



SPECIAL INSPECTOR GENERAL FOR IRAQ RECONSTRUCTION

October 28, 2011

LETTER FOR ADMINISTRATOR, U.S. AGENCY FOR INTERNATIONAL
DEVELOPMENT

SUBJECT: Indirect Costs of Managing Private Security Contracts in Iraq (SIGIR 12-002)

This letter addresses the Special Inspector General for Iraq Reconstruction's (SIGIR) concerns regarding the U.S. Agency for International Development's (USAID) approval of the indirect costs that nonprofit organizations charge for managing their Iraq private security contracts. In three previously issued audit reports, SIGIR found that some nonprofit organizations had used different methodologies for calculating indirect costs for managing their private security contracts, resulting in questionable charges.¹ Because private security costs generally account for a large portion of a nonprofit organization's total expenditures in Iraq, it is critical that the costs to manage these contracts are reasonable and kept to a minimum to allow as much money as possible to be spent on program implementation.

In this review, SIGIR examined six nonprofit organizations to determine the indirect costs they charged for managing their private security contracts. We found that the organizations charged widely varying indirect costs for managing security contracts in Iraq that SIGIR believes require a similar level of effort. For some organizations, the indirect costs charged may be unreasonable relative to the actual administrative costs necessary to support the Iraq program. For example, SIGIR found that one organization charged \$5,225 for managing its \$3.18 million Iraq security contract, while another charged \$915,794 to manage its \$5.39 million security contract.

USAID reviewed a draft of this letter, and it concurred with SIGIR's recommendation that the agency should more closely review the indirect costs associated with security contracts in order to ensure that they are reasonable and equitably charged to the Iraq program. The agency's comments are provided in their entirety in Appendix D.

SIGIR performed this audit under the authority of Public Law 108-106, as amended, which incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978. We conducted our work during May 2011 through October 2011 in Arlington, Virginia.

Background

Since 2003, the U.S. Department of State (DoS) and USAID have spent billions of dollars in Iraq to achieve a variety of objectives such as improving the capacity of national government

¹ *The Iraq Community Action Program: USAID's Agreement with CHF Met Goals, but Greater Oversight is Needed*, SIGIR-11-014, 4/27/2011; *National Democratic Institute Grant's Private Security Costs and Impact Generally Supported, but Department of State Oversight Limited*, SIGIR 11-001, 10/13/2010; *Improved Oversight Needed for State Department Grants to the International Republican Institute*, SIGIR 10-022, 10/29/2010.

institutions, strengthening the effectiveness of local government, expanding private sector economic opportunities, and ensuring open and fair electoral processes. DoS and USAID provide funding through contracts, grants, and cooperative agreements (referred to as “awards” hereafter) to nonprofit organizations in order for them to implement various programs.

When receiving these awards, the nonprofit organizations use the funding to pay for direct and indirect costs incurred to implement programs. Direct costs are those that specifically support a program’s activities or services. Those costs may include the salaries, fringe benefits, and travel costs of those who directly implement the program; supplies and equipment; and contractors’ services. Indirect costs, on the other hand, are those that are incurred for common or joint purposes and not readily identifiable with a particular award.² Examples of indirect costs include office space, utilities, clerical and managerial staff salaries, and contract management that are shared and applied equitably across all of an organization’s activities. To the extent that indirect costs are reasonable, allowable, and allocable under federal guidelines, they are legitimate costs of doing business and payable under a federal award.

Determining Indirect Cost Rates and Resulting Indirect Costs

Nonprofit organizations negotiate indirect cost rates, that is, the percentage of an award that can be used to pay for indirect costs, with the federal agency that provides it with the largest value of awards (also known as the cognizant agency). An indirect cost rate is a standardized method of charging individual awards for their share of indirect costs that the organization incurs to manage their activities. The rate is expected to determine fairly and conveniently, what proportion of indirect costs each award should bear. Indirect cost rates are calculated by dividing the organization’s total allowable indirect costs by some direct cost base³ and are expressed as a percentage. Figure 2 shows how an indirect cost rate is computed.

