whether exceptions on the summary were followed up by the appropriate accounting personnel in a timely fashion. No exceptions noted.

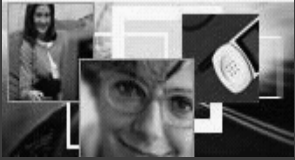


Payroll (continued)

- Selected a sample of three months from each of the following reconciliations and examined for timely generation of the reports and evidence of Payroll Supervisor reviews (e.g., sign-offs). In addition, we reviewed whether reconciling items were followed up by the appropriate personnel on a timely fashion:

- ❖ Payroll Expenses (Subledger and GL) Reconciliations
 - ❖ Bank (GL and Bank) Reconciliations
- No exceptions noted.

- Performed substantive testing of payroll costs
 - Selected a sample of 30 employees and agreed to payroll checks and payroll check registers to verify the validity and accuracy of payroll costs. No exceptions noted.



Review of Internal Audit Results

- Review of Internal Audit Reports
 - o Obtained all internal audit reports issued during the year. We reviewed those reports to determine whether any issues noted relate to financial statement assertions or the allowability of costs under the DOE contract.

- Re-performance of Internal Audit Cost Allowability Testing
 - o Reviewed Internal Audit testing of cost allowability during the period from Oct. 1, 2004 through May 31, 2005. We selected 71 transactions that were tested by Internal Audit. We reviewed the supporting documentation for the costs to ensure that the costs are allowable under the DOE contract and that our conclusions and those of Internal Audit were consistent. No exceptions noted.

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