



U.S. Department of Energy
Office of Inspector General
Office of Audit Services

Audit Report

Management Controls over Monitoring and Closeout of Small Business Innovation Research Phase II Grants

OAS-M-08-09

July 2008



Department of Energy

Washington, DC 20585

JUL 14 2008

MEMORANDUM FOR THE MANAGER, CHICAGO OFFICE

A handwritten signature in black ink, appearing to read "Rickey R. Hass".

FROM: Rickey R. Hass
Assistant Inspector General
for Environment, Science, and Corporate Audits
Office of Inspector General

SUBJECT: INFORMATION: Audit Report on "Management Controls over
Monitoring and Closeout of Small Business Innovation
Research Phase II Grants"

BACKGROUND

The Small Business Innovation Development Act of 1982 (Public Law 97-219) established the Small Business Innovation Research Program to assist small businesses in developing new ideas and technology. Under this program, the Department of Energy (Department) sets aside 2.5 percent of its research and development budget for grants to small businesses. The Department uses these funds to award competitive grants to small businesses for exploring the technical merit or feasibility of new ideas and technology. These research and development grants are awarded in several phases and often culminate in the grantee producing a prototype product or process that can be demonstrated to potential investors. Grantees are required to prepare a final expenditure report at completion of the grant and to maintain records supporting the expenditures of Federal grant funds for three years following completion of the final expenditure report. The Office of Science's Chicago Office (Chicago) is responsible for the administration of the Department's Small Business Innovation Research Phase II (SBIR II) grants. As of September 30, 2007, there were 334 active SBIR Phase II grants with a total award value of \$277 million.

In the Office of Inspector General report, *Administration of Small Business Innovation Research Phase II Grants* (DOE/IG-0521, August 2001), we identified weaknesses related to cost sharing and allowability of costs submitted by grantees. During that audit, questioned costs of approximately \$2.4 million and unsupported costs of approximately \$2.4 million were identified. Management concurred with our findings and pledged to resolve all questioned and unsupported costs. The objective of our audit was to determine whether previously observed weaknesses with the administration of the SBIR II grant program had been corrected.

RESULTS OF AUDIT

Our review disclosed that Chicago had not corrected all previously reported weaknesses in monitoring and administering the SBIR II grants program. Specifically:



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- Action had not been completed to resolve about \$1.2 million of the approximately \$2.4 million of questioned costs identified in our previous audit of SBIR II grants; and,
- Chicago was not reviewing grant costs or closing out completed awards in a timely manner. Testing revealed that Chicago had not completed action on or was unable to provide grant files for 87 percent, or 73 out of 84, of SBIR II grants that had been completed for more than three years. In seven out of the eight grants sampled, the grantee had not been contacted in over three years. Of these seven, four had never been contacted and urged to send the documents necessary to close out the grant.

Chicago did not give sufficient attention to verifying that costs incurred by SBIR II grantees were allowable. Chicago officials told us that problems with insufficient staff and resources required them to focus the majority of their attention on active awards rather than SBIR II grant close out. Chicago also indicated that it used a risk-based process to determine whether to conduct desk reviews or audits before closing out grants. While this risk-based process may be sufficient with higher dollar value grants, it effectively excludes most SBIR II grants from review or audit because these grants seldom exceed \$1 million – Chicago's threshold for automatic close out of grants without known problems.

Without improvement in the timeliness of the grant closeout and review processes, the Department may pay for unnecessary and unallowable costs. For example, we identified \$27,610 in questionable costs and \$749,749 in unsupported costs during our testing of closed grants. Further, because of extensive delays in the close out process, Chicago's ability to recover the \$1.2 million in costs questioned in our previous SBIR II audit is uncertain. We also identified \$7.4 million in SBIR II funding associated with grants where an audit or desk review may still be needed; however, the required document retention period had expired, thereby putting the ability to complete these assessments in jeopardy.

To its credit, Chicago resolved about 75 percent of the questioned and unsupported costs noted in our previous audit report and made attempts to improve the timeliness of closeouts. However, additional improvements in the administration of SBIR II grants were needed. Accordingly, we made several recommendations addressing the timeliness and efficiency issues discussed in this report.

