Regional Inspector General for Audit
Singapore

AUDIT OF INTERNATIONAL IRRIGATION MANAGEMENT INSTITUTE'S INDIRECT COSTS

Audit Report No. 5-383-96-001-N
October 18, 1995

FINANCIAL INFORMATION IN THIS REPORT MAY BE PRIVILEGED.
THE RESTRICTIONS OF 18 USC 1905 SHOULD BE CONSIDERED
BEFORE ANY INFORMATION IS RELEASED TO THE PUBLIC.

INSPECTOR GENERAL

AGENCY FOR INTERNATIONAL DEVELOPMENT

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

October 18, 1995

TO: David A. Cohen, Mission Director, USAID/Sri Lanka

FROM: Richard C. Thabet, RIG/A/Singapore Richard C. Thabet

SUBJECT: Audit of International Irrigation Management Institute's (IIMI) Indirect Costs, Report No. 5-383-96-001-N

Enclosed are three copies of the subject audit report (prepared by the accounting firm, Ernst & Young, Sri Lanka) for your action. The audit covered the period from January 1, 1989 through December 31, 1994. During this period, IIMI reported that it received a total of $316,856 for indirect costs from USAID.

The audit objective was to determine whether the indirect costs claimed by IIMI are in accordance with the terms of the cooperative agreements with USAID, and applicable cost principles.

The auditors concluded that the indirect costs claimed by IIMI exceeded those proposed in this report by $204,944.

We are making the following recommendation which will be included in the Office of the Inspector General's audit recommendation follow-up system:

> Recommendation No. 1: We recommend that USAID/Sri Lanka: (1.1) finalize the indirect cost rate for IIMI based on the rate recommended in this report shown as Proposed Rate No. 1 giving due consideration to IIMI's position as shown under Proposed Rate No. 2; and (1.2) Based on the final rates negotiated, recover from or refund to IIMI any amount different from that already disbursed.

We appreciate the courtesies and cooperation USAID/Sri Lanka and IIMI extended to the auditors and our staff during the course of this audit.

Please advise me within 30 days of any actions planned or taken to close the above recommendation.

Attachment: a/s

INTERNATIONAL IRRIGATION MANAGEMENT INSTITUTE

FINANCIAL AUDIT OF INDIRECT COST RECOVERY RATES FOR 1989 - 1994

IQC - D/O # 383-0499-C-10-3452-00

ERNST & YOUNG

JULY 1995

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INTERNATIONAL IRRIGATION MANAGEMENT INSTITUTE

FINANCIAL AUDIT OF INDIRECT COST RECOVERY RATES FOR 1989 - 1994

TABLE OF CONTENTS

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July 17, 1995

Mr. Richard C. Thabet
Regional Inspector General for Audit, Singapore
US Agency for International Development
03-01, Tong Building
302, Orchard Road
Singapore 0923
Singapore

Dear Sir

The report submitted herewith details the results of our audit of the indirect costs for USAID's Co-operative Agreements with the International Irrigation Management Institute (IIMI) for the years 1989 - 1994 as per the specific guidelines given in the Delivery Order, # C-10, under IQC # 383-0499-C-00-3452-00.

IIMI - THE ORGANIZATION AND ITS PROGRAMS

IIMI was established in September 1983, in order to conduct research and training in irrigation and water management. The institute which has its Head-Office in Sri Lanka and 11 field offices located worldwide, is presently governed by a twelve member Board of Governors.

The Institute was established in Sri Lanka in 1985 by an Act of Parliament as an autonomous, non profit, international organization to strengthen national efforts to improve and sustain the performance of irrigation systems in developing countries through the development and dissemination of management innovations.

USAID AND ITS CO-OPERATIVE AGREEMENTS WITH IIMI

USAID is amongst the primary donors of funds to IIMI. In 1994, USAID was the third largest donor contributing US$ 1.2 million which amounts to 13% of the total grants for the year.

Funds provided by USAID can be categorized as follows:

a) *Restricted Funding*
These funds are donated for specific projects and should be spent on the respective project. During the six year period commencing from January 1, 1989 to December 31, 1994, USAID has provided restricted funding for twelve separate projects.

b) *Unrestricted Funding*
These funds are provided to support the institute's core activities. For the financial periods under review (1989 - 1994) USAID has provided unrestricted funding amounting to US$ 1.875 Mn.

For ten of the aforementioned twelve projects the donor has agreed to an indirect overhead charge to be levied upon them, based on a negotiated percentage applied to the direct costs incurred in each project. An indirect overhead charge was not applied for the remaining two projects.

The projects to which an indirect overhead rate is applicable are listed below:

1. Irrigation Systems Management - Sri Lanka (383-0080-A-PG-7040-00)

2. Irrigation Support Project for Asia and Near East (ANE-0289-G-SS-7035-00)

3. Initiation of an IIMI Program - West Africa (936-4111-G-IR-7026-00)

4. Accelerated Agricultural Production Project - Philippines (492-0385-A-SS-900-00)

5. Collaborative Program with Indian Institutions in Research, Training and Information Dissemination (386-0484-00-9102-00)

6. Irrigation Management Policy Support Activity (ANE-0289-C-00-7044-00)

7. Support for IIMI's Program in Irrigation Research in Pakistan - Phase II (391-0467-A-00-1818-00)

8. Institutional Development and Strengthening Banganga Project - Nepal (367-0153-A-00-1127-00)

9. IIMI's Design of the Rights to Resources Project - Sri Lanka (383-0499-A-00-2044-00)

10. Shared Control of Natural Resources - Sri Lanka (383-0109-A-00-3413-00)

Brief details of all the Co-operative Agreements are provided in Appendix A.

