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OFFICE OF INSPECTOR GENERAL
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MEMORANDUM

DATE: July 28, 2003

TO: Jack Martin
Chief Financial Officer
U.S. Department of Education

FROM: J. Wayne Bynum *s/J. Wayne Bynum*
Regional Inspector General for Audit
Region IV

SUBJECT: **FINAL AUDIT REPORT**
Contract Closeout Audit of Office of Educational Research and Improvement Contract No. RJ96006001 At Appalachia Educational Laboratory
Control Number ED-OIG/A04-C0020

Attached is the subject report presenting our finding and recommendations resulting from our contract closeout audit of OERI Contract No. RJ96006001 with the Appalachia Educational Laboratory in Charleston, WV.

In accordance with the Department's Audit Resolution Directive, you have been designated as the action official responsible for the resolution of the findings and recommendations in this report.

If you have any questions, please contact me at 404-562-6477 or Assistant Regional Inspector General Mary Allen at (404-562-6465).

Please refer to the above control number in all correspondence relating to this report.

Attachment

cc: Glen Perry, Director, Contracts and Purchasing Operations, OCFO
Cynthia Bond-Butler, Audit Liaison Officer, CPO, OCFO

Contract Closeout Audit of Office of Educational Research and Improvement Contract No. RJ96006001 At Appalachia Educational Laboratory

FINAL AUDIT REPORT

ED-OIG/A04-C0020
July 2003

Our mission is to promote the efficiency, effectiveness, and integrity of the Department's programs and operations.

U.S. Department of Education
Office of Inspector General
Atlanta, Georgia

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate Department of Education officials.

In accordance with the Freedom of Information Act (5 U.S.C. § 552), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

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EXECUTIVE SUMMARY

The Appalachia Educational Laboratory (AEL) in Charleston, WV, is a non-profit education research and development institution that performs contract work for the Department of Education (Department). The Department's Office of Educational Research and Improvement[1] (OERI) issued Contract No. RJ96006001 to AEL for the period December 1995 through December 2000. The audit objective was to determine whether costs claimed were incurred, allowable, and adequately supported.

Total funds drawn down by AEL for the contract were $24,316,470. The total allowable contract amount was $23,971,940. Thus, AEL received $344,530 more than the total approved contract amount.

AEL incurred indirect costs of $258,983 in excess of the amount allowable by the contract. The provisional indirect cost rate was 21.6 percent. AEL requested a final indirect cost rate of 26.6 percent based on actual indirect cost expenditures. The Office of the Chief Financial Officer, Indirect Cost Group approved the final indirect cost rate. However, the contracting officer had not modified the contract limit to reflect this increase.

We recommend that the Chief Financial Officer require AEL to return contract overpayments totaling $344,530. We also recommend that the Chief Financial Officer make a determination whether to modify the contract to allow the additional indirect costs incurred. If the contract limit is increased to cover the indirect cost overrun, the amount that AEL owes the Department will be reduced to $85,547 ($344,530 overpayments less $258,983 additional indirect costs).

AEL concurred that it received $344,530 in excess funds for the contract. AEL pointed out that Federal law allows contractors to request a contract appropriation to cover indirect cost overruns when unspent program funds are available, and that AEL has pending a request for an additional modification to collect $258,983 in indirect cost expenditures at the rate approved by the cost determination branch for fiscal year 2000 (26.6 percent). AEL awaits a decision on the contract modification before refunding either the full $344,530 or the $85,547 that it believes the Government is due.

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[1] The Education Sciences Reform Act of 2002, dated November 5, 2002, replaced the Office of Educational Research and Improvement (OERI) with the Institute of Education Sciences. For the purposes of this report, the name of the former agency is used since the contract was issued by and completed under OERI.

AUDIT RESULTS

Except as noted below and within the context of our scope of work described in the report, we found that the costs billed by AEL were incurred, allowable, and supported. We found that AEL received $344,530 more than the total allowable contract amount and that AEL incurred $258,983 in indirect costs in excess of the amount allowed by the contract. The table below summarizes the results of our review:

				Finding Number
Direct costs claimed	$18,939,269	$18,939,269	$0	
Indirect costs claimed	$4,593,442	$4,334,459	$258,983	2
Management Fee claimed	$698,212	$698,212	$0	
Total contract costs claimed	$24,230,923	$23,971,940	$258,983	
Contract Funds Drawn	$24,316,470	$23,971,940	$344,530	1

Finding No. 1 – Draw Downs of Federal Funds Exceeded Allowable Contract Costs

AEL received $344,530 in excess funds from the Department for Contract No. RJ96006001. From December 1995 (beginning of the contract) to December 1997, the Department of Education used the Payment Management System (EDPMS) for contract payments. Using this system, AEL drew down funds on an as needed basis for all of its contracts and reported back to the Department the amounts disbursed for each contract. In December 1997, the Department switched to the Education Central Automated Processing System (EDCAPS) for contract payments, a reimbursement payment system. Cash on hand as of March 31, 1998, and drawdowns during April 1998 were assigned by the Department in May 1998 to all open awards based on an algorithm. The AEL comptroller performed reconciliation in September 2000 to determine the amount allocated to Contract No. RJ96006001 at the time the Department assigned funds to the awards.

