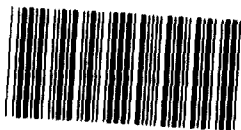


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UNITED STATES GENERAL ACCOUNTING OFFICE

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STATEMENT OF
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U.S. GENERAL ACCOUNTING OFFICE

BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

ON

SERVICE CONTRACTS BETWEEN U.S. EMBASSIES

AND EMPLOYEE ASSOCIATIONS

Mr. Chairman, Members of the Subcommittee:

I am pleased to be here to discuss the problems related to U.S. embassy service contracts with employee associations at overseas posts. Specifically, Mr. Chairman, you requested that we review the extent to which embassies have entered into contracts with associations, the motivations for using associations as contractors, and the propriety of this arrangement given the dependent relationship between the embassies and the employee associations.

I would like to point out that our work is still ongoing, and what I will present today is a status report, not a detailed

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or final assessment of the issues raised. Furthermore, our Office of General Counsel is currently reviewing the propriety of contract arrangements between the embassies and the associations and has not yet reached a determination.

Our work thus far has been conducted at the State Department headquarters and at three overseas locations--Ivory Coast, Turkey, and Egypt. We have also done limited work at the other foreign affairs agencies, which are similarly engaged in contracts with employee associations. We are planning additional audit work at other posts and expect a final report at a future date. Today I would like to present information on some of the more significant problems and concerns we have found to date. But before we discuss these in any detail, a little background information would be helpful to better understand the issues.

BACKGROUND

Foreign service posts overseas often require various commercial services, such as building maintenance, vehicle operation and repair, warehousing, janitorial services, gardening, and security. At one time, direct-hire foreign service nationals were employed to provide these services. Because of ceilings on the Department's employment levels, posts increasingly turned to contract personnel for these support services. At this time, the State Department does not have good data on total personnel currently employed under service contracts with the U.S. government or the cost of such contracts.

To obtain personnel for various support functions, embassies frequently contract with their employee associations. Posts use the associations as contractors because they lack the authority to contract directly with the individuals. The Department of State prohibits such contracts between the embassy and individuals unless specifically justified and authorized at the Department level. Direct contracts establish employer/employee relationships and constitute personal service contracts.

The Department is currently studying contracting arrangements at selected posts to determine whether it is more cost effective to perform services in-house or contract out. If it is determined that it is more cost effective to provide services in-house, then the posts may be authorized to contract directly with individuals. At this stage, it is uncertain as to when or whether the practice of contracting through associations will be significantly affected by this study.

PROPRIETY OF USING ASSOCIATIONS

The use of an employee association to provide contractual support services to an embassy is clearly beyond the scope of associations' traditional types of activities, such as providing commissary, exchange, club, restaurant, and recreational facilities to employees and their dependents at post. There is no explicit prohibition against an association providing a contractual function. However, federal procurement regulations have long provided that contracts shall not knowingly be entered into between the government and organizations which are controlled by government employees, except for the most compelling

reasons, such as cases where the needs of the government cannot otherwise be supplied.

The nature of the relationship between an embassy and its association raises certain questions. Specifically, the association is entirely dependent on the embassy for its livelihood. Embassy personnel sit on the association board and benefit directly from association services and facilities; embassies provide various logistical support to associations, such as space, utilities, and supplies; as U.S. government instrumentalities, associations have duty-free privileges; and host governments consistently view employees hired under association contracts as employees of the U.S. government. Under no circumstances can an association be considered an independent contractor and make judgments and decisions apart from the embassy.

The question of the propriety of using associations as contractors is currently under review by our General Counsel. We expect a determination in the near future.

EXTENT OF EMBASSY/ASSOCIATION
SERVICE CONTRACTS

Although the practice of contracting for services through employee associations stretches back a decade or more, until recently Department of State data on the nature and extent of these arrangements have been limited.

A 1979 Department survey of post contracting activities identified a total of about 10,000 contract employees under both nonpersonal and personal service contracts. Of this amount, about half were reported as being procured through personal service contract arrangements.

It has only been within the last 18 months that the Department of State has had specific, detailed information on employee association activities, including contractual services with the U.S. government. Information compiled in mid-1984 by State's Office of Commissary and Recreation Affairs documents the widespread nature of embassy/association contracts. Of the 125 posts that responded, 62, or about 50 percent, reported that the employee association supplied contractual services to the U.S. government. The number of contract employees was reported at about 6,000 under contracts totalling about \$27 million. More recent information indicates these totals may be low. With only 83 of 131 associations reporting, over 6,500 persons at an annual cost of over \$36 million have already been identified.

Each of the embassies we visited in April 1985--Cairo, Abidjan, and Ankara--had large contracts with its association. At each post an "umbrella" contract covered services to State and other agencies, such as USIA, DOD, Agriculture, Commerce, and others. In Abidjan and Cairo, where AID had a presence, the association had a separate contract with AID.

Information we collected during our overseas work on the value of association contracts and the number of contract employees is as follows. The totals include data for all U.S. government agencies involved in the contracts.