MANAGEMENT REACTION

The Chicago Office concurred with the report and provided corrective actions it intended to take. These actions are responsive to our recommendations. Management's verbatim comments and planned actions are included as Appendix 3.

Attachment

cc: Acting Deputy Secretary
Under Secretary of Energy

Chief of Staff
Team Leader, Audit Liaison Team, CF-1.2

**REPORT ON MANAGEMENT CONTROLS OVER MONITORING AND
CLOSEOUT OF SMALL BUSINESS INNOVATION RESEARCH PHASE II
GRANTS**

**TABLE OF
CONTENTS**

SBIR Phase II Grants

Details of Finding 1

Recommendations and Comments 3

Appendices

1. Objective, Scope, and Methodology 5

2. Related Audit Report 7

3. Management Comments 8

SBIR PHASE II GRANTS

Grant Administration

The Office of Science's Chicago Office (Chicago) had not corrected all weaknesses in the Small Business Innovation Research Phase II (SBIR II) grants program. Specifically, management had not completed resolution of questioned costs from our previous audit of SBIR II grants. Additionally, testing revealed a number of problems with the timely close out of completed grants.

Previous Audit Findings

Management had not yet resolved a portion of the questioned costs we identified in our previous audit of SBIR II grants. Specifically, of the \$2.4 million in questioned costs, management had not resolved costs of \$1,225,234. In addition, Chicago closed one of the four grants we reported in 2001 even though the issue identified in our previous audit was not addressed. Chicago officials indicated they were in the process of resolving these issues.

Grant Close Out

Chicago is also not closing out SBIR II grants in a timely manner. The Code of Federal Regulations (CFR) requires grantees to submit a final expenditure report within 90 days of the completion of the grant term. After the final expenditure report is filed with the Department, the grantee must retain grant documentation for three years. Thus, the Department of Energy (Department) has a three-year window of opportunity to review and close out SBIR II grants should it need to request supporting cost information from the grantee. Our testing, however, revealed that the Department is foregoing this window of opportunity and is taking longer than three years to close out its SBIR II grants. As of September 30, 2007, nearly 270 SBIR II grants were considered complete by Chicago but had not yet been closed out. We selected for review all 84 grants with completion dates exceeding three years as these grants had the greatest potential to have funds at risk. As shown in the table below, Chicago had not completed action on or was unable to provide us with the file for 73 of the 84 SBIR II grants that had been completed for more than three years.

SBIR II Grants Not Acted Upon as Prescribed

<u>Final Expenditure Reports:</u>	<u>Number</u>	<u>Percentage</u>
Not Received as of February 2008	35	42%
Received more than three years prior to February 2008	34	40%
Grant file could not be located	4	5%
Total out of 84 SBIR Grants	<u>73</u>	<u>87%</u>

We identified 35 instances in which an expenditure report had not been received even though the grant had been completed for more than three years. The Department still has the right to request information because the grantee's three-year record retention period does not begin until the final expenditure report is submitted. However, in seven of the eight grants reviewed, the grantee had not been contacted for more than three years. In four of these seven instances, the grantee had never been contacted and urged to send the documents necessary to close out the grant. Long delays in closing out completed awards increases the risk that grantees will not remain going concerns and be capable of supplying needed records.

In the 34 instances where the final expenditure report was received more than three years prior to our review, Chicago told us that an audit or desk review may still be needed for 10 of the grants. However, the window of opportunity for the Government to request that grantees supply records for these 10 grants has lapsed. Therefore, these grantees may have destroyed their records because they are not obligated to retain grant documents after the three-year period unless Chicago directed them to do so before the period lapsed. In reviewing the seven files that were available for our review, we could not find evidence that Chicago had directed the grantees to retain grant documents beyond the three-year period.

