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AUDIT OF
COMPLIANCE WITH INDIRECT COST RATES
BY A.I.D. CONTRACTORS AND GRANTEES

Audit Report No. 87-04
July 30, 1987

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

July 30, 1987

MEMORANDUM FOR M/FM, Curtis Christensen
SER/OP, Terrence McMahon

FROM: RIG/A/W, Mervin F. Boyer, Jr.

SUBJECT: Audit of Compliance with Indirect Cost Rates by A.I.D. Contractors and Grantees 1/

This report presents the results of our audit of contractor compliance with Negotiated Indirect Rate Cost Agreements (NICRAs). Please advise us within 30 days of any additional information relating to actions planned or taken to implement the recommendation. We appreciate the cooperation and courtesy extended to our staff during the audit.

Background

A.I.D. contracted for almost $3 billion in technical service contracts in 1985. A majority of these contracts involve contractors who, since they may have contracts with several other organizations, are permitted to allocate a portion of their overall operating costs (overhead) to each contract. A provisional percentage is established by the initial contract negotiation, and should be amended at periodic intervals to reflect more accurately the contractors' actual expenditure experience. Such amendments may result from a contractor's proposal to establish a new rate for subsequent periods, or from an audit of the indirect costs made by the cognizant audit agency which either accepts the contractor's proposals or recommends a new rate. This audit can be made either by the Office of the Inspector General (IG) or other cognizant audit agency.

On the basis of this proposal or audit the contractor and A.I.D. contracting officer negotiate a final rate for the period in question, and establish a new provisional rate for subsequent

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1/ The survey included both contracts and grants. However, for simplification, the terms contract and contractor can be understood to apply equally to grant and grantee, since the application of overhead rates is the same in principle.

periods. This agreement, signed by both parties, is called a Negotiated Indirect Cost Rate Agreement (NICRA) and is forwarded to appropriate A.I.D. officials, namely Controller's office (M/FM), the relevant Project Office and the Inspector General's Office (RIG/A/W). Since the NICRA may be issued some time after the periods of time involved, and frequently covers several fiscal years, (see Exhibit II for examples), a retroactive adjustment is often required on the part of the contractor to compensate for overhead charges that were billed at earlier provisional rates. The adjustment can be either upward or downward. It is generally reflected as part of a subsequent voucher, but sometimes near the end of the contract period takes the form of a bill of collection or special payment. The A.I.D. office responsible for negotiating contractor overhead is the Overhead and Special Costs and Contract Close-out Branch (PS/OCC) of the Office of Procurement (SER/OP).

Audit Objectives and Scope

The Regional Inspector General for Audit/Washington has completed a compliance review of A.I.D. monitoring of contractor charges for indirect cost. Our objective was to determine whether recommended indirect cost rates were being negotiated by the Agency, and the agreed upon rates were actually applied by the contractor. We did not attempt to assess the reasonableness of the rate recommended by the auditors or finally negotiated by the contract officer. A listing of forty contractors which had been audited for overhead rates for fiscal years 1985 and 1986 was compiled. The related NICRAs were requested and vouchers submitted by the twenty-three contractors who had received changes in the overhead rate were examined to determine whether or not new rates were being applied and previous billings properly adjusted. The audit was conducted from April through June 1987 in the A.I.D./W offices of SER/OP and M/FM, and was made in accordance with generally accepted government auditing standards.

Results of Audit

The Agency was generally complying with implementation of the indirect rates recommended by the cognizant audit agencies. NICRAs were issued in all cases sampled, and the rate agreed upon was the same as the audit recommendation in 96 percent of the cases. In most, but not all cases, we found that the contractor was applying the new rates, although there was an understandable tendency to apply upward adjustments more promptly (within three months) since this resulted in more money to the contractor, and delay downward adjustments (in some cases for six or seven months), since smaller claims and possibly a refund to A.I.D. usually resulted.

However, A.I.D. did not have an effective method of monitoring compliance with indirect cost rates, which allowed incorrect rates to be billed in six cases of the twenty-three cases, and has created a potential for much greater abuse (See Exhibit I). Neither the contracting officers who negotiate the rates, the project officers who administratively approve the contractor's billings, nor the voucher examiners in M/FM who certify the vouchers for payment, consistently test to see if the latest rates are being applied. In fact, in 35 percent of the vouchers we examined, it could not be determined from the financial data submitted exactly what rate was being charged. Therefore, we are recommending that FM require minimum standards for voucher documentation of overhead charges, and that SER/OP communicate these criteria to the contractors along with the NICRAs.

