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Financial Review of Contract No. DPE-5834-Z-00-0008-00 Supporting the Narcotics Awareness and Education Project No. 936-5834

Bureau for Research and Development
Office of Education

JOSEPH R. FERRI & Associates

Prepared for the
Agency for International Development
under Purchase Order
No. HNE-5832-0-00-2094-00

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FINANCIAL MANAGEMENT CONSULTANTS

4400 Vacation Lane Arlington, Virginia 22207

February 9, 1993

Dr. Anthony Meyer, Project Manager
R&D/ED
Room 609, State Annex 18
Washington, D.C. 20523

Dear Mr. Meyer:

Enclosed is our report on the Financial Review of Contract No. DPE-5834-Z-00-0008-00 Supporting the Narcotics Awareness and Education Project No. 936-5834. The review was done under A.I.D. Purchase Order No. HNE-5832-0-00-2094-00 dated September 24, 1992.

As requested, five copies of this report are being sent to you. Two copies of the report are being sent to U.S.A.I.D., POL/CDIE, Room 219C, State Annex 18, Washington, D.C. 20523.

We appreciated the cooperation and courtesy extended to us during the review by your office and by the prime contractor, Development Associates, Inc., Arlington, Virginia, and the three subcontractors that we visited.

Sincerely,

Joseph R. Ferri

Joseph R. Ferri
President

FINANCIAL REVIEW OF CONTRACT NO. DPE-5834-Z-00-0008-00 SUPPORTING THE NARCOTICS AWARENESS AND EDUCATION PROJECT NO. 936-5834

This report summarizes the results of the financial review of Contract No. DPE-5834-Z-00-0008-00 with Development Associates Incorporated, (DA), Arlington, Virginia. The contract supports the Narcotics Awareness and Education Project No. 936-5834.

BACKGROUND

The Narcotics Awareness and Education Project is directed by the Office of Education, A.I.D. Bureau for Research and Development. Development Associates Incorporated administers the project under a five year cost-plus-fixed-fee and buy-in type prime contract issued May 9, 1990. The contract value is $13,864,923, including cost and fee.

The stated purpose of this contract is to strengthen the capabilities of lesser developed countries institutions to design, implement and evaluate effective drug awareness and prevention programs. The contract also provides for technical support (technical assistance, training, information dissemination, operation research, and evaluation) to the U.S. Agency for International Development (A.I.D.) and to host countries upon request. A.I.D. units from at least ten to fifteen countries are expected to request such support and make financial contributions (buy-ins). The central focus of the activities is on drug demand reduction through public awareness.

The work is carried out by Development Associates and its subcontractors--Macro-International, Inc. formerly Macro Systems, Inc. (MI), the Academy for Educational Development (AED), and Porter/Novelli (PN).

The estimated cost of the core part of the contract is $4,164,853. As of August 31, 1992 A.I.D. had made $1,170,000 available for implementation of the core contract, and DA had incurred costs of $960,104. Estimated cost of the buy-in part of the contract is $9,700,070. As of August 31, 1992, a total of $2,865,094 had been made available and $1,777,680 had been spent under the buy-in provisions. Contract funds come from several sources; the Bureau for Research and Development, other Bureaus and offices, A.I.D. Missions, and host governments.

Joseph R. Ferri and Associates was contracted with to make a financial review to ensure that parties to the contracts and subcontracts have adequate and sound financial management and accounting procedures in place. Also, that A.I.D. funds are properly accounted for and billed according to A.I.D. regulations and provisions of the agreements, and that contractors are carrying out the purposes of the contract according to the agreements, Office of Management and Budget requirements and A.I.D. regulations. The financial review was not intended to be an audit nor an evaluation of performance. It was expected, however, that sufficient testing of the financial management systems would be done to decide whether adequate internal controls, accounting procedures, and documentation systems are in place and being followed.

The work was done in November and December 1992 at A.I.D. offices in Arlington, Virginia and at contractor and subcontractor locations in Rosslyn, Virginia, Washington, D.C. and Silver Spring, Maryland. We held discussions with responsible officials and reviewed accounting records and financial reports to carry out the purposes of the financial review. We also did a sufficient amount of detailed testing of selected cost categories to decide whether adequate accounting and internal control systems were in place and working.