The total funds drawn down by AEL for Contract No. RJ96006001 was $24,316,470. We verified that this amount included all disbursements under the EDPMS system, the allocation of funds by the Department at the time of the switch to the EDCAPS system, a cash advance that AEL received from the Department, and all reimbursements made to AEL under the EDCAPS payment system. We determined that the total allowable contract amount was $23,971,940. Thus, AEL received $344,530 more than the total allowable contract amount ($24,316,470 total payments received less $23,971,940 total allowable contract costs).

The Government's payment obligation is limited to allowable cost amounts. Contract No. RJ96006001, Section G.4, Invoice and Contract Financing Request Submission, states:

> The Government agrees to pay the Contractor as complete compensation for all work and services performed and materials furnished under this contract those allowable costs defined in the contract clause entitled 'ALLOWABLE COST AND PAYMENT' in the amount not to exceed the estimated costs specified in the contract.

RECOMMENDATION

The Chief Financial Officer should require AEL to:

1.1 Return $344,530 received in excess of the total allowable contract amount.

AEL RESPONSE

AEL's written response to the draft report, a copy of which is attached to this report, concurred that AEL received $344,530 in excess funds for REL Contract RJ96006001. The response stated that significant increases in direct costs in fiscal years (FY) 1999 and 2000 and in costs charged to indirect in FY 2000 resulted in an overrun of the REL contract. The direct cost overrun was recorded as a loss in the corporate reserve in FY 2001. Federal law allows contractors to request a contract appropriation to cover indirect cost overruns. When unspent total program funds are available as they are in this case, the contracting officer may grant such an additional appropriation. OERI delayed a final ruling on the request pending two activities: The negotiation of the final indirect cost rate for FY 2000 and the completion of the OIG audit. AEL has pending a request for an additional modification to collect $258,983 in indirect cost expenditures at the rate approved for FY 2000 (26.6 percent). AEL notified the Department of the overpayment and awaits a decision on the contract modification before refunding either the full amount or the $85,547 that it believes the Government is due.

OIG COMMENTS

The drawdown of $344,530 in excess funds is separate from the issue of whether the Department will provide an appropriation to cover the additional indirect cost incurred by AEL. AEL should have returned the $344,530 to the Department when it determined in September 2000 that it had received excess funds. See Finding 2 for a discussion of the indirect cost issue.

Finding No. 2 – Direct and Indirect Costs Incurred in Excess of Amounts Allowed by the Contract

AEL incurred indirect costs of $258,983 and direct costs of $54,074 in excess of the amount allowable in the contract. AEL submitted a claim for reimbursement for the indirect cost overrun. It did not submit a claim for reimbursement for the direct cost overrun. The provisional indirect cost rate was 21.6 percent for FY 2000. AEL requested and received from the Department a final indirect cost rate of 26.6 percent for FY 2000 based on actual indirect cost expenditures. Total indirect costs claimed exceeded the allowable contract limit by $258,983.

Although the contracting office had approved a final indirect rate for AEL that covered the indirect cost overrun, a determination had not been made whether to amend the contract limit to cover the additional indirect cost.

Contract No. RJ96006001, Section G.4, Invoice and Contract Financing Request Submission, states:

> The Government agrees to pay the Contractor as complete compensation for all work and services performed and materials furnished under this contract those allowable costs defined in the contract clause entitled 'ALLOWABLE COST AND PAYMENT' in the amount not to exceed the estimated costs specified in the contract.

RECOMMENDATION

The Chief Financial Officer should:

2.1 Make a determination whether to modify the contract limit to cover the additional indirect costs incurred. If the Chief Financial Officer modifies the contract to allow the additional indirect costs incurred, the amount owed to the Department under Recommendation 1.1 above will be $85,547 ($344,530 contract overpayment less $258,983 additional indirect costs).

AEL RESPONSE

AEL concurred that it incurred direct and indirect costs in excess of amounts allowed by the contract. The response stated that this is frequently the case, particularly when projecting expenditures in advance for a multi-year period. AEL objected to the finding on the basis that (1) the direct cost overrun has been absorbed by the corporation, (2) AEL notified the Government in advance of the anticipated overrun in indirect costs, and was informed that if sufficient program funds were left, an appropriation to cover the overrun in indirect costs would likely be provided, and (3) if an appropriation for those costs is not provided, the Government will have no loss or liability, the loss will be absorbed by the corporation.