Accuracy of Contractor's Indirect Costs Not Being Monitored

Contractor billings to A.I.D. for overhead (indirect cost) expenses are not being closely monitored by the Agency. The contracting officers, who negotiated the rates, see only the final voucher submitted by the contractor. Neither the respective project officers in the Bureaus, who administratively approve vouchers for payment, nor the voucher examiners in Financial Management (FM), who are responsible for certifying payment of contractor claims, routinely verify the accuracy of contractor line item billings for indirect costs. The reasons for this are two-fold.

First, in the absence of specific handbook guidance regarding monitoring the rate charged, a degree of uncertainty exists as to where the responsibility for such a determination lies. Some FM staff felt that the Project Officer's administrative approval of the voucher signified an endorsement of the line items therein including the overhead line item. Others cited Federal Acquisition Regulations (FAR) language which holds the Contracting Office responsible for ensuring that prior year indirect cost claims are settled in connection with contract closeout procedures. Yet another opinion held that since overhead rates were generally established by audits, the final rates would be determined by the final audit, and that it was redundant to look closely at rates being charged in the interim.

None of these impressions are completely accurate. A.I.D. Handbook 19 gives the authorized certifying officer (ACO) general responsibility for checking vouchers, but leaves it to the ACO as to what is reviewed and to what level of detail. Neither the A.I.D. Handbook, nor the Comptroller's Handbook contain specific guidance with regard to monitoring the overhead rates charged. Final audits may only affect the rate for a part of the life of the contract, and should not be relied upon, particularly in view of the backlog of audit requests. The contract closeout procedure takes place too late in the process to be an effective control.

A second factor is related to FM/PAFD workload. With each voucher examiner processing thousands of vouchers each year, it was considered more cost effective to concentrate on more easily verifiable direct cost items. While examiners stated that they occasionally looked to see if an overhead charge looked "about right", they did not have time to perform mathematical calculations to determine what rates were being used, or look to see if retroactive overhead adjustments were made. In a few cases (five out of twenty-three), where contractors provided support for their indirect cost calculations, the rate could be easily calculated. In the preponderance of cases, this could not be done easily, and in the case of 35 percent of the contractors reviewed, the computations could not be made on the basis of the information provided. We also noted that the Defense Contract Audit Agency (DCAA) found it necessary to direct one contractor to "promptly submit (indirect rate) adjustment vouchers...clearly delineated so as to be readily identifiable for verification...".

We also tested compliance with negotiated rates for six contracts at four overseas posts. While our limited sample size did not permit conclusions, at least one case of non-compliance was noted. The USAID which reported that the contractor had not made the proper adjustment also commented:

> the dispersion of responsibility for this contract, with the accounting in Gaberone, the Contracting Office in Nairobi, the voucher processing under FRLC and the negotiation of rates in Washington, is obviously a less than ideal situation for monitoring contractor compliance.

We were unable to quantify the dollar impact of not monitoring the indirect cost rates more closely. We concede that at present the dollar amounts may be limited. We attribute this to two factors. First, the overwhelming majority of overhead adjustments are upward, i.e., will allow the contractor to bill more money, so there is a natural incentive for the contractor to quickly respond. Secondly, according to SER/OP officials, most contractor financial officers find it in their best interest to make the required adjustments as they go along, thereby avoiding a situation at contract close-out where the contractor might be faced with the need to make a large refund, or (in the case of a delayed upward overhead rate adjustment) be faced with insufficient funds remaining in the contract to allow reimbursement for his already earned indirect costs.

Despite these mitigating circumstances, however, we did observe enough instances (seven out of twenty-three cases) of contractor failure to adjust overhead rates in a timely fashion (thereby resulting in monetary losses to one of the parties) to demonstrate that closer monitoring of overhead rate charges is warranted. (see Exhibit I)

Some of these examples had resulted from prior audit reports done by RIG/A/W, DCAA or other non-Federal auditors, while others were uncovered by our audit. While it is difficult to estimate the extent of either the condition or the effect illustrated by these examples, the absence of monitoring of overhead rate billings or adjustments calls for some remedial action by management. This is especially true in the case of contracts under $500,000, for which final audits are no longer being routinely recommended.

We have recommended that FM establish minimum standards for accepting or rejecting vouchers which contain overhead. While we wish to give management the latitude to establish such standards, we suggest that, in view of manpower limitations, such standards could require project officers to (at least periodically) include a rate verification process in the course of the administrative approval process. Another suggestion would be to require all vouchers for cost-reimbursement contracts, etc. to contain at a minimum the current indirect rate <u>and</u> the base against which it is applied so as to facilitate the voucher examiner's verification of the claim. Where more than one overhead rate applies (e.g. home office, field, G&A rates), each base and rate should be clearly identified.

<u>Recommendation No. 1</u>

We recommend that the Office of Financial Management:

a. issue clarification to voucher examiners defining their responsibilities for monitoring overhead billings; and

b. prescribe the minimum standards for accepting or rejecting vouchers which contain overhead claims.