SUMMARY RESULTS OF THE FINANCIAL REVIEW

The review showed that Development Associates, Inc. and the three subcontractors had adequate financial controls. The accounting systems ensured that A.I.D. funds were properly accounted for and billed according to A.I.D. regulations except for the matters discussed below. Notwithstanding these generally positive comments about the financial controls and accounting systems, we believe that the Contracting Officer, the A.I.D. Program Manager, and DA officials can (1) improve execution of the contract and subcontracts, (2) monitor events more effectively to ensure compliance with certain agreement terms, (3) recover unallowable costs, and (4) possibly enhance program performance.

Development Associates provided comments on the draft report. They said that the financial review was thorough and professional, and that the findings and recommendations should help improve management of the project. They also said that action had been initiated already to implement the recommendations that the A.I.D. Project Manager would support. Where appropriate, the report draft was changed to reflect the Development Associates' comments. The only major disagreement appeared to relate to the Other Matters section of the report. Development Associates said that the treatment of regional coordinators salaries as consultants costs was proper and had been approved by past government audits. They requested that the issue be removed from the report. We retained this point in the report because there is an evident conflict that we believe should be resolved between Development Associates and A.I.D. procurement officials.

The full text of Development Associates' comments was provided to the A.I.D. Project Manager in a separate letter.

FINDINGS AND RECOMMENDATIONS

1. LEVEL-OF-EFFORT REPORTING AND MANAGEMENT

According to the contract, 1,188 person-months of direct labor in specific professional labor categories are required to achieve the goals, purposes, and outputs of the contract. A core group (or "key" people) was established comprised of a Project Director, a Training Specialist, and an Operations Research/Social Marketing Specialist. In addition, an Information Dissemination Specialist, a Home Office Manager/Field Activity, an Administrative Assistant, and a Secretary was to provide the basic headquarters support over the five-year life of the project.

The contract identifies the education, training, and experience wanted for each professional position. The headquarters staff was allocated four hundred twenty-three (423) person-months. In addition, the headquarters effort was to be supplemented by 112 person-months of Short-Term Consultants. The prime contract also provides for a specified level-of-effort totaling 653 person-months for In-Country Coordinators and Short-Term Consultants. The positions are filled by DA staff and subcontractor staffs. Thus, the subcontracts with Macro, International, the Academy for Educational Development and Porter/Novelli also contain requirements of 235.25, 234.70 and 65 person-months of professional direct labor respectively.

The contract and the subcontracts clearly require a specified level-of-effort according to defined professional labor categories. From a contract compliance perspective, it follows that the financial reporting by DA and its subcontractors should show the progress being made against each of these personnel requirements. Yet, the project has not been managed on a person-month basis. Nor has there been any attempt to track and report the person-months provided by professional personnel categories.

We understand that staff utilization has been rearranged from time to time to save money thereby affecting the personnel levels contained in the contract. One person identified as a full-time key person, for example, worked only part-time on the contract. Another key person position was not occupied until about twenty months after the contract was awarded. These rearrangements of staff time are an appropriate use of A.I.D.'s management options to carry out the contract. However, they do not mitigate the basic contract requirement for the contractor to provide specified levels-of-effort in certain professional labor categories, nor the need to report and track such expenditures.

There was no clear explanation of why the contract has not been managed based on stated personnel requirements. DA officials assured us that they were able and willing to provide whatever data A.I.D. needed. However, they said that the contract does not specifically require such reporting and A.I.D. managers have never requested such reporting. Nevertheless, in their comments on the draft report, DA said that it had now instituted procedures to consolidate and report level-of-effort expenditures monthly .

RECOMMENDATION

We recommend that the Contracting Officer and the A.I.D. Project Manager review the conditions described here and either use level-of-effort reporting or modify the contract terms and conditions so that such reporting is not required.

2. BUDGETARY CONTROLS AND EXPENDITURES

The budget for the five-year contract period totals $13,864,923. The budget is broken out by various cost categories such as labor, overhead, fringe benefits, equipment, travel, and subcontracts. Under the terms of the contract, DA can adjust the line item amounts as long as it stays within the total budget amount or the obligated amount, whichever is less, except for indirect costs and salaries and wages that are controlled by other contract provisions. In effect, DA has considerable discretion in the expenditure of funds.

This flexibility is an A.I.D. management prerogative and can be useful in achieving the contract's technical objectives given the tightness of funds situation that exists. With respect to this management approach, we would only note that conformity with agreed upon line item budgets is a fundamental principle of A.I.D.'s financial management control over contractor activities. Also, a contractor's operating flexibility is not unduly hindered by realistic budgets and tracking and reporting requirements. Quite the contrary, controls over the allocation of financial resources judged to be necessary for meeting the contract's stated goals enhance the process, and A.I.D. program managers should retain this control except in the most unusual of circumstances.