AUDIT OBJECTIVES AND SCOPE OF WORK

We have conducted a financial audit to examine and express an opinion on the proposed indirect cost rates as they relate to the Co-operative Agreements between USAID and IIMI, for the one year periods from January 1, 1989 to December 31, 1994.

The objectives of our assignment were as follows:

- Determination of whether the indirect cost rates proposed by IIMI for the one year periods from January 1, 1989 to December 31, 1994 are in accordance with the terms of the Co-operative Agreements and applicable cost principles, and specific instructions given by office of the Regional Inspector General for Audit, Singapore (RIG/A/S).

- Identification and investigation of any items which are not fully supported with adequate records or which are not reasonable, allowable or allocable under the terms of the Co-operative Agreements.

In accordance with the scope of work specified in the "Guide for Financial Audits" issued by the USAID Office of the Inspector General, the following procedures were adhered to:

- Conducted meetings with officials of IIMI, USAID/Sri Lanka and RIG/A/S.
- Reviewed the following documents:
  - The initial Grant Agreement and all subsequent amendments and modifications
  - US Auditing standards published by the American Institute of Certified Public Accountants
  - Government Auditing Standards issued by the Comptroller General of the United States ("Yellow Book", 1994 Revision)
  - Audit reports for the financial periods 1991 - 1994

SCOPE LIMITATION

The accounting records of IIMI for the financial periods 1989 and 1990 are in an illegible state due to floods. Therefore, as intermitted to and agreed with Mr. Thomas Egan RIG/A/S Audit Manager, audit procedures for the aforementioned financial periods, were not carried out.

METHODOLOGY

* Obtained schedules of direct costs, indirect costs and the audited indirect cost rates for the relevant financial periods from IIMI.
* Each indirect cost expenditure category was analysed into its line items and was segregated to its respective monthly expenditure from the project ledger.
* From the monthly analysis of the indirect cost expenditure a sample of months were selected which covers at least 50% of the total value for that expenditure line item.
* On perusal of the project ledger for the respective months a sample of vouchers were selected based on the ledger narration and the dollar value. Vouchers were selected giving due consideration to the risk involved.
* After the completion of vouching, a schedule was prepared of questioned costs.
* According to the scope of work specified by the RIG/A/S, interest expense and liquor expenses were, disallowed in calculating the recommended indirect cost recovery rates.
* Notional Rent charged during the years 1992 to 1994 and the estimated depreciation charge on donor funded assets of specific projects in 1991 were disallowed.

* Two scenarios of rates as instructed by the officials of RIG/A/S, are given by disallowing unrestricted funds given by USAID in the respective years on the following basis :

  - disallowing fully funds given by USAID

  - disallowing it in proportion to its contribution to indirect expenditure.

  Appendix F gives the comments of IIMI where they have explained their position in relation to the treatment of the unrestricted funds given by USAID. It is advisable for the Contracting Officer to consider these comments prior to finalizing the most appropriate indirect cost recovery rate.

SAMPLING APPROACH

The indirect cost expenditure line items were chosen to carry out monthly analyses depending on their dollar value and the nature of the items. During the initial years (ie. 1991 and 1992) such items were selected mainly based on the risk attached to them, which was aided by the experience gained in carrying out audit work during the recent years. (ie. 1993 and 1994)

AUDIT RESULTS

We have computed the indirect cost recovery rates according to the guidelines stipulated by the officials of RIG/A/S as depicted below :

Recommended Rates	1991 %	1992 %	1993 %	1994 %
Rate 1	25.98	26.44	26.43	27.38
Rate 2	28.43	29.33	29.40	29.32

Both Recommended Rates exclude ineligible expenses such as notional rent, interest, liquor expenses and depreciation on project specific assets. Rate 1 excludes unrestricted income from USAID in total whilst rate 2 excludes it in proportion to its contribution to indirect expenditure.

FINDINGS

During the course of the audit the following issues came to our notice :

- IIMI's policies in relation to international travel have not been approved by USAID.
- Depreciation on project specific assets purchased out of donor funds has been included in the indirect cost rate computation for the financial year 1991, which was a result of the policy prevailing at that time.
- A notional rent charge has been included in the IIMI indirect cost rate computations for the financial years 1992 to 1994.

RECOMMENDATIONS

We recommend the following courses of action to prevent or minimize any disagreements that may arise in the future.

- IIMI should submit their policies in relation to international travel to USAID for approval.
- USAID should review the respective grantees' policies in relation to indirect costs prior to agreeing to a provisional indirect cost recovery rate in the Co-operative Agreements.
- USAID should clearly specify the ineligible costs that should be excluded from the indirect cost base in each Co-operative Agreement.
- Depreciation on project specific assets and notional rent (where depreciation is already charged) should be excluded from indirect cost computations.

Please note that we have excluded depreciation on project specific assets and notional rent in computing the Recommended Rates.

According to the relevant Recommended Rates the amounts refundable to USAID/IIMI for the financial periods 1991 - 1994 are as depicted below :

Recommended Rates	Amount refundable to USAID/(IIMI) US$
Rate 1	40,189
Rate 2	(28,764)

Therefore we recommend the Contracting Officer of USAID to finalize the indirect cost recovery rates in consultation with the grantee and RIG/A/S.

