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Report to the Chairman, Legislation and
National Security Subcommittee,
Committee on Government Operations
House of Representatives

March 1986

EMBASSY CONTRACTING

Contracts With Employee Associations Should Be Terminated



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United States
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Washington, D.C. 20548

National Security and International
Affairs Division

B-217776

March 18, 1986

The Honorable Jack Brooks
Chairman, Legislation
and National Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In your January 15, 1985, letter you expressed concerns regarding the motivation for and propriety of contracts between U.S. embassies and employee associations and requested us to review these contracting activities. Traditionally, employee organizations provide commissary, restaurant, and recreational facilities to employees and their dependents at overseas posts. Our objective was to determine the extent to which embassies have entered into contracts with associations, the rationale for using associations as contractors, and the appropriateness of these arrangements.

In summary, our review disclosed that employee association contracts were widely used by embassies to obtain support personnel for overseas posts. At all but one of the locations we visited, we found these contracts to be essentially sham contracts under which employee associations performed minimal contract administration functions while profiting from management fees. Recently, the Department of State has taken some steps to tighten controls and provide some oversight of these activities. However, these efforts do not address the highly questionable use of the contracts themselves. Federal regulations prohibit contracts between the government and organizations controlled by the government except in unusual circumstances.

We believe recent legislation, which gives the Department unrestricted authority to contract directly for personnel, provides an alternative to contracting with associations. We recommend terminating existing service contracts between embassies and employee associations as soon as possible, consistent with the orderly conduct of official business, unless there are compelling reasons to continue using the associations as contractors.

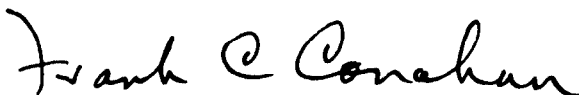
This report describes the embassies' use of association contracts, the problems we found with such arrangements in six overseas locations,¹ and makes several recommendations to correct the problems noted. Details of our review are provided in appendix I to this letter.

Our review was conducted at the Department of State during the period February through September 1985. Fieldwork was carried out at embassies in Abidjan, Ankara, and Cairo in April 1985 and in Paris, London, and Mexico City in August and September 1985. As part of our work, we interviewed Department and embassy officials and reviewed available contract information and statistical data in Washington, D.C., and at the overseas posts. We also held limited discussions with other U.S. foreign affairs agencies, including the U.S. Information Agency, Agency for International Development, and the Peace Corps.

We did not obtain the views of responsible officials on our conclusions and recommendations or ask the Department of State to provide official comments on a draft of this report. Except as noted above, our review was conducted in accordance with generally accepted auditing standards.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,



Frank C. Conahan
Director

¹Information on association service contracts was compiled at embassies in Abidjan, Ivory Coast; Ankara, Turkey; Cairo, Egypt; London, United Kingdom; Mexico City, Mexico; and Paris, France. Preliminary information on such contractual arrangements in Abidjan, Ankara, and Cairo was provided during testimony before the Legislation and National Security Subcommittee, House Committee on Government Operations, on July 31, 1985.

Embassies' Use of Contracts With Employee Associations

Foreign service posts require various commercial services, such as security, building maintenance, cleaning, and vehicle operation and repair. Because of limits placed on the number of embassy employees, posts increasingly turned to contract personnel to provide these services. According to post officials, contracting with employee associations was often done because (1) the embassies lacked the authority to contract directly with individuals (that is, to enter into personal service contracts which establish an employer/employee relationship) and (2) qualified local contractors were unavailable or were too costly. However, post officials could provide little documentation showing that, prior to contracting with the associations, local market studies were done to determine the availability of services; or that cost comparisons were made which demonstrated the higher cost of contracting with commercial companies.

Although the practice of contracting with employee associations has existed at least since the late 1960s, until recently the Department of State had little data on the nature and extent of these arrangements. A State Department survey showed that, as of November 1985, 67 of 137 associations reported service contracts with the U.S. government. These contracts, which involved over 8,800 contract employees, had an annual value of \$38 million. A Department official told us that these figures are understated because some posts failed to accurately report the full extent of their contracting activities. He added that at least eight associations known to have government service contracts had not responded to a request for such information. Furthermore, the Department's data contained some obvious errors. For example, the Department's tabulation showed the value of the employee association contract at the London Embassy to be less than \$200,000, whereas the total contract value was estimated to be about \$1.5 million at the time of our visit. State Department officials could not explain this and similar differences.