OIG COMMENTS

The Chief Financial Officer will determine the extent to which the contract may be modified to cover indirect costs. We did not amend the finding or recommendation.

BACKGROUND

AEL is a private, nonprofit education research and development institution that serves as one of the Federally supported Regional Educational Laboratories. AEL is located in Charleston, WV, and primarily serves the States of Kentucky, Tennessee, Virginia, and West Virginia. AEL is governed by a 28-member Board of Directors composed of representatives from various State Departments of Education, higher educational institutions, teachers' associations, school administrators' associations, and the public at large.

The Regional Educational Laboratory Program is the Department's largest research and development program designed to help educators, policy makers, and communities improve schools. The program's statutory mission is "to promote knowledge-based school improvement to help all students meet high standards and to help the nation meet the National Educational Goals" (Public Law 103-227, enacted in 1994). Although AEL had supplementary funding through other grants and contracts, its primary source of funding was through OERI.

Contract No. RJ96006001 was a cost-reimbursement plus fixed fee contract. OERI and the Contract and Purchasing Operations were responsible for overseeing the contract. The period of performance of the contract was December 11, 1995, through December 10, 2000, and the total allowable contract limit was $23,971,940.

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether costs claimed were incurred, allowable, and adequately supported. Audit coverage included Contract No. RJ96006001 for the period December 1995 to December 2000. Our review focused on the following areas:

- Accumulating and reporting contract costs,
- High-risk cost categories,
- Contract payments, and
- Reconciliation of funds received from the Department during the switch from the EDPMS system to the EDCAPS (GAPS) system.

To accomplish our objective, we:

- Interviewed AEL's management officials and staff,
- Reviewed Contract No. RJ96006001, including the statement of work,
- Reviewed the OMB Circular A-133 audit reports for years 1996 through 1999,
- Reviewed laws and regulations to gain an understanding of allowable costs, and
- Traced vouchers and payment data from the Department's records to AEL's general ledger detail to verify payments received.

The audit concentrated on fiscal years 1997 through 2000 since there was a previous audit (Audit Control Number A03-70007) performed by the U.S. Department of Education, Office of Inspector General that covered the period of December 1, 1995 through November 30, 1996. There were no unresolved findings regarding the labor/payroll functions of AEL from the previous audit report.

The following table shows the size of our judgment sample of labor costs and nonpayroll costs.

			Dollar Value In Population
Labor Costs	40	$93,979	$12,135,785
Nonpayroll Costs	81	$202,481	$ 6,857,558

To test labor costs, we judgmentally selected 40 employee records for review for the contract period. There were 12 reimbursement claim invoices for each fiscal year of the contract. Each invoice had seven task orders to which funds were allocated on a monthly basis. We tested invoices during the four fiscal years 1997 through 2000. We selected two invoices per year and within those invoices one task order and within that task order a judgment sample of five employees based on high, medium, and low salary levels. The payroll for the selected employees was verified for accuracy, allocable, and reasonableness. We traced the records to supporting documentation to verify that costs claimed were incurred, allowable, and adequately supported.

To test nonpayroll costs, we judgmentally selected 81 expenditures from the reimbursement claim invoices. The expenditures were selected based on high cost items in each category. Three invoices were selected from each of the 1998, 1999, and 2000 fiscal years for a total of 9 invoices. Within those invoices, we selected one of the seven task orders performed under the contract to select expenditures to be tested for a total of nine task orders reviewed. The nonpayroll direct cost items tested were professional services, subcontracts, travel, meeting and conferences, publication and printing, communications, general supplies, equipment, and other direct costs. We obtained the supporting detail expense reports of costs claimed for the month selected by task order. These cost items were tested to verify that they were supported by invoice, authorized, related to task order, and supported by cancelled check. We reviewed the supporting documentation (i.e., purchase requisitions, invoices, travel vouchers, subcontractor agreements, etc.) to determine if the expenditures were supported, approved, reasonable, and allowable to the contract.

To determine the proper identification and allocation of indirect cost we relied principally on the work performed by the OMB Circular A-133 auditor. We reviewed AEL's 1996 through 2000 OMB Circular A-133 audit reports and did not identify any problems with indirect cost identification and allocations. In addition, we visited the OMB Circular A-133 auditor to review the 1999 and 2000 audit working papers to review the extent of the audit testing of indirect cost rates. We limited our review of AEL indirect costs to concerns identified by the Department's Indirect Cost Rate Group. The Supervisor of the Indirect Cost Rate Group suggested that we review indirect cost items that had a significant increase for fiscal year 2000. For the fiscal year 2000 indirect rate submission, we requested detailed cost reports and tested 43 indirect cost items. From these cost reports, we judgmentally sampled high cost items in each category of indirect cost reviewed to determine that the costs were allowable in accordance with OMB Circular A-122.