² Indirect costs are also often called “overhead costs.”

³ The direct cost base is also referred as the distribution base or the application base. The objective of choosing an appropriate base is to distribute indirect costs equitably and in accordance to the benefits received by the different programs and projects generating direct costs. There are three commonly used direct cost bases. The Modified Total Direct Cost base includes all direct costs incurred by the organization with the exception of items such as capital expenditures, subcontracts, flow through funds, etc. The Salaries and Wages base includes only the direct salaries and wages incurred by the organization. The Salaries and Wages plus Fringe Benefits base includes only the direct salary and wages and the direct fringe benefits incurred by the organization.

Figure 2—Methodology to Compute an Indirect Cost Rate^{a, b}

$$\frac{\text{Total Indirect Costs}}{\text{Total Direct Cost Base}} = \text{Rate}$$

Note:

^a In this example, the organization has identified the Total Direct Cost as the appropriate base of allocating its indirect costs.

^b Sometimes, more than one indirect cost rate is used when a single indirect cost rate for all activities of a nonprofit organization may not be appropriate because it may not take into account different factors which may substantially affect the indirect costs applicable to a particular award. Typically, the indirect cost rates for USAID grantees include fringe benefits, and one or more overhead rates.

Source: SIGIR.

Once the negotiated indirect cost rate is established and formalized through the Negotiated Indirect Cost Rate Agreement, it is binding on all Federal awards, not just those the cognizant agency provides.⁴ That is, if the cognizant agency determines that a nonprofit organization warrants an X% indirect cost rate, this rate applies to all awards that the nonprofit organization receives from the federal government. To determine the amount of indirect costs of individual awards, the indirect cost rate is multiplied by the applicable direct cost base of that award.

The Office of Management and Budget Circular A-122

The Office of Management and Budget (OMB) Circular A-122 “Cost Principles for Non-Profit Organizations” establishes the principles for determining costs that can be charged to awards with nonprofit organizations. The purpose of the circular is to:

- (1) ensure that the federal government bears its fair share of costs,
- (2) identify allowable and unallowable costs for determining the actual cost of federal programs, and
- (3) establish policies and procedures for indirect costs allocation.

To this end, during the indirect cost rate negotiation, the cognizant federal agency attempts to ensure that indirect costs are distributed equitably across all the nonprofit organization’s awards and programs. To do this, the cognizant federal agency determines whether the direct cost base the nonprofit is using in the calculation of indirect costs will result in an equitable distribution. For example, if an organization has an award (e.g., for work in Iraq) that has a disproportionate amount of direct costs (such as security contract costs), the amount of indirect costs that is allocated to that award could be considerably higher and therefore distorted. In such a case, OMB Circular A-122 authorizes the cognizant federal agency to exclude some costs in the direct cost base in order to equitably distribute indirect costs.

⁴ The Negotiated Indirect Costs Rate Agreement contains both final rates for past periods and provisional rates for current and future periods. The provisional rate is established for use in reimbursing indirect costs under cost-reimbursement contracts and grants until a final rate can be established. A final indirect cost rate is established after the close of the contractor's fiscal year and, once established, is not subject to change.

Private Security Costs Make Up a Significant Part of Some Nonprofit Organizations’ Expenditures in Iraq

The six nonprofit organizations that SIGIR reviewed together paid about \$40.16 million for their private security contract costs, out of nearly \$185.82 million in federal funds they spent in Iraq in FY 2010. Organization C paid \$8.01 million in private security contract costs in FY 2010, or about 52.74%, of its total federal expenditures in Iraq. Organization E’s private security contract costs were also significant, totaling about \$13.71 million, or 44.10% of its total federal expenditures for the year. Table 1 provides a summary of private security contract costs incurred by the six nonprofit organizations in SIGIR’s review.