Each of the six embassies we visited had large contracts with its association. At two locations (Paris and Ankara), an overall contract covered services to State and other agencies such as the United States Information Agency (USIA), Department of Defense (DOD), Agriculture, and Commerce. In Abidjan and Cairo, the Agency for International Development (AID) had a separate contract with the association, and in Mexico City, USIA had a separate contract with the association. In London, the embassy entered into eight separate service contracts, each covering a specific function.

**Appendix I
Embassies' Use of Contracts With
Employee Associations**

Table I.1 shows the value of the contracts and the number of contract employees we were able to document at the posts visited:

Table I.1: Contract Values and Number of Contract Employees at Locations Visited by GAO

Dollars in millions		
Posts	Value of contracts ^a	Employees under contract
Abidjan	\$1.1	384
Ankara	2.1	430
Cairo	4.1	889
London	1.5	132
Mexico City	.6	138
Paris	3.2	313

^aThe value of contracts covers different periods (either fiscal year 1984 or 1985) and was based on the most complete data available at time of our visit.

**Embassy/Association
Contracts Were
Improper**

In contracting for services overseas, posts are required to adhere to federal procurement regulations as implemented through the Department's own procurement regulations. In 1967 the Department withdrew authority from the posts to enter into personal service contracts without Departmental approval. However, Department procurement regulations authorized the posts to enter into nonpersonal service contracts—contracts which allow for services to be provided to the government, by individuals or organizations, as long as the government does not directly supervise the manner of performance of the work, or reserve the right of selection or dismissal of individual employees.

At each of the embassies visited, we identified deficiencies in contracting practices and procedures related to association service contracts. In particular, we found that (1) embassy service contracts with associations had all the attributes of personal service contracts which had not been specifically authorized by the Department, (2) some contracts did not follow federal acquisition regulations, (3) associations were making unauthorized profits on service contracts, and (4) association accounting systems were deficient with respect to activities under the contracts.

**Service Contracts Create
Unauthorized Personal
Service Arrangements**

At the six embassies we visited, service contracts with the associations were, for the most part, nonpersonal service contracts in name only. Contract employees usually were under the control of permanent embassy personnel and normally were treated no differently than the direct-hire employees. In effect, the contracts were personal service contracts, which established unauthorized employer/employee relationships between the government and the contract personnel.

Although the service contracts provided for certain functions to be performed by the associations as contractors, in most cases, embassy personnel were carrying out these responsibilities. At five locations we visited, embassy staff were substantially involved in the hiring and terminating of employees under the association contract. At each post, the embassy's administrative section authorized the hiring of additional employees. Also, for the most part, vacancy announcements, application processing, interviewing, and selection were handled by embassy employees in the Personnel, Budget and Fiscal, and Administrative Sections. In all but one location (London), terminating contract employees was the responsibility of the embassy. In London, the association manager participated in the termination process.

Similarly, day-to-day supervision of the contract employees was a prime responsibility of permanent embassy personnel. Verification of hours worked by contract employees was not normally an association responsibility. At all locations visited, the contract employees worked side-by-side with direct-hire employees and were supervised almost solely by embassy personnel. One notable exception to this practice was in London where the association manager played a comparatively active role in contract employee supervision. The association manager there provided substantial direction to the security and gardening contract employees and supervisors.

The primary service being provided by the associations was the preparation and maintenance of payroll records and the disbursement of payroll funds to the employees. In Abidjan, even these limited functions were not performed. That location's association only tabulated the hours worked by contract employees and computed the amount of compensation. Actual payments were made by the embassy's Budget and Fiscal Section.

Another aspect of the personal service nature of these arrangements involved the types of positions being filled by association contract employees. Predominantly, embassies have contracted with employee

associations to provide services, such as security guards, maintenance workers, and janitors. However, at the posts we visited, except Mexico City, the associations also hired clerical/administrative workers, whose work is necessarily supervised by government employees, as well as certain professionals, such as medical staff and translators who should be hired under individual nonpersonal service contracts. Employees in these categories totaled about 22 percent of all employees under the association service contracts.

At the embassy in Mexico City, clerical, commercial support, and professional services employees were being hired under individual nonpersonal service contracts rather than under the association contracts. The post had entered into 88 separate service contracts for these services.