Post-Award Cost Reviews

Chicago did not give sufficient attention to verifying that costs incurred by SBIR II grantees were allowable. Chicago officials told us that problems with insufficient staff and resources required them to focus their attention on active awards rather than grant close out. Chicago also indicated that it used a risk-based process to determine whether to conduct desk reviews or audits before closing out grants. The current process uses a judgmental approach to select grants for desk reviews or audits based on a number of risk factors tied to financial measures and past experiences. However, SBIR II grants are infrequently subjected to desk reviews or audits because Chicago's process permits grants under \$1 million without any known concerns to be closed by the contracting officer without such reviews. SBIR II grants have typically fallen below this threshold and subsequently have not been subjected to audits or desk reviews. Of the 12 grants we selected for review, none had been selected for a post-award cost review.

Potential for Unnecessary and Unallowable Costs

Without improvement in the timeliness of the grant closeout and review process, the Department may pay for unnecessary and unallowable costs. For example, we requested support from 12 grantees for review and identified \$27,610 in questioned costs. We also questioned \$749,749 as unsupported due to the failure of one of the grantees to provide requested records. Further, the recoverability of \$1,225,234 in costs identified in our previous SBIR II audit is uncertain, considering three of the four grants with questioned costs provided their final expenditure report more than three years ago. Therefore, the supporting cost data may not be available for the Department's review. In fact, over \$7.4 million in SBIR II funding is tied to grants where the need for an audit or desk review is expected or unknown and the required retention period has expired. Grantees may have legitimately destroyed their records – actions that could jeopardize the performance of these assessments.

To its credit, Chicago resolved approximately 75% of the total questioned and unsupported costs from our previous report. Chicago officials also said they have attempted to improve the close out process. For example, officials said they offered incentives to employees to expedite grant close outs.

RECOMMENDATIONS

To help resolve the issues discussed in this report and improve administration of SBIR II grants, we recommend that the Manager, Chicago Office, direct acquisition officials to:

1. Make a determination regarding the allowability of costs questioned in this report;
2. Initiate steps to ensure grantees submit their final expenditure report within the required timeframe and that grant files are closed in the required amount of time after receipt of the final expenditure report; and,
3. Enhance the existing closeout process used to select SBIR II grants for audit by also including randomly selected grants that are not otherwise selected based on risk.

MANAGEMENT AND AUDITOR COMMENTS

Chicago concurred with the recommendations and identified corrective actions they plan to complete by December 31, 2008. These actions include a determination of the allowability of questioned costs; actions to decrease the time required to close out grants; and revisions to the closeout policy and procedures to allow for random audit sampling of SBIR II grants being closed out.

We consider management's comments and planned actions to be responsive to our recommendations.

Appendix 1

OBJECTIVE

The objective of this audit was to determine whether previously observed weaknesses with the administration of the Small Business Innovation Research Phase II (SBIR II) grant program had been corrected.

SCOPE

The audit was performed from October 2007 to July 2008 at the Office of Science's Chicago Office (Chicago) in Argonne, Illinois. The scope of the audit considered the 83 SBIR II grants that were closed out in Fiscal Years 2006 and 2007 and the 267 grants classified as inactive but not yet closed out as of September 30, 2007, with a completion date December 31, 2004, or earlier.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed applicable laws and regulations, as well as internal Chicago policies for administering SBIR II grants;
- Performed follow-up on the status of recommendations from the previous Office of Inspector General Audit of SBIR II grants;
- Contacted the Defense Contract Audit Agency to determine if audit reports were issued for grantees in our sample, and reviewed those available;
- Reviewed the files of selected grantees to determine grant terms and the extent of review activity by Chicago personnel for the administration of the awards;
- Reviewed supporting documentation from selected grantees to determine the allowability of costs claimed;
- Reviewed grantee final expenditure reports to determine when they were received; and,
- Held discussions with personnel from Chicago.

This performance audit was conducted in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. The audit included tests of

controls and compliance with laws and regulations necessary to satisfy 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. Also, we considered the establishment of performance measures in accordance with the Government Performance and Results Act of 1993 as they related to the audit objective; however we did not identify any measures related to SBIR II grants. We relied on computer-processed data to identify the population of SBIR II grants in order to accomplish our audit objective. Based on our comparisons of computer-processed data to supporting documentation, we determined that the data used to satisfy our audit objective were reliable.