Table 1—Nonprofit Organizations’ Private Security Contract Costs for FY 2010

	Total Federal Expenditures	Total Private Security Contract Costs	Percent of Total
Organization A	\$27,626,116	\$1,020,574	3.69%
Organization B	27,811,842	5,387,024	19.37%
Organization C	15,189,252	8,011,282	52.74%
Organization D	56,747,876	3,175,585	5.60%
Organization E	31,093,486	13,713,278	44.10%
Organization F	27,348,162	8,848,635	32.36%
Total	\$185,816,734	\$40,156,378	

Source: SIGIR’s analysis of data provided by the non-profit organizations.

The other four organizations’ private security costs are also significant, but make up smaller percentages of their overall expenditures. Several reasons explain the differences. For example, Organization A contracts with four to five individuals to provide private security needs rather than one single contractor (i.e., a company). Their officials informed us that contracting with individuals rather than companies reduces costs and allows them more flexibility in managing their private security needs. Organization B’s private security costs are lower because it contracts for only transportation (i.e., “dynamic” or “mobile”) security, rather than for both dynamic and static (i.e., guarding its compound) security. In addition, some nonprofit organizations work in less-volatile provinces than other organizations where more, and therefore more costly, protection is required. Lastly, some types of activities that the nonprofit organization conducts (such as monitoring elections) require a higher level of security.

Because costs of private security in Iraq are generally significant, the indirect costs associated with their management could potentially be high and distort the distribution of indirect costs, especially if the nonprofit organizations include the total value of these contracts in the direct cost base used in calculating indirect costs.

Nonprofit Organizations Calculate Indirect Costs for Managing Private Security Contracts Differently, Resulting in Varied and Seemingly Unreasonable Costs

SIGIR’s review showed that the six nonprofit organizations charged widely varying amounts of indirect costs associated with managing their security contracts in Iraq that SIGIR believes requires a similar level of effort. For some organizations, the amount charged under the Iraq program seems unreasonably high. To illustrate, one organization spent about \$5.39 million in security contract costs and charged \$915,794 as the cost of managing the contract, while another organization paid about \$3.18 million on security contracts but charged only \$5,225 as the cost of managing those contracts. Such a vast difference occurred because organizations used different bases on which to apply the approved negotiated indirect cost rate to determine the dollar value of their costs of managing these contracts. Table 2 shows the costs of private security contracts and the indirect costs that the six nonprofit organizations charged the government.

Table 2—Indirect Costs Charged for Private Security Contract Management in FY 2010

	Total Private Security Contract Costs	Indirect Costs Charged^a	Percent
Organization A	\$1,020,574 ^b	\$334,243	32.75%
Organization B	5,387,024	915,794	17.00%
Organization C	8,011,282	132,987	1.66%
Organization D	3,175,585	5,225	.16%
Organization E	13,713,278	108,593	.79%
Organization F	8,848,635	61,470	.69%
Total	\$40,156,378	\$1,558,312	

Note:

^a SIGIR used the organization’s provisional indirect cost rate for FY2010 when the final rate was not available.

^b This figure excludes the cost of the security manager for his time in managing these security contracts.

Source: SIGIR’s analysis of data provided by the non-profit organizations.

As stated above, the way an organization determines the direct cost base affects the amount of indirect costs. To illustrate, Table 3 shows that Organizations A, B, and C included the entire value of their private security contract costs in their direct cost base. Organization D, on the other hand, included only \$25,000 of their security contract costs—and for the entire year—while Organization E included \$25,000 each month for two of its private security contracts.

Table 3—Base Costs Used for Calculating Indirect Costs of Private Security Contracts Administration in FY 2010

Nonprofit Organization	Direct Cost Base	Elements Included
Organization A	\$1,020,574	Total value of private security contracts
Organization B	\$5,387,024	Total value of private security contracts
Organization C	\$8,011,282	Total value of private security contracts
Organization D	\$25,000	\$25,000 for the year
Organization E	\$572,944	\$25,000 each month for two of its private security contracts
Organization F	\$300,000	\$75,000 each task order ^a

Note:

^a Organization F issued task orders to its security contractor. Each task order was considered a separate contract that varied in length from three to six months. Its Negotiated Indirect Cost Rate Agreement allowed the organization to include up to \$75,000 of the value of each of its task orders in the direct cost base for calculating indirect costs. For FY 2010, Organization F applied the \$75,000 limit to four task orders.