Post contracting officials explained that the move to individual contracts was made because of embassy dissatisfaction with the association contract and because they expected the contract to be terminated. The officials acknowledged that many of these contracts, although written as nonpersonal service contracts, were in actuality personal service contracts.

**Service Contracts Violate
Procurement Regulations**

Association service contracts we reviewed violated several pertinent regulations dealing with the types of contracts entered into, the justification for sole-source contracting, and the specificity of the contract scope of work. We also found one case where an individual hired under the association contract violated USIA procurement regulations.

Federal acquisition regulations prohibit cost-plus-percentage-of-cost contracts. In addition, Department procurement regulations prohibit posts from entering into cost-type contracts, including cost-plus-fixed-fee contracts. According to a Department contracting official, cost reimbursement contracts are not authorized because post contracting personnel lack the necessary expertise to effectively monitor cost-type contracts. Instead, Department procurement regulations require that contracts set a firm-fixed price for the services to be provided, or, in the case of labor-hour contracts, contain a cost estimate based on fixed hourly rates of pay for an estimated level of manpower. In both cases, the regulations state that the price and the hourly rates should include all costs incurred to administer the contract. Separate management fees are not allowable.

At the six posts we visited, almost all of the service contracts with the associations improperly contained provisions characteristic of cost-reimbursement contracts. The association contract in Abidjan stipulated a separate percentage fee above the estimated contract cost to administer the contract. In Cairo, the contract was written to include a percentage fee as part of the cost of the contract. The service contract in Ankara did not include a management fee; however, the association was authorized a 2.5 percent fee above the cost of the contract to cover administrative expenses. In Mexico City and Paris, the contracts stipulated that the contractor be paid a fixed fee above the agreed upon contract cost. The service contracts in London appeared to be firm-fixed price contracts; however, a percentage management fee was included in the contract price.

Department regulations provide that post procurement actions be carried out on a competitive basis to the maximum extent possible. Contracting with an association on a sole-source basis is supposed to be justified and documented. However, at the locations we visited, post officials could provide no formal justifications supporting the decision to use the associations as contractors. Three posts had some information on recent efforts to competitively bid selected services, but this was developed after-the-fact in response to the Department's A-76 studies.

Most of the association contracts we reviewed did not describe in detail the tasks required, how often these tasks should be done, and the appropriate staffing levels. For example, in Ankara, Mexico City, and for some services in Abidjan the scope of work in the contract did not specify in detail the services to be performed but merely listed the services covered. In London, only three of the eight service contracts provided specific information on the extent and frequency of work to be performed. Association contracts in Cairo and Paris contained the least detail on the services to be provided. In each case, the contract contained only a listing of contract employees by function.

The service contract between the Paris embassy and its association violated USIA procurement regulations by not adequately justifying and approving a former USIA official rehire. The USIA Cultural Affairs Officer, who had just retired, was added to the association contract in Paris to temporarily serve as the Acting USIA Deputy Public Affairs Officer until the Deputy returned from leave in the United States.

Under USIA regulations, former employees of the Agency may be rehired up to 2 years following separation from employment, but such an action

requires a written justification discussing the issue of conflict of interest and the written approval of the Director of USIA. Documentation to support the rehiring of the former Cultural Affairs Officer did not address the question of conflict of interest, and the Director's approval was not obtained.

**Associations Are Profiting
From Service Contracts**

Department of State guidance to the overseas posts, at least since 1982, provides that cost should be the basis for establishing the price for contracts between the government and the association. Instructions dated April 28, 1982, stated that an association "is not an independent entrepreneur and takes little, if any, risk of loss in its contracts with the USG [U.S. government], there would normally be no basis for allowing [an association] a profit on such contracts." In a July 1985 revision to the Foreign Affairs Manual, the Department again stipulated that association overhead expenses and management fees on government contracts must be clearly identified and appropriately justified, and that profits were prohibited.

**Excessive Management Fees Result
in Profits for Associations**

Although the Department of State policy clearly states that employee associations should not be making profits on their contracts with the government, associations have continued to do so. These profits have been used to subsidize the associations' other activities, such as restaurants, snack bars, and recreation centers. At the six overseas posts we visited, each of the associations was making a profit on the management fee being assessed on embassy service contracts, and had used profits to finance association operations. Table I.2 shows the percentages upon which the contract management fees were computed and estimated profits at the locations we visited. Association accounting information on the extent of profits being made on embassy contracts was incomplete. Therefore, we computed profit amounts shown in the table by deducting identifiable contract administration costs such as salaries, audit fees, and supplies from management fee revenues.