ACKNOWLEDGMENTS

We wish to place on record our appreciation of the co-operation and assistance provided to us by the officials of the following organizations,

- International Irrigation Management Institute
- US Agency for International Development, Mission to Sri Lanka
- The Office of the Regional Inspector General for Audit, Singapore

ERNST & YOUNG

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July 17, 1995

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03-01, Tong Building
302, Orchard Road
Singapore 0923
Singapore

Dear Sir

REPORT ON SCHEDULE OF COMPUTATION OF INDIRECT COST RATES FOR THE FINANCIAL YEARS ENDING DECEMBER 31, 1991 - 1994

We have examined the schedules of computation of indirect cost rates for the above mentioned financial periods.

Our examination was made in accordance with the US Government Auditing Standards, issued by the Comptroller General of the United States and Generally Accepted Auditing Standards as promulgated by the American Institute of Certified Public Accountants. Furthermore our examination was made in accordance with specific guidelines laid down by the office of the Regional Inspector General for Audit, Singapore.

The computation of the indirect cost rates, according to the proposed guidelines and recommended guidelines are shown in Exhibit 1.1 according to the respective financial periods.

In our opinion the schedules of computation of indirect cost rates for the respective financial periods are presented fairly except for the questioned costs identified according to specific guidelines stipulated by the Office of the Regional Inspector General for Audit, Singapore.

- **Partners :** M T L Fernando FCA J S Mather BA BSc. (Econ) FCA G A E Gunatilleke BSc. FCA A D B Talwatte ACA FCMA T K Bandaranayake BSc. FCA Mrs L C Nanayakkara ACA W R H Fernando ACA FCMA AIDPM CPA M P D Cooray ACA FCMA AIDPM H M A Jayesinghe ACA

COMPUTATION OF INDIRECT COST RECOVERY RATES

We have detailed the different indirect cost recovery rates in Exhibit 1.1 and the amounts recoverable on the application of different rates to the direct cost base in Exhibit 1.2. In the difference columns in Exhibit 1.2 a positive value indicates the amount refundable to USAID and a negative value indicates the amount refundable to IIMI.

Appendix B contains definitions and formulae for the direct/indirect expenditure and the indirect cost recovery rates. Appendix C contains detail computations for each financial period whilst Appendix D contains a summary of questioned costs for each financial period. Further, Appendix E schedules the questioned costs in detail.

FINDINGS

1. *IIMI's policies in relation to international travel*

Condition :
During the course of our audit we noticed that IIMI policies in relation to international travel were inconsistent with USAID guidelines. For example:

- Under IIMI policy an international staff member may travel business class if the travel time is more than six hours and if it is approved by the Director General.

- According to USAID guidelines a staff member may travel business class if the travel time is more than fourteen hours.

- Further, IIMI travel policies allow board members to travel first class if business class travel facilities are not available. However, USAID guidelines normally disallow first class travel.

Cause :
The reason for this discrepancy may possibly be due to IIMI not submitting their policies in relation to international travel to USAID for approval or USAID not specifically requesting for the aforementioned policies for review.

Recommendations :
- IIMI should submit their policy in relation to international travel to USAID for approval.

- We recommend USAID to initially undertake a review of the grantee's policies in relation to indirect costs incurred by the grantee and approve the policies prior to agreeing to a provisional indirect cost recovery rate in the Co-operative Agreements.

- Furthermore, it would be advisable for USAID to specify ineligible costs in relation to the indirect cost base in the respective Co-operative Agreements, thereby avoiding any misconceptions the grantee may have regarding ineligible costs that should be excluded from indirect costs.

Our findings in relation to International Travel are quantified below :

Year	Total International Travel Cost	Expenditure Vouched in our sample		Cost of Business Class Travel in our sample	Cost of First Class Travel in our sample
		Percentage	Amount		
	US$	%	US$	US$	US$
1991	160,089	61	97,395	52,972	-
1992	261,313	56	147,322	56,988	235
1993	209,874	77	161,603	65,080	2,220
1994	136,379	76	104,322	59,525	147
Total	**767,655**		**510,642**	**234,565**	**2,602**

However, it should be noted that business and first class travel expenditure has not been deducted in the calculation of recommended rates for each year under review, as the IIMI policies provide for such travel facilities.

Management Comments
IIMI has consistently followed its Board approved policies, which are clearly documented. Had USAID requested IIMI's travel policies IIMI would have submitted them.

E & Y Comments
The Contracting Officer of USAID will have to decide regarding the appropriateness of the international travel expenditure considering that these policies have not been subject to review by USAID due to the aforementioned reasons.

2. ***Depreciation on project specific assets for the financial year ended December 31, 1991.***

Condition :
For the aforementioned financial period IIMI has not made a distinction between core assets and project specific assets which have been funded by donors (complimentary assets).

Cause :
The distinction between core assets and complimentary assets was initially made in the financial statements for the period ended December 31, 1992. Prior to that all assets were considered to be core assets, in terms of their policy.

Recommendation :
Depreciation on project specific assets should be excluded in the indirect cost rate calculations as such assets have already been funded entirely by donors.

Management Comments
IIMI's total program was considered core in 1991. Accordingly the total depreciation charged in 1991 should be an allowable expense. It is assumed that certain project specific assets are complementary and the depreciation charge is disallowed. This is incorrect. The assets depreciated were core assets and the depreciation charge should be permitted as an indirect expenditure.

E & Y Comments
It is understood that in 1991 IIMI's total program was considered core and depreciation was provided accordingly. As discussed in the finding the distinction between core and Project specific assets (complementary assets) was initially made in 1992. If this same policy applied in 1991 then depreciation on project specific assets would be disallowed. We have made this adjustment to be consistent with regard to the depreciation adjustment of the other financial periods.