Source: SIGIR's analysis of data provided by the non-profit organizations.

For these organizations, the inclusion of all, or a large portion, of their private security contracts costs in the direct cost base resulted in indirect costs that appear unreasonably high and inequitably distributed to the Iraq awards. Specifically, charging the Iraq awards from \$108,593 (Organization E) to \$915,794 (Organization B) to manage security contracts seems unreasonable relative to the \$5,225 that Organization D charged for what appears to be comparable efforts. Furthermore, once the indirect cost rate is applied to the unusually high cost of security, the Iraq awards could be absorbing more of the nonprofit organization's total indirect costs. The ultimate effect of such accounting is that there is less funding for program implementation.

USAID Approved Indirect Costs Charged

Nonprofit organization officials argued that the USAID Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch—the cognizant federal agency—had already approved indirect cost rates that they can charge on all their federal awards. These officials stated that in the negotiation process, USAID officials reviewed and approved the methodologies that they use to determine the base for calculating indirect costs. In all cases, USAID had approved of the amount of Iraq security contract costs that were included in the base of calculation. For some nonprofit organizations, this meant that they could charge indirect costs on the entire value of their security contracts. For others, USAID had approved of alternate methodologies to determine the direct base costs in which to apply the indirect cost rate. Thus, the nonprofit organizations officials argued that they are charging only the total allowable indirect costs they incur on all their federal awards.

According to USAID officials, they rely on the nonprofit organizations' audited financial statements to assist them in the indirect cost rate negotiation process.⁵ In these audits, USAID

⁵ The six organizations in SIGIR's sample are required by OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, to have annual audits conducted on their financial statements by independent auditors.

officials stated that the independent auditors review the calculations that would ensure an equitable distribution of indirect costs. Barring any gross distribution or material deficiencies, USAID usually accepts the results of these audits.

Conclusions

Ensuring that nonprofit organizations charge only appropriate and reasonable indirect costs across all, and each individual, federal award is an important goal. Doing so best assures that the maximum amount of funding is available for program implementation, and that an individual award does not shoulder an unwarranted burden of an organization's indirect costs. Given the insecure conditions in Iraq, nonprofit organizations' security costs are higher than those they experience elsewhere in the world. On this fact alone, it would be expected that organizations could charge a greater share of their Iraq award costs as indirect costs. However, Federal regulations sought to ensure that this did not occur. The intent of OMB Circular A-122 was that individual awards would not be burdened by indirect costs significantly higher than other awards, but that these costs would be more equitably shared among all of an organization's awards. Thus, all awards would more equitably pay for managing the totality of programs.

However, our focused review of six nonprofit organizations demonstrates that there is a large disparity in the amount the organizations charged for indirect costs in managing security contracts of similar scope. For some nonprofit organizations, such disparity led to an inordinate amount of award funds in Iraq being used to pay for indirect costs, rather than for direct program activities. Notwithstanding the limited scope of the review in which SIGIR focused only on security contract costs, and the complexity of the indirect cost rate determinations, the disparity and amount of indirect costs charged for managing these contracts warrants a closer review.

Recommendation

We recommend that the USAID Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch more closely review the indirect costs associated with security contracts in order to ensure that they are reasonable and equitably charged to the Iraq program.

Management Comments and Audit Response

USAID provided written comments on a draft of this letter and concurred with SIGIR's recommendation. In its response, USAID noted that indirect costing is not a uniform process, and individual organizations have wide latitude under the governing OMB Circulars to choose a methodology that best allocates costs to all its final cost objectives and not just those in one country or for one program. While current OMB Circulars allow for different methodologies to allocate costs, the non-profit organizations' chosen methodologies may not ensure reasonableness of those costs charged to the Iraq programs. SIGIR believes that USAID's review of the indirect costing practices will help ensure both reasonableness and equitable allocation.