**Appendix I
Embassies' Use of Contracts With
Employee Associations**

**Table I.2: Basis for Computing
Association Management Fees and
Estimated Profits Earned on
Government Contracts at Six Posts**

Post	Management fee	Estimated contract profit
		Period covered
Abidjan	6% of employee salaries and benefits ^a	\$43,700 (FY 84)
Ankara	2.5% of employee salaries and benefits	\$31,000 (CY 85)
Cairo	5% of employee salaries and Egyptian social security ^b	\$80,000 (CY 84)
London	5-8% of employee salaries and benefits ^c	\$20,000 (CY 84)
Mexico City	75% of salary costs of four association personnel involved in contract administration	\$ 9,600 (FY 85)
Paris	445 French francs per salary payment to each local national ^d ; \$20 per payment to each American	\$23,000 (FY 85)

^aTotal percentage relates to contract covering State and other U.S. agencies except AID; AID contract contained a fixed management fee equivalent to 6 percent of contract cost.

^bPercentage relates to contract covering State and other U.S. agencies except AID; AID management fee was 5.6 percent of contract cost.

^cThe association administered eight separate service contracts; management fees assessed for seven were between 5 and 8 percent; the remaining contract was assessed a fee of 25 pence per hour worked by each contract employee or \$0.40 (exchange rate—1 British pound = \$1.60 U.S.).

^dBased on exchange rate in effect at the time of our work at post (8.5 French francs = \$1 U.S.), fee is about \$52.00.

At five of the six posts no written justifications for the management fees were available. Fees were arbitrarily set and were not supported by actual administrative costs incurred in connection with the contract. For example, in May 1984 the association in Abidjan was granted an increase in its management fee to 6 percent to provide additional revenue to the association to avoid bankruptcy. The former Board President had authorized \$17,000 to purchase 2,200 cases of beer, which subsequently could not be sold. The purchase depleted the association's funds and prevented the organization from taking delivery of a food order. According to the embassy's administrative officer, the management fee on the employee association contract was raised to provide the necessary funds.

In London, the association charged different percentage fees for the various service contracts it administered for the post. According to the association manager, the fees were not based on actual costs but on what he thought embassy contracting officials would accept.

In Mexico City, the contract management fee was not a fixed amount. To cover administrative costs, the association there was reimbursed for 75 percent of the salary costs of the association manager and three staff members performing administrative duties on the contract. Based on our discussion with embassy and association officials, however, we do not believe that all of the personnel working on contract administration were spending 75 percent of their time on contract-related matters.

The association in Paris was charging two separate fees to manage the embassy service contracts—445 French francs (about \$52) for each monthly salary payment made to a local national contract employee and \$20 for each monthly payment to an American contract employee. The association manager provided some data to support management costs, but we could not verify the time association personnel estimated they spent on contract administration. Also, the association manager could not provide information to justify the two different fee amounts. As of August 1985, the Paris association management fee revenue was exceeding the association's estimated administrative costs.

All posts we visited were not complying with Department instructions issued in 1982 and again in July 1985 prohibiting profits on association contracts with the government. At the three locations we visited after the July 1985 reaffirmation of the policy, we found that post and association officials had no definitive plans to eliminate profits on the embassy service contracts.

Association Accounting Systems Related to Contract Activities Are Deficient

Department of State guidance to the associations outlines certain steps the associations should follow in setting up accounting systems. Service contracts generally stipulate that the association, as the contractor, will maintain accounting records to support transactions related to the contracts. At the posts we visited, most of the associations were not tracking and accounting for contract income and expenses, and in most cases, association statements did not fully reflect the profits being made on embassy service contracts. Also, at one location the lack of separate accounting records apparently contributed to the unauthorized use of government funds for non-contract-related purposes.

In Abidjan, a private accounting firm's independent review of the association's statement of income and expenses for the period July through November 1984 found that the association accounting system did not comply with State Department guidelines. The report noted the absence of such basic documents as a chart of accounts and a general ledger,

inadequate accounting registers, and irregular preparation of financial statements. Information on contract costs had to be obtained from the embassy's Budget and Fiscal Office. Financial information received by State in August 1985 indicated that the Abidjan association was still deficient in accounting for costs under the contract. Association financial statements for the period January 1 to June 30, 1985, showed that about \$23,000 in non-contract salary costs of association personnel was improperly charged to the government contract.