The depreciation charge for project specific assets for 1991 has been computed based on the average proportion of depreciation on complementary assets to core assets for the financial periods 1992- 1994. However, it should be noted that the adjustment to the rate arising out of this is minimal.

3. *Notional rent charge during the financial years 1992 to 1994.*

Condition :
During the said financial periods IIMI has charged notional rent which is equivalent to the capital repayment on the Program Related Investment (PRI) loan. This loan has been utilized for the purpose of up front lease payment on building, leasehold improvements and purchase of heavy-duty equipment, etc. However, there is an amortization/depreciation charge on the fixed assets which were purchased utilizing these loan funds. Hence, in effect the notional rent charge amounts to a double charge.

Recommendation
The notional rent charge should be excluded from the computation of indirect cost recovery rates.

Management Comments
We agreed with Ernst & Young's recommendation and agree with the adjustment of the rate.

SUMMARY OF INDIRECT COST RECOVERY RATES

YEAR	PROJECT	PROVISIONAL RATE	CEILING RATE	AUDITED RATE FOR THE YEAR	PROPOSED RATE 1	PROPOSED RATE 2	RECOMMENDED RATE 1	RECOMMENDED RATE 2
1994	SCOR	32.0 %	34.5 %	33.4 %	31.9 %	29.9 %	27.4 %	29.3 %
	Egypt	32.0 %	-					
1993	SCOR	32.0 %	34.5 %					
	Pakistan phase II	29.0 %	-	33.1 %	30.2 %	27.3 %	26.4 %	29.4 %
1992	India	25.0 %	-	34.6 %	30.3 %	27.4 %	26.4 %	29.3 %
	Pakistan phase II	29.0 %	-					
	IMPSA phase II	25.8 %	-					
	Nepal	28.0 %	-					
	Rights project	28.0 %	-					
	ISM	25.0 %	-					
1991	Philippines	23.8 %	24.0 %	31.7 %	24.0 %	24.0 %	24.0 %	24.0 %
	India	25.0 %	-		28.6 %	26.2 %	26.0 %	28.4 %
	IMPSA phase I	25.8 %	-					
	IMPSA phase II	25.8 %	-					
	ISM	25.0 %	-					
	ISPAN	20.0 %	-					
	Nepal	28.0 %	-					
	Pakistan	29.0 %	-					

NOTES

1. Proposed Rate 1 : Deducts the proportion of USAID contribution to indirect expenses.
   Proposed Rate 2 : Deducts the total unrestricted income from USAID.
   Recommended Rate 1 : Deducts the total unrestricted income from USAID and disallowed expenses.
   Recommended Rate 2 : Deducts the proportion of USAID contribution to indirect expenses and disallowed expenses.
   (Please refer Appendix B for further details)

2. The detailed computations of the proposed & recomended rates are given in Appendix C

AMOUNTS REFUNDABLE TO USAID/(IIMI) UNDER THE DIFFERENT INDIRECT COST RECOVERY RATES

YEAR	PROJECT	DIRECT COSTS	AMOUNT RECEIVABLE AS PER					ACTUAL AMOUNT RECEIVED	AMOUNT REFUNDABLE TO USAID/(IIMI)				
			AUDITED RATE A	PROPOSED RATE 1 B	PROPOSED RATE 2 C	RECOM. RATE 1 D	RECOM. RATE 2 E	F	F-A	F-B	F-C	F-D	F-E
1994	SCOR	549,385	183,495	175,254	164,266	150,422	161,080	175,803	(7,691)	549	11,537	25,382	14,724
	Egypt	9,144	3,054	2,917	2,734	2,504	2,681	2,926	(128)	9	192	422	245
		558,529	**186,549**	**178,171**	**167,000**	**152,925**	**163,761**	**178,729**	**(7,819)**	**559**	**11,729**	**25,804**	**14,969**
1993	SCOR	212,531	70,348	64,184	58,021	56,172	62,484	58,010	(2,338)	3,826	9,989	11,838	5,526
	Pakistan phase II	349,981	115,844	105,694	95,545	92,500	102,894	102,113	(13,731)	(3,581)	6,568	9,613	(781)
		562,512	**186,191**	**169,879**	**153,566**	**148,672**	**165,379**	**170,123**	**(16,068)**	**244**	**16,557**	**21,451**	**4,744**
1992	India	13[illegible]5	46,356	40,595	36,709	35,423	39,295	34,111	(12,245)	(6,484)	(2,598)	(1,312)	(5,184)
	Pakistan phase II	437,460	151,361	132,550	119,864	115,664	128,307	126,881	(24,480)	(5,669)	7,017	11,217	(1,426)
	IMPSA	69,465	24,035	21,048	19,033	18,367	20,374	17,944	(6,091)	(3,104)	(1,089)	(423)	(2,430)
	Nepal	87,325	30,214	26,459	23,927	23,089	25,612	24,437	(5,777)	(2,022)	510	1,348	(1,175)
	Rights Project	100,787	34,872	30,538	27,616	26,648	29,561	28,220	(6,652)	(2,318)	604	1,572	(1,341)
	ISM	97,333	33,677	29,492	26,669	25,735	28,548	24,937	(8,740)	(4,555)	(1,732)	(798)	(3,611)
		926,346	**320,516**	**280,683**	**253,819**	**244,926**	**271,697**	**256,530**	**(63,986)**	**(24,153)**	**2,711**	**11,604**	**(15,167)**
1991	Philippines	312,109	98,939	74,906	74,906	74,906	74,906	59,370	(39,569)	(15,536)	(15,536)	(15,536)	(15,536)
	India	115,268	36,540	32,967	30,200	29,947	32,771	26,563	(9,977)	(6,404)	(3,637)	(3,384)	(6,208)
	IMPSA phase I	117,596	37,278	33,632	30,810	30,551	33,433	29,504	(7,774)	(4,128)	(1,306)	(1,047)	(3,929)
	IMPSA phase II	39,135	12,406	11,193	10,253	10,167	11,126	10,075	(2,331)	(1,118)	(178)	(92)	(1,051)
	ISM	45,521	14,430	13,019	11,927	11,826	12,942	11,374	(3,056)	(1,645)	(553)	(452)	(1,568)
	ISPAN	35,504	11,255	10,154	9,302	9,224	10,094	5,040	(6,215)	(5,114)	(4,262)	(4,184)	(5,054)
	Nepal	83,093	26,340	23,765	21,770	21,588	23,623	23,267	(3,073)	(498)	1,497	1,679	(356)
	Pakistan phase II	161,413	51,168	46,164	42,290	41,935	45,890	46,281	(4,887)	[illegible]17	3,991	4,[illegible]46	391
		909,639	**288,356**	**245,800**	**231,459**	**230,144**	**244,784**	**211,474**	**(76,882)**	**(34,325)**	**(19,985)**	**(18,670)**	**(33,310)**
TOTAL		**2,957,026**	**981,611**	**874,532**	**805,844**	**776,667**	**845,620**	**816,856**	**(164,755)**	**(57,676)**	**11,013**	**40,189**	**(28,764)**