Post/Association Contracting Data
Obtained At Posts Visited
By GAO

	<u>Abidjan</u>	<u>Ankara</u>	<u>Cairo</u>
Value of contract	\$1.1 million ^a	\$2.1 million ^b	\$4.1 million ^c
Number of contract employees (April 1985)	384	430	889

^aTotal for fiscal year 1984--most complete data available at time of our visit.

^bEstimated contract cost as of April 1985.

^cTotal cost of contract for calendar year 1984.

REASONS FOR CONTRACTS

In each location, embassy officials commented that current ceilings on direct-hire U.S. and foreign service national personnel were not sufficient to provide the level of services required at the posts. The only alternative, officials pointed out, was to turn to contract services, and using the associations was considered the most viable approach.

Department officials cite several reasons for using the associations. For example, some have pointed to the lack of local contractors, and others have suggested that contracting with the association is a less costly alternative in some cases. Yet, there are no indications that posts have actually canvassed the local market for available services, or that posts have made cost-comparison studies (with the exception of those done recently under management's auspices) which document higher cost of contracting with commercial companies.

PROBLEMS NOTED IN POST/ASSOCIATION
CONTRACTUAL ARRANGEMENTS

As you know, Mr. Chairman, the problems arising from association contracts with the government are long-standing deficiencies. We, as well as State's Inspector General, for years, have identified problems in these arrangements, and in addition, our work indicates problems are continuing. In particular, we found that posts were obtaining services through associations under unauthorized personal service contracts; that associations were profiting on these contracts; that associations were not providing all services required by the contracts; that as written, some contracts do not follow federal acquisition regulations; and that some associations were not maintaining adequate accounting records to support activities under the contracts.

Contractual arrangements
are questionable

As I mentioned earlier, the contractual arrangements between embassies and associations are questionable. In Abidjan, Ankara, and Cairo we found that the service contracts between the post and the employee association, although written as nonpersonal service contracts, had all of the characteristics of personal service contracts; specifically, an employer/employee relationship existed and employees were hired, supervised, and terminated by government personnel. Specific information we obtained at the three locations we visited is summarized as follows.

Abidjan - The embassy contract covered administrative services of a continuing nature (for example, security guards, drivers, maintenance personnel). Contract

employees worked side-by-side with permanent embassy personnel. Contract execution was being carried out almost exclusively by post personnel who were doing the recruiting, hiring, supervising, and terminating of contract employees. The embassy's Budget and Fiscal section paid the salaries and any severance payments of the contract employees. The only contract function being performed by the association was the tabulation of employee hours worked and forwarding the data to the embassy paying agent.

Ankara - We observed similar contract practices in Ankara. Embassy employees were performing almost all of the personnel functions (recruiting, hiring, firing) and were supervising the contract employees in their daily work. Services were of a continuing nature and contract personnel worked with direct-hire embassy employees. The association was handling the payroll function, including maintaining employee records and disbursing salary payments. The scope of work to be provided under the contract was not specific but merely listed services covered by the contract.

Cairo - As in Abidjan and Ankara, the contract involved services of a continuing nature, and selection, supervision, and termination of contract personnel was done by embassy employees. Primarily, the association processed the paperwork for hiring and

firing contract employees and handled all payroll functions. The contract did not specify what services were to be provided. The contract was basically a pay mechanism which included some general contract provisions and a listing of contract employees.

Associations are profiting
on contracts with posts

Another area of concern, Mr. Chairman, relates to profits being made by employee associations on contracts with the embassies. Although the contracts do not mention profits, associations are paid a management fee to recover the costs of administering the contract. In many cases, fees are arbitrarily set at higher amounts than the management costs incurred, and as a result, associations make profits.

State Department guidance to the overseas posts, at least since 1982, points out that in contracts between the government and the association, cost should be the basis for establishing the price for the contractual services. Since the association is not an independent enterprise and assumes little or no risk of loss under contracts with the post, there normally is no basis for allowing an association a profit on such contracts. This position was recently reaffirmed by the Department.

Information received by the Department in 1984 from the overseas posts shows that of the 62 associations which reported service contracts with the government, 39 indicated they were making profits from the contracts. The total of all profits amounted to \$1.1 million. The State Department is currently updating this information.

At the three posts we visited, each of the associations was making a profit through the management fee being assessed on the government contracts. The fees were established as a percentage of the contract price (which is a violation of procurement regulations) and were not supported by actual costs incurred. In one instance, the fee was raised to compensate for an unwise purchase decision. The details are as follows:

Abidjan - The association raised the contract management fee from about 4.3 percent to 6 percent in May 1984. The increase was granted to provide additional revenue to the association to avoid bankruptcy. Specifically, the former President of the Board directed the association manager to purchase 2,200 cases of beer at a cost of \$17,000, which later could not be sold. The purchase depleted the association's funds to the extent that it was unable to take delivery of a food order. Consequently, the management fee was raised to provide the necessary funds. Our analysis shows that for fiscal year 1984, the association received management fees totalling \$55,000, and of this amount, we estimated about \$43,700 was profit.