The table below compares budgeted costs for the two-year period, May 9, 1990, to May 8, 1992, with expenditures for the 27-month period, May 9, 1990, through August 31, 1992

	Budget	Expenditures	Percent Expended
DA *	$2,607,848	$2,264,428	86.83
MI	680,995	205,277	30.14
AED	663,317	243,043	36.64
PN	231,961	70,780	30.51
Total	$4,184,121	$2,783,528	66.52

* Excludes listed sub-contractor budgets and expenditures.

The above comparison shows that through August 1992 DA had expended about 87 percent of its total budget for the period while subcontractors had expended about 30-36 percent of their budgets. The comparison also shows that DA's budget is about 62 percent of the total budget. But, that DA had made about 81 percent of all reported expenditures. Although the above table compares a two-year period with a twenty-seven month period, the data suggests that a disproportionate share of project resources is going to fund DA's expenses. This raises the question whether the work expected to be done by subcontractors will be fully carried out. Subcontract work makes up about forty percent of the total budgeted cost and is considered central to the success of the project.

The President, DA said that he recognized the distribution of resources problem and attributed it to the uncertainty of available funding. The DA Project Manager attributed the pattern of project resource utilization to the shortage of buy-in funds and because part of what now is classified as subcontracts was budgeted as other direct costs. In commenting on the draft report, DA said that this report section was misleading because it compares actual expenditures with a budget that has not been fully funded. Also, the budget envisioned certain participation levels by other countries that has not been realized thus limiting the amount of funds available for subcontractor performance. We believe DA raises some valid points; however, the analysis is sufficient to suggest a concern over the expenditure patterns.

DA disagreed with the recommendation that more stringent budgetary controls be implemented stating that such controls could be counterproductive. As stated earlier, we favor tighter controls to enhance performance under the contract.

RECOMMENDATION

We recommend that the Contracting Officer and the A.I.D. Project Manager consider instituting more stringent limitations on significant budget cost categories such as salaries for more effective control of the work and the contract costs.

We also recommend that the A.I.D Project Manager review the expenditure trends between DA and the various subcontractors and evaluate whether the available funds are being distributed in a way that will achieve the project's goals and purposes.

3. APPROVAL OF STARTING SALARIES

The prime contract and the three subcontracts reviewed require that starting salaries of employees whose salaries are charged as a direct cost be approved, in advance and in writing, by the Contracting Officer. Allowable salaries and wages may not exceed the Contractor's established policy and practice, including the established pay scale for equivalent classifications of employees, nor may any individual salary or wage exceed the employee's current salary or wage or the highest rate of annual salary or wage received during any full year of the immediately preceding three years.

Starting salaries of certain employees such as those designated to fill the key positions identified in 1, above were approved in the contractor's "Best and Final Offer". The review showed, however, that starting salaries for many employees not included in the Best and Final Offer were hired after the contract was awarded. These employees were charged as direct costs to the contracts and were not approved as required. This condition existed at DA and at Macro, International and Porter/Novelli.

Commenting on the draft report, DA said that it had started taking action to get approval of all starting salaries as required by the contract.

RECOMMENDATION

We recommend that the Contracting Officer and the Project Manager ensure that Development Associates establishes and implements procedures for the prime and the related subcontracts for obtaining the required A.I.D. approvals for starting salaries.

4. LIMITATIONS ON SALARY INCREASES

The prime contract and the three subcontracts reviewed stipulated that after an employee's completion of each twelve month period of satisfactory services under the contract they may be granted salary increases of not more than 4.5 percent of the employee's base salary. Salary increases of any kind exceeding these limitations or exceeding the maximum salary of an FS-1 may be granted only with the advance written approval of the Contracting Officer.

These limitations often were not followed because companies followed their own organization's practices for compensating employees. The review found twenty-six raises of more than 4.5 percent (the largest raise being 18.75 percent) and fourteen raises that were given before the employees completed the required twelve months of service under the contract. In addition, two employees of the subcontractor, Porter/Novelli, were billed to the program at more than the FS-1 rate for a short time.

RECOMMENDATION

We recommend that the Contracting Officer and the Project Manager (1) ensure that Development Associates implements procedures for complying with the contract provision limiting salary increases, (2) have Development Associates calculate the extent of non-compliance and credit the A.I.D. contract appropriately.

5. RECONCILIATION OF CHARGES TO THE CONTRACT

Contract costs are controlled, in part, by reconciling the amounts charged to A.I.D. by Development Associates for their subcontractors with the amounts shown on the subcontractors' records. These amounts should agree. The review showed, however, that these records were not always in agreement for various reasons. DA was unaware of these differences when they happened, an indication that Development Associates needed to strengthen its controls over the reconciliation of subcontractor costs.