NOTE

All figures are in US$.

EXHIBIT 1.2

12

APPENDIX A

USAID FUNDED PROJECTS AT IIMI

Project	Amount Pledged US$	Cumulative Expenditure up to Dec. 31, 1994 US$
Accelerated Agricultural Production Project Philippines (AAPP) Program to support the irrigation objective of the USAID supported AAPP in the Philippines	1,485,070	1,483,126
Support for IIMI's Program in Irrigation Research in Pakistan (Phase I) To support IIMI's efforts to strengthen Pakistan's national capacity to improve the performance of irrigation systems through management innovations	2,000,000	2,000,000
Irrigation Systems Management (ISM) Sri Lanka To assist USAID's Irrigation System Management Project through the development and implementation of research on key irrigation management issues, and to strengthen Sri Lanka's national capacity for irrigation management research.	590,718	590,719
Collaborative Program with Indian institutions in research training and information dissemination To explore and initiate collaborative projects between IIMI and Indian institutions through research and professional development exchange. This work is designed to strengthen the capacity of Indian institutions to contribute to the improvements of irrigation systems	500,000	500,000

APPENDIX A (Contd)

Project	Amount Pledged US$	Cumulative Expenditure up to Dec. 31, 1994 US$
Irrigation Management Policy Support Activity (IMPSA) Phase II Project aimed at supporting the Government of Sri Lanka's policy initiatives in the irrigation sector through a participatory approach to building policy consensus on what should be done over the next decade and beyond	136,619	136,619
Institutional Development and Strengthening Banganga Project - Nepal To provide support for IIMI's action research program with government department of irrigation in Banganga irrigation system	218,474	218,474
Rights to Resources Project To provide overall support and specific analyses which will be the basis of the design of the new program to support participatory approaches to resources management	134,007	134,007
Support for IIMI's Program in Irrigation Research in Pakistan - Phase II To improve the capacity and relevancy of water management research in Pakistan	1,636,755	1,636,755
Irrigation Support Project for Asia and the Near East (ISPAN) To increase IIMI's capacity to develop more effective training and professional development programs	460,000	419,452
Initiation of an IIMI Program in West Africa To support an IIMI regional representative in Burkina Faso to plan the Institute's programs in West African region in collaboration with interested national agencies	344,000	344,000

APPENDIX A (Contd)

Project	Amount Pledged US$	Cumulative Expenditure up to Dec. 31, 1994 US$
Provision of an Institutional Development Specialist on the IMP Redesign Project Services of an IIMI staff member to serve on the technical assistance team as an institutional development specialist under ISPAN Activity No. 6648 (21 days)	6,972	6,972
Shared Control of Natural Resources (SCOR) To assist Sri Lanka to sustain the productivity of land and water resources within selected watersheds through shared control by local user group and the government involving formal agreements and joint management	2,533,000	1,395,886

APPENDIX B

DEFINITIONS OF EXPENDITURE/INCOME AND INDIRECT COST RECOVERY RATES

1. ***Total unrestricted expenditure***

   Consists mainly of indirect expenditure but includes direct expenditure as well. This expenditure excludes capital expenditure and contract research.

2. ***Total direct expenditure***

   All direct expenditure excluding capital expenditure, contract research and overhead charges on projects are classified as direct expenditure.

3. ***Total indirect expenditure***

   This includes all indirect expenditure such as administration costs which are recoverable by the application of the indirect overhead rate and these are funded by unrestricted sources.

4. ***Total unrestricted income from USAID***

   This is a lump sum paid each year by USAID to be utilized for unrestricted expenditure.

5. ***USAID contribution to indirect expenditure***

   This is calculated proportionately according to the following formula.

$$\frac{\text{Total Indirect Expenditure}}{\text{Total Unrestricted Income}} \times \text{Total Unrestricted Income from USAID}$$

APPENDIX B (Contd)

6. ***Audited Rate***

This is the actual indirect cost rate as disclosed in the Audited Financial Statements.