Similarly, financial statements of the association in Ankara did not accurately portray the status of the government service contract. Year-end adjustments to reconcile differences between the estimated and actual payroll costs were not being made. Also, contract costs were being overstated because association accounting personnel were improperly charging the salaries of several snack bar employees to the contract. (We estimated this overcharge for 1984 to be about \$12,000.) In addition, the association's financial statements did not accurately identify the extent of profits being made on the embassy service contract. The association accountant explained that the net profit amount was not all directly related to excessive management fees but that a portion of the profit, which could not be readily identified, was attributable to exchange rate gains.

Similarly, in London and Paris, the financial statements did not readily permit a determination of whether the associations were profiting on contracts with the government. The statements reported gross profits earned on contract services, but administrative expenses incurred in connection with contract management were not separately identified and applied to management fee revenues received from the government. Instead, such expenses were included as part of the association's total operating expenses, which also included non-contract related activities.

Finally, in Mexico City, we found that the lack of separate accounting records for the embassy service contract resulted in the improper use of government funds to cover the severance liabilities of contract employees. In September 1983, the association informed the embassy that about \$61,000 in severance funds, which were commingled with other association operating funds, had inadvertently been used to purchase such items as a refrigerated truck, freezers, and inventory for the commissary. Our review of association records showed that the amount of severance funds improperly used may have been as much as \$100,000. Although the association, at the embassy's instruction, took immediate steps to avoid similar problems in the future, it was not

required to repay the funds spent for association purposes. According to the association manager, repayment of the funds would have bankrupted the association.

State's Efforts to Correct Problems Have Been Inadequate

Within the last 2 years, State has taken action to increase its oversight of association activities and to correct some problems relating to association service contracts with the U.S. government. The actions have focused on identifying the scope of contracting activities; reviewing and approving service contracts; and publishing guidance regarding adherence to procurement regulations, composition of association board of directors, and prohibition on contract profits. The Department is also currently studying the feasibility of contracting out for support services. Ultimately, associations may be removed from the service contracting business, but 4 years into the study, no association contracts have yet been terminated.

Actions to Increase Contract Oversight Are Limited

State's Office of Commissary and Recreation Affairs, under the Deputy Assistant Secretary for Operations, Bureau of Administration, is charged with overseeing association service contracting activities. This office, established in October 1983, is responsible for providing management counsel, guidance, and oversight to the associations. It also monitors the Central Commissary and Recreation Fund, which provides financial assistance—primarily in the form of interest-free loans—to employee associations overseas. As of September 30, 1985, the fund, which is supported by voluntary association contributions, had a value of about \$1.3 million.

At the beginning of our audit work in early 1985, the office was carrying out only minimal oversight functions with respect to association service contracts. At that time, visibility over contracting activities was limited and information on the types and amounts of contracts in effect or the numbers of personnel employed under contract was incomplete. In addition, operating guidelines for the employee organizations did not acknowledge that service contracts with embassies existed.

During our review, the Department initiated several efforts to strengthen its oversight capabilities. In June 1985, the Office of Commissary and Recreation Affairs requested detailed contracting data from the associations to update and validate information submitted in 1984. In July 1985, the Department issued an addition to its Foreign Affairs Manual (6 FAM 519) outlining post and association requirements

concerning service contracts. Key provisions of the change require that (1) associations submit all service contracts with the U.S. government to the Department for review and approval, (2) post procurement actions follow the federal and Department acquisition regulations, (3) embassy procurement personnel not hold positions on the association board of directors if the association provides contractual services to the U.S. government, and (4) association managers justify all administrative costs to ensure that associations are not earning profits on government contracts.

Although the latest Department efforts to remedy association contracting problems have been positive steps, the initiatives, on their own, are insufficient to correct contracting deficiencies. The guidelines, as written, have been misinterpreted or disregarded by some post officials. For example, in Paris, we found that the administrative officer had not forwarded copies of all embassy service contracts with the association because he believed the contracts were outside the scope of the new requirements. The contracts were subsequently submitted to the Department. Also, three posts we visited after the new contracting guidelines were issued had not initiated actions to assure that profits were not being made on the embassy contracts.