We did not rely extensively on computer-processed data extracted by AEL for use in analyzing costs billed to the contract. AEL could not provide a detailed printout of direct and indirect cost items for the entire period of the contract. Therefore, we judgmentally selected invoices and cost items in the invoices. From the selected invoices, we reviewed the supporting detail for each task order. Our review of payroll costs, nonpayroll costs, and indirect costs did not disclose any problems with the project cost detail reports. As a result, we relied principally on the invoiced reimbursement vouchers submitted by AEL to the Department and AEL's hardcopy payroll and accounts payable detail ledger to support AEL's claimed cost under the contract.

Although we did not extensively rely upon AEL's computer system to verify cost claimed under the contract, nothing came to our attention during our review of direct and indirect cost which would indicate those computer systems were inaccurate. AEL's OMB Circular A-133 audits for 1996 through 2000 did not disclose any problems with AEL's information systems.

The audit covered the contract period December 1997 through December 2000. Audit work was performed during the period October 2002 through January 2003. We conducted an exit conference with AEL officials on March 25, 2003.

The audit was conducted in accordance with generally accepted government auditing standards appropriate to the scope of review described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of the audit, we assessed the system of management controls, policies, procedures, and practices applicable to AEL's administration of the contract. Our assessment was performed to determine the level of control risk for determining the nature, extent, and timing of substantive tests to accomplish the audit objective. Due to inherent limitations, an evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the management controls. No management or internal control weaknesses were identified while determining if direct and indirect costs claimed under the contract were incurred, allowable, and adequately supported.

AEL

Committed to Achieving Excellence in Learning

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June 18, 2003

J. Wayne Bynum
Regional Inspector General
for Audit, Region IV
61 Forsyth Street, SW, Room 18T71
Atlanta, Georgia 30303

Dear Mr. Bynum:

Attached are AEL's responses to the findings identified in your letter received May 19, 2003 regarding your audit of Contract RJ96006001.

If you have additional questions or need clarification of our responses, please contact Vice President for Administration E. Jane Copley or me.

Sincerely,

Allen D. Arnold
President/CEO

Enclosure

SHIPPING ADDRESS:
1031 QUARRIER STREET
CHARLESTON, WV 25301-2314
www.ael.org

Responses-Appalachia Educational Laboratory
Contract RJ96006001
Audit Control No. ED-OIG/A04-C0020
June 18, 2003

Finding No. 1 – Draw Downs of Federal Funds Exceeded Allowable Contract Costs

AEL concurs that it received $344,530 in excess funds for REL Contract RJ 96006001. Significant increases in direct costs in FY 1999 and FY 2000 charged to the REL contract and significant increases in costs charged to indirect in FY 2000 resulted in an overrun of the REL contract in the amount of $313,057. The direct cost overrun totaled $54,074, and was recorded as a loss in the corporate reserve in FY 2001. Federal law allows contractors to request a contract appropriation to cover indirect cost overruns. In May of 2000, AEL provided a verbal forecast of a significant indirect cost overrun. In early August 2000, AEL provided formal notification to Helen Chang, Carol Chelemer, and Kathy Fuller of the estimated pending $250,000 indirect cost overrun and provided formal notification to the contracting officer that the overrun was anticipated (actual overrun totaled $258,983). When unspent total program funds are available as they are in this case, the contracting officer may grant such an additional appropriation. OERI has delayed a final ruling on our request pending two activities. First, the negotiation of our final indirect cost rate for FY 2000. Second, the completion of the OIG audit of direct and indirect costs. Again, AEL has pending a request for an additional modification to collect $258,983 in indirect cost expenditures at the rate approved by the cost determination branch for FY 2000 (26.6%). Although the department changed payment procedures three times during the course of the contract, AEL's records were exemplary in the tracking and recording of federal cash received allowing the OIG to successfully verify the above balance. AEL had, however, already notified the Department of such overpayment and awaits a decision on the contract modification before refunding either the full amount or the $85,547 we believe the government is due.

Finding No. 2 – Direct and Indirect Costs Incurred in Excess of Amounts Allowed by the Contract

AEL concurs that it incurred direct and indirect costs in excess of amounts allowed by the contract (slightly more than one-tenth of one-percent of the total contract). This is frequently the case, particularly when projecting expenditures in advance for a multi-year period. AEL objects to the finding on the basis that (1) the direct cost overrun has been absorbed by the corporation, (2) AEL notified the government in advance of the anticipated overrun in indirect costs, and was informed that if sufficient program funds were left, an appropriation to cover the overrun in indirect costs would likely be provided, and, (3) if an appropriation for those costs is not provided, the government will have no loss or liability, the loss will be absorbed by the corporation.