7. ***Proposed Rate 1***

This is computed using the following formula as calculated by IIMI.

$$\frac{\text{Total Indirect Expenditure - USAID Contribution to Indirect Expenditure}}{\text{Total Direct Expenditure}} \times 100$$

8. ***Proposed Rate 2***

According to the guidelines given to us by the office of the Regional Inspector General for Audit, Singapore this rate is calculated by using the following formula.

$$\frac{\text{Total Indirect Expenditure - Total Unrestricted Income from USAID}}{\text{Total Direct Expenditure}} \times 100$$

9. ***Recommended Rate 1***

This is one of the rates recommended by us after disallowing expenditure according to specific guidelines laid down by the office of the Regional Inspector General for Audit, Singapore. This is calculated as follows.

$$\frac{\text{Total Indirect Expenditure - * Notional Rent - Total Unrestricted Income from USAID - Disallowed Expenditure}}{\text{Total Direct Expenditure - * Notional Rent - Interest Expense}} \times 100$$

APPENDIX B (Contd)

10. ***Recommended Rate 2***

This is another option recommended by us which is similar to Recommended Rate 1, except for that total unrestricted income from USAID is apportioned as in Proposed Rate 1.

$$\frac{\text{Total Indirect Expenditure - * Notional Rent - USAID Contribution to Indirect Expenditure - Disallowed Expenditure}}{\text{Total Direct Expenditure - * Notional Rent - Interest Expense}} \times 100$$

* Please note that in 1991 there is no notional rent charge. However, the depreciation on project specific assets funded by donors has been deducted, as in 1991 such a charge has been included in the indirect cost rate computation.

APPENDIX C

DETAILED COMPUTATIONS OF INDIRECT COST RECOVERY RATES FOR THE FINANCIAL PERIODS 1991-1994

Financial Year Ended December 31, 1994

- ***Provisional Rates*** -

  Provisional rates are stipulated in the Co-operative Agreements.

- ***Proposed Rate 1*** -

US$ 000's

Total indirect expenditure	=	1951
Total unrestricted expenditure	=	4516
Total unrestricted income from USAID	=	200
Total direct expenditure	=	5848

USAID contribution to indirect expenditure $= \frac{1951}{4516} \times 200$

$= 86$

==

Proposed Rate 1 $= \frac{(1951 - 86)}{5848} \times 100$

$= 31.89\%$

=====

APPENDIX C (Contd)

- ***Proposed Rate 2 -***

Proposed Rate 2 $= \frac{(1951-200)}{5848} \times 100$

$= 29.94\%$

======

- ***Recommended Rate 1 -***

US$ 000's

Notional rent included as indirect expenditure = 141.58

Expenditure disallowed = 8.51

Recommended Rate 1 $= \frac{(1951 - 141.58 - 200 - 8.51)}{5848} \times 100$

$= \frac{1600.91}{5848} \times 100$

$= 27.38\%$

=====

- ***Recommended Rate 2 -***

Recommended Rate 2 $= \frac{(1951-141.58 - 86-8.51)}{5848} \times 100$

$= \frac{1714.91}{5848} \times 100$

$= 29.32\%$

=====

APPENDIX C (Contd)

Financial Year Ended December 31, 1993

- ***Provisional Rates -***

  These rates are stipulated in the Co-operative Agreements.

- ***Proposed Rate 1 -***

		US$ 000's
Total indirect expenditure	=	2007
Total unrestricted expenditure	=	4092
Total unrestricted income from USAID	=	350
Total direct expenditure	=	6072

USAID contribution to indirect expenditure $= \frac{2007}{4092} \times 350$

$= 172$

Proposed Rate 1 $= \frac{(2007 - 172)}{6072} \times 100$

$= 30.22\%$

- ***Proposed Rate 2 -***

Proposed Rate 2 $= \frac{(2007 - 350)}{6072} \times 100$

$= 27.29\%$

APPENDIX C (Contd)

- ***Recommended Rate 1 -***

		US$ 000's
Notional rent included in direct expenditure	=	72.33
Notional rent included in indirect expenditure	=	67.84
Expenditure disallowed - Direct	=	4.95
- Indirect	=	4.89

Recommended Rate 1

$$= \frac{(2007 - 67.84 - 350 - 4.89)}{(6072 - 72.33 - 4.95)} \times 100$$

$$= \frac{1584.27}{5994.72} \times 100$$

$$= 26.43\%$$

======

- ***Recommended Rate 2 -***

Recommended Rate 2

$$= \frac{(2007 - 67.84 - 172 - 4.89)}{(6072 - 72.33 - 4.95)} \times 100$$

$$= \frac{1762.27}{5994.72} \times 100$$

$$= 29.40\%$$

======

APPENDIX C (Contd)

Financial Year Ended December 31, 1992

- ***Provisional Rates -***

  These rates are as stipulated in the Co-operative Agreements.