<u>Recommendation No. 2</u>

We recommend that the Office of Procurement notify the contractors, at the time that new rate agreements are transmitted, what the reporting standards are for billing overhead costs.

M/FM and M/SER/OP officials generally agreed with our findings and recommendations. The Office of the Regional Inspector General for Audit/Washington considers the recommendations resolved. They will be closed when the guidance to voucher examiners and contractors regarding minimum standards for overhead billings has been developed, and issued.

Exhibit I

Examples of Contracts Where Correct Rates Were Not Correctly or Promptly Applied

-- An audit of a major New England PVO in the Family Planning area had resulted in $230,548 in questioned costs related to overhead. The auditors found that $58,269 of this amount was due to the fact that "an adjustment for the difference between provisional and actual overhead rate was never made." A check was eventually issued to A.I.D. by the contractor as part of a negotiated settlement.

-- A Mid-Western University, which had entered into a host country contract with an African government research institute for cereals crop research, failed to use the original contract and subsequently negotiated indirect cost rates from the inception of the contract in November 1982 until December 1985 when cumulative adjustments of $6,824 were made. While the amount was relatively small, it illustrates that the application of incorrect rates can go unnoticed for a considerable period of time.

-- M/FM processed a contractor's vouchers containing overhead charges of 72.0 percent even when the voucher information showed that the budgeted figure for overhead had been clearly exceeded. An Agency funding control violation may have subsequently occurred. One voucher containing a claim of $9,875.86 in overhead costs was processed for payment by FM on October 1, 1986, although the voucher showed cumulative overhead expenditures of $549,431.01 and a budgeted figure of only $540,070.00. A separate column on the contractor's invoice entitled "available funds" also clearly showed a negative availability of $9,361.01. On October 15, 1986, another voucher containing $9,632.30 in overhead and $8,614.65 in G&A costs was also approved for payment by the project officer despite showing a minus $18,723.31 "available" for overhead and only $283.40 remaining for G&A. This voucher was paid by FM on November 14, 1986, but only after reducing it by $13,289.49, so that total expenditures under the contract would not exceed the amounts obligated.

Contract terms often permit Budget line items to be exceeded by a certain percentage, so the main purpose of showing them on vouchers is to alert voucher examiners to funding limitations, to prevent spending more than the obligated amount. In this case, the payment of the voucher despite indications that funding was limited may have enabled an Agency Funding control violation, since a later Advice-of-Charge from an overseas mission placed the contract in what FM referred to as "an over-expended condition". A.I.D. was forced to request repayment from the contractor of $4,348.35. We have asked the Controller's Office to look into the situation in accordance with his responsibilities under Section A9 of Appendix 1A of AID Handbook 19.

-- In the case of a New York voluntary agency, vouchers submitted contained a rate and the amount charged, but in the absence of any information on salaries, or direct costs, it was not possible to determine whether the amount was correct. Overhead adjustments for prior years may have been made, but this could not be verified, nor could the amount of the adjustment be determined from FM records because only one overhead figure is provided, with a footnote indicating that the figure "includes" an adjustment for excess overhead drawn during 1984. We could not determine what the excess was. On a subsequent voucher, we noted that the overhead figure included a "reversal of the adjustment made on the previous voucher in error", but since this was also "included" in a single overhead figure, we could still not determine what, if any, net adjustment had been made.

To further compound the confusion, a later voucher showing a negative overhead amount was submitted to reflect an excess drawn for indirect costs for 1984 and 1985. This was processed as a credit voucher, and posted by FM, but was reversed a month later. When we brought this to their attention, FM staff acknowledged that the reversal should not have been made and corrected the $4,270.00 item. This example further illustrates the difficulty in understanding overhead billings as currently received in FM and the potential for confusion.

-- One of the largest A.I.D. contractors had a dual rate structure, with an 80 percent cost applied to direct salaries and a 50 percent rate to consultant fees. Vouchers did not always break down the overhead charges into these two categories, so it was not always possible to determine the actual rate used on each billing. For some vouchers it was obvious that other (non-base) salaries were included in the total salary figure since the overhead claim was so low. Other vouchers contained substantial charges for overhead but very little in the way of salaries or consultants (on which the overhead is supposedly based). On one other voucher the Project Officer gave administrative approval, but felt it necessary to add the following disclaimer: "...I have no specific knowledge of the content of the sums claimed under each contract line item".