In addition, since the Office of Commissary and Recreation Affairs does not know what contracts exist at the posts, there is no way to ensure that associations are submitting all contracts. Also, the contract review process is designed only to ensure that the contracts are written in compliance with Department and federal regulations—not that the contracts are being carried out as written.

**Study on Contracting Out
May Not Resolve Problems
for Years**

Since 1981, the Department of State's Office of Management Operations, which reports to the Undersecretary for Management, has been studying the feasibility of applying the Office of Management and Budget Circular A-76 approach to overseas posts, that is, contracting out for commercial-type services. State Management Operations officials were unable to estimate when the A-76 project would be fully implemented.

State management teams conducted A-76 studies at five of the six posts we visited—Ankara, Cairo, London, Mexico City, and Paris. Following these studies, four locations sought bids on selected service functions, such as security, maintenance, and cleaning. The results of the bid process at each location indicated it was more cost effective for the embassy to provide the service directly rather than to use contractors.

At the time we completed our work, the A-76 studies had not resulted in the termination of any association contracts. Management Operations' officials commented that a final determination as to whether the associations will continue to serve as contractors at overseas posts following the A-76 process lies jointly with State's regional bureau personnel and the Deputy Assistant Secretary for Operations.

State's Contracting Authority Raises Questions About the Need to Contract With Associations

The Department's recent efforts to remedy the problems with service contracts between the embassies and the employee associations do not address the fundamental issue of whether an association can be a legitimate party to a service contract.

The nature of the relationship between an embassy and its association raises questions as to whether employee associations can be considered independent contractors and, as such, be party to service contracts with the embassy. For instance, embassy personnel sit on the association board and benefit directly from association services and facilities; embassies provide the associations various utilities and supplies; and associations receive duty-free privileges. Also, host governments consistently view employees hired by associations as employees of the U.S. government. Furthermore, as an entity of the embassy an association is ultimately responsible to the principal officer at post for its actions.

While there is no explicit prohibition against an association providing contract personnel to the government, federal procurement regulations state that "contracts shall not knowingly be entered into between the Government and employees of the Government or business concerns or organizations which are substantially owned or controlled by Government employees, except for the most compelling reasons, such as cases where the needs of the Government cannot reasonably be otherwise supplied."

Recent legislation has expanded the Department's authority to contract for personnel overseas, thus eliminating any apparent reason to use an association for this purpose. Specifically, an October 1984 amendment to the Department of State Basic Authorities Act (22 U.S.C. §2669) gave the Secretary of State the authority to "employ individuals or organizations, by contract, for services abroad," and provided that "individuals employed by contract to perform such services shall not by virtue of such employment be considered to be employees of the United States Government." Thus, it appears that the State Department has the

authority to hire employees on personal service contracts, and could do so directly without using employee associations.

Termination of Contracts Raises Questions Regarding the Disposition of Contingency Funds

The termination of contracts between the embassies and the employee associations would require disposition of contingent liability funds now being held by the associations. This action is complicated by the nature of the contractual arrangements between the embassies and the associations and the fact that the associations are not operating as independent contractors.

Since at least 1982, Department regulations have required that employee associations establish contingent liability funds to cover severance and retirement benefits, or subscribe to a host country plan on behalf of their permanent and contract employees. The U.S. government has been contributing appropriated monies to these funds as a part of the cost of the association contract. Department information shows that about 40 associations have set up such funds at an estimated dollar value of about \$3 million. However, this information does not distinguish the portion of the severance funds which apply to the service contract employees from those which apply to the permanent association employees.

On August 2, 1985, embassy officials in Mexico City requested a legal opinion from the Department regarding the liquidation of over \$400,000 in severance funds being held by the association. The embassy administrative officer noted that with contract termination, contract employees would be transferred directly to individual personal service contracts, thus precluding the need for the association to make severance and other termination payments to these employees. The administrative officer pointed out that all parties at post, including post management and association spokesmen, agreed that the funds were the property of the U.S. government. The post requested the Department's legal position on (1) the ownership of the severance funds and (2) the disposition of these funds after they are returned to the embassy's control. One solution offered by the post was to have the association return the funds to the embassy in the form of a gift of furniture and equipment.