Ankara - As of April 1985, the management fee was 2.5 percent of the contract cost, down from 3 percent at the end of fiscal year 1983. Our analysis of contract costs shows that in 1984 the association's profit was about \$22,000. For 1985, it was estimated at \$31,000.

Cairo - The management fee for State and other government agencies, except AID, was 5 percent of payroll costs--AID paid 5.6 percent. In 1984, the association recorded a profit of about \$80,000 from service contracts with the post, which was the most profitable of the association's activities for the year. Contract profits represented about 85 percent of total association profits for the period.

Association accounting systems were deficient

In order to adequately track costs related to activities under the contract, associations must establish accounting and financial reporting systems. In its guidance to the associations the Department of State outlines certain minimum steps associations should follow to put these systems into place. In addition, in most cases, service contracts stipulate that the association, as the contractor, will maintain accounting records to support transactions related to the contract. During our work overseas, we noted that one association was not accounting for contract costs. Another association was erroneously charging expenses to the embassy service contract. Specific details on these two posts are as follows.

Abidjan - An independent audit of the association's statement of income and expenses for the period July through November 1984 found that the accounting system used by the association did not comply with State Department guidelines. The report noted the absence

of such basic documents as a chart of accounts, a general ledger, an itemized accounting, and inadequate accounting registers. In terms of the embassy service contract, the association had established no accounting system to support costs under the contract. Contract cost data we used in our analysis were obtained from the embassy's Budget and Fiscal Office.

Ankara - Financial statements of the association did not reflect the true position of the association. Year-end adjustments to reconcile differences between the estimated and actual payroll costs were not made. Also, embassy contract costs were being overstated because association accounting personnel were charging the salaries of several snack bar employees to the contract. We estimated this overcharge to be about \$12,000 annually.

Concerns expressed by
other foreign affairs agencies

Other foreign affairs agencies have also noted problems with association contracting activities. For instance, an AID Inspector General's report recently discussed several problems with the service contracts in Liberia, including the failure to specify in the contract the management fee AID was paying to the association, and the de facto personal service nature of the contract. The report also criticized the association's accounting system, its system of internal controls, and AID's monitoring of the contract.

Peace Corps has also complained about embassy contracts at two other posts. These complaints included the use of prohibited cost-plus-percentage-of-cost contracts and other violations of procurement regulations, excessive management fees charged by an association, and being required to reimburse the employee association directly even though the contract was between the embassy and the association.

OVERSIGHT OF EMBASSY/ASSOCIATION
CONTRACTING HAS BEEN MINIMAL

Evidence that these problems have existed for a number of years points to the need for more vigilant oversight of embassy contracting for services with employee associations. At the Department level, the oversight function for service contracting lies with the Deputy Assistant Secretary for Operations and his Office of Commissary and Recreation Affairs. This office was established in October 1983 to provide management counsel, guidance, and oversight for the associations. The office analyzes the associations' financial statements and audits and suggests corrective action if necessary, and maintains liaison with geographic bureaus and the Inspector General's office. (At least this was the situation as of late July 1985--we understand that some changes are in the works which may alter organizational responsibilities for employee associations.)

Our information indicates that oversight by this office has been minimal. Visibility over the contracting activities at post is limited. Until recently, virtually no information was

available on the types and amounts of contracts in effect or the numbers of personnel employed under contract. In fact, the number of associations which have contracts for services with the embassies is still uncertain. Again, until recently, guidance concerning operations of employee associations did not address the issue of contracting with embassies for services. The Deputy Assistant Secretary for Operations has remarked that the Commissary and Recreation Affairs office does not have sufficient staff to effectively oversee the operation of the associations. Furthermore, he stated that the office has tried to avoid involving itself in the micro-management of association operations.

In recent months, however, the Department has initiated several efforts to strengthen its oversight capabilities. Specifically, additional information has been requested from the posts regarding the range and volume of their contracting activities. Some preliminary information indicates that the total number of employees under association contracts and the dollar value of such contracts with the U.S. government may, in fact, be far greater than was disclosed in a previous questionnaire. The Department has also issued more explicit guidelines, which, among other things, prohibit embassy employees involved in embassy procurement to hold positions in the association and prohibit associations from making profits on government contracts. In addition, the Department has requested that associations submit all contracts with any U.S. government agencies to the Commissary and Recreation Affairs office for legal and compliance reviews.

At this time, it's too early to tell how successful these efforts will be in dealing with the problems. Furthermore, although some additional guidelines have been issued to the posts, there are no assurances that the posts will operate any differently than they have in the past. As mentioned previously, posts continue to include profits in service contracts even though they were informed in April 1982 that this was not allowed. We will be monitoring the results of these efforts during the remainder of our work.

Mr. Chairman, this concludes my statement. I will be happy to respond to any questions you may have.