In one case, DA's billing to A.I.D. included a $10,000 purchase of equipment by Macro International that was not contained in Macro International's billing to DA. This happened because a different Macro division from the one doing most of the work on the subcontract billed DA directly.

In another case, the Academy for Educational Development billed and was paid $3,701 too much fixed fee on their voucher for March 1991. The charge was corrected on a subsequent voucher, but DA did not correct the billing to A.I.D. This resulted in a credit now being due A.I.D.

In another case Porter-Novelli erroneously dropped $29,019 from its cumulative subcontract cost total. It also omitted an $840 March 1992 billing from its cumulative total submitted to DA.

DA said in response to the draft report that it had taken action to reconcile cumulative costs quarterly, and overbillings, where they exist, will be corrected and the government credited accordingly.

RECOMMENDATION

We recommend that the Contracting Officer and the Project Officer ensure that (1) DA carries out specific reconciliation procedures so that differences in cumulative costs billed to A.I.D. are eliminated, and (2) contract billings are corrected for the $3,701 overbilling of fee.

6. EQUIPMENT PURCHASES

In the approvals section of the contract it says that nonexpendable equipment " . . . which has a unit cost of more than $500 will require approval of the cognizant A.I.D. /W Project Officer, except as specified in paragraphs 5(f), (g), and (h) below." Paragraph 5(h), one of the exception paragraphs, says that:

> Notwithstanding the foregoing, prior to purchasing any nonexpendable equipment, the Contractor shall perform an analysis of the cost of purchasing such equipment vs. the cost of leasing such equipment, and shall submit such analyses to the Contracting Officer, together with the

request to lease or purchase. The Contracting Officer must approve each purchase or lease.

The $10,000 piece of equipment that Macro International billed DA for (see finding on reconciliations of costs) was approved by the cognizant A.I.D. Project Manager (Technical Officer), but the equipment was not approved by the Contracting Officer as required by the contract.

DA, in commenting on the draft report, said that it had taken action now to obtain both Project Manager and Contracting Officer approval of equipment purchases.

RECOMMENDATION

We recommend that the Contracting Officer review conditions described above and (1) either retroactively approve or disallow the equipment purchased, and (2) simplify the contract language to make either the Project Manager or the Contracting Officer responsible for approving equipment purchases.

7. EXPENDITURES MORE THAN AUTHORIZED AMOUNTS

Subcontracts awarded by DA say that DA is not obligated to reimburse allowable costs or fees in excess of the lesser of the budget amounts or the amounts obligated for the subcontracts. This stipulation is a basic financial management control. Its purpose is to control the limited amount of available contract funds by allocating these funds for specific purposes, in this case for subcontract work. The control of available funds is compromised when subcontractors incur costs in excess of the amounts authorized. Moreover, subcontractors are at financial risk because DA is under no obligation to reimburse them for the excesses. The financial review showed that two subcontractors expended and were reimbursed more than the amounts authorized by DA. These conditions were not readily apparent because DA's financial reports showed the subcontract budgeted amounts, but not the amounts authorized and expended.

The Academy for Educational Development's cumulative expenditures through March 31, 1992, for example, were $65,459 more than the authorized amount. To correct the problem, the AED subagreement was amended on April 22, 1992, and $106,000 additional was authorized. Porter/Novelli's cumulative expenditures through September 30, 1992, were $109,630 or $100,130 more than the authorized amount. The Porter/Novelli subagreement was amended on October 5, 1992, and $95,000 additional was authorized. The amendment was made effective August 28, 1991 to cover the approximate 11-month period that Porter/Novelli operated without authorized funding.

Commenting on the draft report, DA said that action had been taken to preclude these situations from happening in the future.

RECOMMENDATION

We recommend that the Contracting Officer and the A.I.D. Project Manager require Development Associates to report as part of their monthly expenditure reports the amounts authorized by subcontractor. These reports should be examined carefully to ensure that costs are not reimbursed above authorized funding levels without proper approval.

8. ADVANCES OF FUNDS

DA documents supporting expenditures for August 1992 showed that a $4,870 disbursement to Comite Paraguay-Kansas actually was an advance of contract funds. Because it was an advance, it should not have been billed to A.I.D. until the advance was liquidated and recorded as an expense. The financial review did not determine the extent that other cash advances may have been improperly reported. The DA Controller indicated, however, that in the future advances would not be billed to A.I.D. until they were reported as expenditures by the recipients. The Controller also indicated that he would review past advances to Comite Paraguay-Kansas and verify that they have been accounted for by expense reports.