On August 26, 1985, State's Legal Office issued an opinion which essentially stated that it would be improper for the association to retain the severance funds after its responsibility for payment of the benefits had been terminated. The opinion stated further that there was no legal objection to using donated severance funds to purchase equipment for

the embassy. We disagree with this opinion, and hold that the unliquidated severance funds should be returned to the U.S. Treasury. As of January 1986, we were informed by a Department official that State legal personnel are reviewing this issue and no action would be taken to dispose of severance funds until State has an opportunity to review this report.

Conclusions and Recommendations

We do not believe the use of employee associations as contractors has been adequately justified. It appears that the embassies have used the associations to get around personnel ceilings and limitations on contracting authority. Associations have subsidized, through unauthorized profits, traditional association activities which benefit Department employees. For the most part, the Department has been aware of the embassy/ association contracts and the inherent problems associated with these arrangements; however, actions to deal with the problems have been minimal.

The basis for contractual arrangements between the government and the associations is highly questionable. Federal regulations state that contracts between the government and organizations controlled by the government should not, under normal circumstances, be entered into. Employee associations depend on the embassies for their existence and livelihood, and the actions of the association board are subject to veto by the principal officer at post. Also, these employee organizations are operated by, and provide services and facilities to, government employees.

Embassy and Department officials have cited the restrictions on hiring additional personnel by contract on a continuing basis as one reason for using the associations as contractors. However, as a result of the 1984 change to State's Basic Authorities Act, the Department now has authority to obtain services overseas through the use of personal service contracts. Therefore, we believe no justification exists for continuing the practice of contracting with associations and that these service contracts should be terminated, except in those few, rare cases where it may be necessary to continue these arrangements because of some compelling reason.

As these contracts are terminated, associations may be required to pay severance and retirement benefits for contract employees who lost their jobs. However, if the employees were transferred directly to individual embassy contracts without a change in employment status, there may be

no need to pay those benefits. If associations are not required to make severance payments, there would be no basis for the associations to keep these funds. Therefore, these funds, which were accumulated through use of appropriated monies, should be returned to the Treasury.

U.S. government funds have been improperly paid to employee associations. All were receiving unauthorized profits, and at two locations we visited (Ankara and Mexico City), associations improperly used government funds for costs unrelated to the service contract with the embassy. Because of the frequency of these problems among the embassies included in our review and other information maintained by the Department, similar situations are likely to exist at other posts.

In our opinion, the government is entitled to recovery of funds paid for unauthorized profits, and used for costs not related to embassies' service contracts. However, we are not recommending that these funds be recovered in their entirety because of the financial difficulties that this could impose on some associations, and because of the potential problems in reconstructing the amount due, given deficiencies in association accounting records. We believe, however, that funds paid after July 1985, when the Department reaffirmed its position on prohibited profit, should be recovered. For that period, we believe that records supporting the unauthorized payments can be reconstructed, and the amounts involved should not place an unreasonable financial burden on associations, or on the Central Commissary and Recreation Fund if associations request financial assistance.

We recommend that the Secretary of State take the following actions:

- Terminate existing service contracts between the embassies and the associations as soon as possible in the orderly course and conduct of public business, unless there are compelling reasons to continue using the associations as contractors.
- Direct the posts to hire contract personnel directly to provide support services overseas, but require that posts formally justify to the Department, in advance, the need for such contract personnel.
- In those cases where the posts determine there are compelling reasons to contract with the association, require that such arrangements be approved in advance at the Department level, establish sufficient oversight and guidance to ensure contracting practices and procedures meet federal and Department procurement regulations, and require that association financial records are adequate to support costs claimed.

**Appendix I
Embassies' Use of Contracts With
Employee Associations**

- Following the termination of service contracts between the embassies and the associations, direct Department and post officials to recover the funds remaining in the contingent liability accounts related to these contracts and take appropriate actions to return these funds to the U.S. Treasury.
- Direct embassy officials in Mexico City to determine the amount of severance funds improperly spent by the association for purchases unrelated to the embassy service contract and to make appropriate arrangements to recover these funds.
- Direct embassy officials in Ankara to determine the amount of snack bar employee salaries improperly charged to the government contract and make arrangements to return these funds to the government.
- Request the Inspector General to also determine whether association funds were misused or used for questionable purposes similar to those discussed for associations in Mexico City and Ankara.
- Direct embassy officials to take action necessary to recover unauthorized profits paid to employee associations after July 1985.



Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
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