-- A large contractor with projects in Africa and Latin America used 9.9 percent as a general and administrative expense reimbursement rate, although an audit brought out that the actual rate as reflected in the NICRA should have been 9.2 percent. An adjustment of $94,502 was made for fiscal year 1986 at the time of the audit, and the cumulative difference on overbilled administrative expenses since fiscal year 1983 was computed as $231,669. At least $21,542 was also due to A.I.D. in connection with closed contracts, whereby the final General and Administrative (G&A) rate had not been adjusted in the year of completion.

Furthermore, the contractor was entitled to use as a base for overhead charges "total direct costs excluding ... participant support costs, and local currency expenditures". The audit pointed out however that over the past ten years there was confusion over the definition of which participant costs have been excluded from the base and that funds converted from dollars to local currency were not excluded at all. This example indicates the potential for both incorrect application of the overhead rates and also how failure to regularly adjust the overhead rate can escape the notice of agency managers until substantial amounts of overbilled indirect costs are owed by the contractor.

A contractor operating overseas was found to owe A.I.D. $14,302 in overhead of the end of one contract. The final payment voucher submitted by the contractor for reimbursement was less than this amount. Rather than process the claim as a no-pay voucher and issue a Bill-of-Collection for the remainder (as the auditors recommended), the USAID paid the final voucher. A Bill of Collection therefore had to be issued for the total amount at a later date.

A Washington, D.C. contractor had delayed making an upward adjustment of his overhead rates. When the adjustment was finally calculated it would have caused the contractor to exceed (overrun) the contract amount. Since the contract had expired and could therefore not be amended to add additional funds), the contractor lost money (perhaps as much as $48,000) by not making overhead adjustments in a timely manner.

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

NEGOTIATED INDIRECT COST RATE AGREEMENT

Date August 16, 1985

SUBJECT: Indirect Cost Rates for Use in Cost Reimbursement Type Agreements With the Agency for International Development (AID)

REFERENCE: Contractor's Proposal dated July 22, 1985

CONTRACTOR or GRANTEE: Academy for Educational Development (AED)
680 Fifth Avenue
New York, NY 10019

PART I - NEGOTIATED INDIRECT COST RATES (%)

	Effective Period		Overhead Rates	
Type	From	Through	Regular (a)	Pass-Through (b)
Provisional	1-1-84	12-31-84	27.2	1.9
Provisional	1-1-85	Until Amended	28.0	2.0

Base of Application

(a) Total direct costs but excluding costs of subcontracts, equipment, educational past differential and housing allowance and participant expenses.

(b) Subcontract expenses only

Acceptance of the rate(s) agreed to herein is predicated upon the conditions: (1) that no costs other than those incurred by the grantee/contractor were included in its indirect cost rate proposal and that such costs are legal obligations of the grantee/contractor; (2) that the same costs that have been treated as indirect costs have not been claimed as direct costs; (3) that similar types of costs have been accorded consistent treatment; and (4) that the information provided by the grantee/contractor which was used as the basis for acceptance of the rate(s) agreed to herein is not subsequently found to be materially incomplete or inaccurate.

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D.C. 20523

NEGOTIATED INDIRECT COST RATE AGREEMENT

Date October 11, 1984

SUBJECT: Indirect Cost Rates for Use in Cost Reimbursement Type Agreements With the Agency for International Development (AID)

REFERENCE: Bechtel National, Inc. letter dated August 28, 1984, and Department of Energy provisional billing rates of August 8, 1984

CONTRACTOR or GRANTEE: Bechtel National, Inc.
50 Beale Street
San Francisco, CA. 94119

PART I - NEGOTIATED INDIRECT COST RATES (%)

Type	Effective Period From	Effective Period Through			

Location/Fiscal Period	Engineering	Construction	G & A
1-1-84 to 12-31-84 (DOE letter of August 28, 1984)			
Bechtel Petroleum-Houston (BP/H)	69.27 (1)	139.21 (5)	--
Bechtel Petroleum-San Francisco (BP/SF)	55.17 (1)	74.49 (5)	--
Process Engineering (PE)	95.68 (1)	--	--
Research and Engineering (R&E)	66.35 (3)	32.65 (5)	12.88 (6)
Procurement	15.06 (4)	--	--
Payroll Additive	35.50 (7)	--	--
Los Angeles Power (LAPD)	46.86 (2)	28.80 (5)	--

Base of Application

See attached notes.

Acceptance of the rate(s) agreed to herein is predicated upon the conditions: (1) that no costs other than those incurred by the grantee/contractor were included in its indirect cost rate proposal and that such costs are legal obligations of the grantee/contractor; (2) that the same costs that have been treated as indirect costs have not been claimed as direct costs; (3) that similar types of costs have been accorded consistent treatment; and (4) that the information provided by the grantee/contractor which was used as the basis for acceptance of the rate(s) agreed to herein is not subsequently found to be materially incomplete or inaccurate.

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APPENDIX 1

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