- ***Proposed Rate 1 -***

		US$ 000's
Total indirect expenditure	=	2059
Total unrestricted expenditure	=	3435
Total unrestricted income from USAID	=	425
Total direct expenditure	=	5958

USAID contribution to indirect expenditure $= \frac{2059}{3435} \times 425$

$= 255$

Proposed Rate 1 $= \frac{(2059 - 255) \times 100}{5958}$

$= 30.28\%$

- ***Proposed Rate 2 -***

  Proposed Rate 2 $= \frac{(2059 - 425) \times 100}{5958}$

  $= 27.43\%$

APPENDIX C (Contd)

- ***Recommended Rate 1 -***

		US$ 000's
Notional rent included in direct expenditure	=	72.16
Notional rent included in indirect expenditure	=	66.61
Expenditure disallowed	=	10.98

Recommended Rate 1 $= \frac{(2059-66.61 - 425- 10.98)}{(5958 - 72.16)} \times 100$

$= \frac{1556.41}{5885.84} \times 100$

$= 26.44\%$

- ***Recommended Rate 2 -***

Recommended Rate 2 $= \frac{(2059-66.61 - 255- 10.98)}{(5958 - 72.16)} \times 100$

$= \frac{1726.41}{5885.84} \times 100$

$= 29.33\%$

APPENDIX C (Contd)

Financial Year Ended December 31, 1991

- ***Provisional Rates -***

  These rates are as stipulated in the Co-operative Agreements.

- ***Proposed Rate 1 -***

		US\$ 000's
Total indirect expenditure	=	1722
Total Unrestricted expenditure	=	3041
Total unrestricted income from USAID	=	300
Total direct expenditure	=	5432

$$\text{USAID contribution to indirect expenditure} = \frac{1722}{3041} \times 300 = 170$$

$$\text{Proposed Rate 1} = \frac{(1722 - 170)}{5432} \times 100 = 28.57\%$$

- ***Proposed Rate 2 -***

$$\text{Proposed Rate 2} = \frac{(1722-300)}{5432} \times 100 = 26.18\%$$

APPENDIX C (Contd)

- ***Recommended Rate 1 -***

		US$ 000's
Depreciation included in direct expenditure	=	129.32
Depreciation included in indirect expenditure	=	44.03
Expenditure disallowed	=	0.305

Recommended rate 1

$$= \frac{(1722-44.03-300-.305)}{(5432-129.32)} \times 100$$

$$= \frac{1377.67}{5302.68} \times 100$$

$$= 25.98\%$$

- ***Recommended Rate 2 -***

Recommended Rate 2

$$= \frac{(1722 - 44.03 - 170 - .305)}{(5432 - 129.32)} \times 100$$

$$= \frac{1507.67}{5302.68} \times 100$$

$$= 28.43\%$$

APPENDIX D

SCHEDULES OF QUESTIONED COSTS

Financial Year Ended December 31,1994

		US$ (000's)
Notional rent		
- Indirect		141.580
Expenditure disallowed		
Liquor expenses		0.311
Interest on PRI (Program Related Investment) loan		8.200

		150.091
		======

Financial Year Ended December 31, 1993

		US$ (000's)
Notional rent		
- Direct	72.33	
- Indirect	67.84	140.170
Expenditure disallowed		
Liquor expenses		0.246
Interest on PRI loan		
- Direct	4.95	
- Indirect	4.64	9.590

		150.006
		======

APPENDIX D (Contd)

Financial Year Ended December 31,1992

			US$ (000's)
Notional rent			
-	Direct	72.16	
-	Indirect	66.61	138.77
Expenses disallowed			
	Interest on PRI Loan		10.98
			149.75

Financial Year Ended December 31, 1991

			US$ (000's)
Depreciation			
-	Direct	44.03	
-	Indirect	129.32	173.350
Expenses disallowed			
	Liquor expenses		0.305
			173.655

APPENDIX E

DETAILED BREAK-DOWN OF QUESTIONED COSTS

The details of questioned costs found in our sample is given below :

Financial Year Ended December 31, 1994

Liquor Expenses

Month	Voucher No.	Amount US$
April	MTOO 4912	13
February	MTOO 4731	76
November	MTOO 5459	34
December	MTOO 545	188
Total		**311**

Interest on PRI Loan

Month	Amount US$
January - March	2,178
April - June	2,089
July - September	2,001
October - December	1,912
Total	**8,180**

APPENDIX E (Contd)

Notional Rent

Month	Amount US$
January - March	35,261
April - June	35,350
July - September	35,438
October - December	35,526
Total	**141,575**

Financial Year Ended December 31, 1993

Notional Rent

Month	Amount US $
January - March	34,911
April - June	34,998
July - September	35,086
October - December	35,173
Total	**140,168**

NOTE : The notional rent of US$ 140,168 is apportioned as follows :

Direct	52%
Indirect	48%

APPENDIX E (Contd)

Liquor Expenses

Month	Voucher No	Amount US$
November	MTOO 4485	107
May	MTOO 3821	5
December	MTOO 4531	12
	MTOO 4532	122
Total		**246**

Interest on PRI Loan

Month	Amount US$
January - March	2,528
April - June	2,441
July - September	2,353
October - December.	2,266
Total	**9,588**

The total interest of US$ 9,588 has been apportioned as follows :

Direct	52%
Indirect	48%

APPENDIX E (Contd)

Financial Year Ended December 31, 1992

Notional Rent

Month	Amount US$
January - March	34,564
April - June	34,650
July - September	34,737
October - December	34,824
Total	**138,775**

Note : The notional rent of US$ 138,775 has been apportioned as follows :

Direct - 52%

Indirect - 48%

Interest on PRI Loan

Month	Amount US$
January - March	2,875
April - June	2,789
July - September	2,702
October - December	2,615
Total	**10,981**

APPENDIX E (Contd)

Financial Year Ended December 31, 1991

Depreciation (on assets of specific projects purchased out of donor funds)

Years	Amount US$	As a % of Total Depreciation
1994	180,717	38.86
1993	183,320	42.56
1992	217,763	46.31
Total		**127.73**
Average % of depreciation on complimentary assets		42.58