RECOMMENDATION

We recommend that the Contracting Officer instruct DA to establish control procedures that will ensure that (1) all Paraguay-Kansas advances (and other advances) are liquidated by reports of expenditure, and (2) unexpended advance funds are recovered.

9. NOVATION AGREEMENT

Macro Systems, Inc., a subcontractor to DA, officially changed its name to Macro International on April 22, 1991. The change in corporate name requires that the cognizant Federal agency, the National Institutes of Health, issue a novation agreement. An agreement is needed so that Macro International officially assumes Macro Systems' obligations under Government-funded agreements. As far as we were able to learn no such agreement had been requested of or issued by the National Institutes of Health.

After this matter had been called to its attention, DA said it had written to Macro International and asked for the proper documentation.

RECOMMENDATION

We recommend that the Contracting Officer request through Development Associates a copy of a Novation Agreement for Macro

International from the National Institutes of Health.

10. SUBCONTRACT ADMINISTRATION

An important means of maintaining good financial control is through effective administration of subcontracts, which in the Narcotics Awareness project make up about thirty to forty percent of expected project expenditures. Development Associates has no internal review group specifically responsible for subcontract administration. Essentially, DA relies upon the integrity of its subcontractors, the interaction of project officials, and the review of reimbursement vouchers to "administer" its subcontracts. This approach has not been as effective as it should be.

Matters discussed in this report, such as (1) exceeding salary limitations, (2) not obtaining appropriate approvals for equipment purchases, (3) reimbursing subcontractors for more than authorized amounts, and (4) not reconciling billings sent to A.I.D. with billings received from subcontractors demonstrate basic subcontract administration weaknesses. Another example involves subcontractor controls over time sheets supporting direct labor charges. Controls over time sheets generally were adequate. But eleven of the sixteen time sheets reviewed at Porter/Novelli contained changes that were not explained and initialed by the employee and the department head as appropriate.

An internal review function operating independently of the A.I.D. project with assigned responsibilities for checking on the implementation of company operating procedures and government contract requirements would strengthen financial controls over subcontracts. The President, Development Associates agreed that such a group probably would have caught many of the discrepancies discussed in this report. He said efforts were being made to increase DA's staff capability in this area and expected some measures would be put into practice shortly.

RECOMMENDATION

We recommend that the Contracting Officer and the A.I.D. Project Manager initiate discussions with Development Associates management to consider establishing an internal review capability to strengthen financial controls over subcontract activities.

11. Other Matters

A related financial control matter came up that should be resolved by the A.I.D. Office of Overhead/Special Costs and Close Out Branch, Office of Procurement. This office establishes the overhead rates of contractors that are acceptable for charging to A.I.D. contracts.

Concurrent with its work under the A.I.D contract, DA employed persons designated as Regional Coordinators for work under a U.S. Department of Health and Human Services contract. These coordinators received regular salary checks from DA and their wages were reported to the Internal Revenue Service on the W-2 forms as regular employees. For fiscal years 1990, 1991, and 1992, salaries totaled $150,023. The associated fringe benefit costs during this period of $13,150 were charged as Other Direct Costs to the HHS contract. For contract charging purposes, however, DA considered these Regional Coordinators to be Consultants not regular employees and charged their labor costs to the HHS contract as Consultants costs. Accordingly, these costs did not bear the full overhead burden of direct labor charges.

The effect of this practice was to lessen DA's direct labor base so that the A.I.D. contract was charged more overhead than it would have if the Regional Coordinators were charged as direct labor. This is because direct labor is the base used for the distribution of overhead. An earlier A.I.D. Office of Inspector General audit report took issue with the practice. In response to the audit report, DA in 1988 apparently agreed to change its practice and to charge Regional Coordinators as direct labor. A.I.D. Overhead/Special Costs and Close Out Branch officials told us it was their understanding that DA had, in fact, changed its method of charging such costs.

The President, DA disagreed there was such an agreement. He pointed out that subsequent audits by the Defense Contract Audit Agency had accepted DA's method of charging Regional Coordinator costs. He also said that the method was accepted by the Department of Health and Human Services through a contract modification in January 1992.

Based on the above discussion, DA's treatment of these costs appears to conflict with information obtained from the A.I.D. Office of Overhead/Special Costs and Close Out Branch. This matter should be resolved by the A.I.D. office in consultation with DA.