Management waived an exit conference.

RELATED AUDIT REPORT

- *Administration of Small Business Innovation Research Phase II Grants* (DOE/IG-0521, August 2001). The audit found that the Department of Energy (Department) had not appropriately verified that all costs claimed by Small Business Innovation Research Phase II (SBIR II) grantees were, in fact, allowable and used for developing the specific innovations described in the relevant grant documents. The Department generally limited its cost reviews to pre-award evaluations of the costs proposed in the applications submitted by grantees; it did not place sufficient emphasis on post-award reviews of actual costs. As a result, the audit found that the Department reimbursed grantees for questionable costs. For example, three grantees did not provide any support for about \$2.4 million in claimed costs. Further, the Department did not verify that grantees fully contributed their portion of cost sharing, which was a requirement of the grants. It was noted that ten SBIR II grantees reported providing \$2.4 million less in cost sharing than required by the terms of the relevant grant agreements. The audit also reported that grantees were not submitting final cost data within required timeframes and grants were not being closed out in a timely manner.



Department of Energy

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JUN 20 2008

Rickey R. Hass
Assistant Inspector General
for Environmental, Science, and Corporate Audits
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SUBJECT: FOLLOW-UP DRAFT REPORT ON "MANAGEMENT CONTROLS OVER MONITORING AND CLOSEOUT OF SMALL BUSINESS INNOVATION RESEARCH PHASE II GRANTS"

Management concurs with the recommendations as contained in the Draft Report. We acknowledge the need to improve the administration and closeout of the Small Business Innovation Research (SBIR) Phase II awards. However, we continue to make progress in our closeout performance. During FY 2006 we closed 452 inactive instruments; during FY 2007, we closed 592, a 31% increase. Following are our comments relative to the specific recommendations, including corrective actions planned and general observations:

Recommendation Number 1: Make a determination regarding the allowability of questioned costs in this report.

The respective Contracting Officers will make a determination of allowability regarding the \$1,225,234 questioned costs from the previous audit finding and the additional questioned costs of \$777,359 by December 31, 2008.

Recommendation Number 2: Initiate steps to ensure grantees submit their final expenditure report within the required time frame and that grant files are closed in the required amount of time after receipt of the final expenditure report.

The following actions are being implemented and will be completed by December 31, 2008:

- a. Request additional funding to increase the level of effort on our support service closeout contract;
- b. Evaluate alternatives and modify the support service closeout contract to enhance the incentives for improved grant closeout performance;
- c. Revise procedures and timeframes for requesting financial information from grantees;
- d. If the ability is available in STRIPES' automated capability, utilize STRIPES to track and manage closeout requirements;
- e. Establishment of a team of functional experts to explore potential process improvements.



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- 2 -

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Recommendation Number 3: Enhance the existing closeout process used to select SBIR Phase II grants for audit by also including randomly selected grants that are not otherwise selected based on risk.

Current closeout policy and procedures will be revised to require the random audit sampling of SBIR Phase II grants being closed out. In addition, an audit will be considered for any award in closeout that appears to have questionable costs. This revision will be completed by December 31, 2008.

General Observations

- On page 2 of the draft Memorandum for the Manager of Office of Science Chicago Office, the second sentence of the second bulleted paragraph, we suggest the sentence be reworded to read as follows: "Of those SBIR II grants that had been completed for more than three years (84 total), testing revealed that Chicago had not completed action on 69 (82%) of the awards and could not locate 4 (5%) of the files." In addition, please use our suggested wording on page 1 of the Draft Report in the paragraph entitled "Grant Close Out".
- On page 2 of the Draft Report in the paragraph entitled "Post-Award Cost Reviews", we recommend that the word "inadequate" in the 2nd line be replaced with the word "insufficient"; and after the word "staff" in the 3rd line, add the words "and resources".

We appreciate the opportunity to comment on this draft report. If you have any questions, please contact James R. Bieschke at 630-252-2120 or jim.bieschke@ch.doe.gov.


Roxanne E. Purucker
Manager

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