The estimated depreciation on donor funded assets(407,150 * 42.58) = US$ 173,364

==========

This estimated depreciation has been apportioned according to the actual depreciation charged to direct expenditure and indirect expenditure as depicted below :

	Total Depreciaition US$	Percentage	Apportionment of Estimated Depreciation on donor funded assets
Direct	103,528	25	43,341
Indirect	303,622	75	130,023
Total	**407,150**	**100**	**173,364**

APPENDIX E (Contd)

Liquor Expenses

Month	Voucher No.	Amount US$
December	MTOO 8641	15
December	MTOO 8559	233
December	MTOO 8580 MTOO 8583	57
Total		**305**

INTERNATIONAL IRRIGATION MANAGEMENT INSTITUTE

27 July 1995

M/s. Ernst & Young
Chartered Accountants
201, De Saram Place
P.O. Box 101
Colombo 10

Dear Sir/Madame:

Financial Audit of Indirect Costs in Relation to
USAID'S Cooperative Agreements

Thank you for your letter of 17 July, enclosing a copy of the amended draft report, covering the period 1991 - 1994. After reviewing the report, we have one major observation and several minor ones. First, however, let me convey our gratitude to Mr. Thomas Egan and each of you who worked with him; you have been highly professional in working with us and we benefited enormously from our interactions with you all.

In the report, USAID has computed overhead recovery rates for the period 1991 to 1994 using two alternate methods. The first (rate 1) excludes the entire unrestricted core grant income received by IIMI from USAID each year. We believe this is logical only if we assume that these grant funds are used solely to finance IIMI's indirect activities and that none of these core unrestricted funds are used for direct research. This is not true and we believe that use of this rate produces the least accurate accounting.

In the second alternate (rate 2), it is assumed that a proportionate share of the unrestricted grant funds from USAID have been used to finance IIMI's indirect activities and the other part has gone for direct research. This approach is closer to reality, but still distorts the picture somewhat, for the reasons detailed below. It is with great respect that we ask you to consider the points made below.

As explained in our meeting with Mr. Egan, the Institute's expenses are classified as direct or indirect, based on the type of the expenditure. Managerial and administrative expenses are considered indirect, while research, technical assistance and other program activities are considered direct. This is in keeping with standard financial practices and general accounting theory. Indirect cost recovery formulas are based on costs, not on income. Mixing the two is like mixing apples and oranges and produces a negative bias in the cost recovery formula. Indeed, it is to USAID's advantage that indirect costs be estimated fully and neutrally, by cost category alone. This would permit IIMI to fully recover the proper share of indirect costs from its direct expenditures. By so doing, USAID itself benefits, because the maximum amount of its unrestricted contribution can be deployed to IIMI's program activities. We believe that the unrestricted AID donors would like to participate in IIMI's direct program activities every bit as much as the restricted bilateral AID donors.

Mailing: P. O. Box 2075, Colombo, Sri Lanka
Location: 127, Sunil Mawatha, Battaramulla, Sri Lanka
Telephone: 94-1-867404, 869080, 869081 Telex: 22318 IIMIHQ CE Facsimile: 94-1-866854 E-Mail: IIMI@CGNET.COM

The Institute's indirect cost recovery policy is closely scrutinized by the Board of Governors, is discussed by the Board frequently and audited annually. The Board has approved the indirect cost recovery formula and has directed Management to fully recover indirect costs from direct activity expenditures. As noted previously, the indirect cost rate is a means of dividing and classifying expenses and has nothing whatsoever to do with income. Indeed, reducing the rate for certain types of income confuses the original purpose and results in a rate which undercounts indirect expenditures.

To summarize, reducing the rate by any portion of the AID unrestricted contribution works ultimately to the disadvantage of AID itself. By preventing IIMI from fully recovering indirect costs from direct activities, USAID headquarters is penalized and a disproportionately high share of their unrestricted grant must be used for administrative costs. In addition, it unintentionally endorses financial practices which are less than optimal. We ask that you consider these points in making your final rate determination. Finally, we ask that you allow the Institute's indirect cost recovery policy -- which is transparent, neutral and approved by IIMI's Board of Governors -- to stand.

In addition to the above, we would make the following minor points. With regard to the depreciation charged against operating income in 1991, it was agreed at our meeting with Mr. Egan and team, that IIMI's total program was considered core in 1991. Accordingly, we agreed that the total depreciation charged in 1991 would be considered an allowable expense. On page 8 of the report, it is assumed that certain project specific assets are complementary and the depreciation charge is disallowed. This is incorrect. IIMI's policy is to depreciate only core assets, not complementary assets. The criteria applied to identify a core project from a complementary project is clearly laid out in IIMI's Medium Term Plan, which has been approved by the Technical Advisory Committee (TAC) of the CGIAR. The assets depreciated were core assets and the depreciation charge should be permitted as an indirect expenditure.

We agree with Ernst & Young's recommendation with regard to notional rent and agree with the adjustment of the rate, accordingly.

With regard to international travel, IIMI has consistently followed its Board approved policies, which are clearly documented. Had USAID requested IIMI's travel policies in the first instance, IIMI would have submitted them gladly, as in the case of IIMI's purchasing policies, national staff and international staff terms and conditions.

We are grateful to you for the opportunity to bring these points to your attention and would be happy to answer any additional questions you may have.

Yours sincerely,

Nancy O. Andrews/HJ

Nancy O. Andrews
Director, Finance and Administration

cc: Mr. Robert Bertram
Dr. Leslie Swindale
Dr. David Seckler
Dr. Randolph Barker