We appreciate the courtesies extended to the SIGIR staff. For additional information on the report, please contact Glenn D. Furbish, Assistant Inspector General for Audits (Washington, DC), (703) 604-1388/ glenn.furbish@sigir.mil, or Jim Shafer, Principal Deputy Assistant Inspector General for Audits (Washington, DC), (703) 604-0894/ james.shafer@sigir.mil.



Stuart W. Bowen, Jr.
Inspector General

cc: U.S. Secretary of State
U.S. Ambassador to Iraq
U.S. Secretary of Defense

Appendix A—Scope and Methodology

In May 2011, the Special Inspector General for Iraq Reconstruction (SIGIR) initiated Project 1110 to examine the indirect costs that nonprofit organizations were charging the government for managing their private security contract costs in Iraq. SIGIR judgmentally selected six nonprofit organizations based on factors such as the amount of total federal funding received, the amount of funding used to pay for private security contracts, and the availability of data from prior audits. These nonprofit organizations included:

- ACDI/VOCA
- Cooperative Housing Foundation
- International Relief and Development, Inc.
- International Foundation for Electoral Systems
- National Democratic Institute for International Affairs
- International Republican Institute

We obtained data from these six nonprofit organizations on their total federal expenditures in Iraq for fiscal year 2010, the amount of those funds spent on private security contracts, and the amount included in the direct cost base used for calculating indirect costs. We also obtained their Negotiated Indirect Cost Rate Agreements with the U.S. Agency for International Development (USAID) Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch in order to determine the indirect cost rates applicable to the management of security contracts. Lastly, we interviewed senior officials from the nonprofit organizations, USAID, the U.S. Department of State, and the Office of Management and Budget to gain a better understanding of the indirect cost rate negotiation process and federal guidelines regarding indirect costs.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We performed this audit under the authority of Public Law 108-106, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978. SIGIR conducted its work during May 2011 through October 2011 in Arlington, Virginia.

Use of Computer-processed Data

We did not use computer-processed data in this report. However, we reviewed audits conducted on the nonprofit organizations' financial statements which may have been computer-processed data.

Internal Controls

In conducting the audit, we spoke with officials from USAID Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch on their processes for ensuring that the data provided to them from the nonprofit organizations are accurate.

Prior Coverage

We reviewed the following reports by SIGIR and the Government Accountability office.

Special Inspector General for Iraq Reconstruction

The Iraq Community Action Program: USAID's Agreement with CHF Met Goals, but Greater Oversight is Needed, SIGIR-11-014, 4/27/2011.

National Democratic Institute Grant's Private security Costs and Impact Generally Supported, but Department of State Oversight Limited, SIGIR 11-001, 10/13/2010.

Improved Oversight Needed for State Department Grants to the International Republican Institute, SIGIR 10-022, 7/29/2010.

Government Accountability Office

Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices, GAO-10-477, 5/18/2010.

Appendix B—Acronyms

Acronym	Description
DoS	Department of State
OMB	Office of Management and Budget
SIGIR	Special Inspector General for Iraq Reconstruction
USAID	U.S. Agency for International Development

Appendix C—Audit Team Members

This report was prepared and the audit conducted under the direction of Glenn D. Furbish, Assistant Inspector General for Audits, Office of the Special Inspector General for Iraq Reconstruction.

The staff members who conducted the audit and contributed to the report include:

Tinh T. Nguyen

James Shafer

Robert Whiteley

Appendix D—USAID Management Comments



October 21, 2011

Mr. Stuart Bowen
Special Inspector General for Iraq Reconstruction
400 Army Navy Drive
Arlington, VA 22202

Dear Mr. Bowen:

I am pleased to provide the U.S. Agency for International Development's (USAID) formal response on the draft SIGIR audit report "Indirect Costs of Managing Private Security Contracts in Iraq Is Responsive to SIGIR Recommendations." (SIGIR 12-002)

Recommendation No 1:

We recommend that the USAID Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch more closely review the indirect costs associated with security contracts in order to ensure that they are reasonable and equitable charged to the Iraq program.

USAID concurs with this recommendation. USAID's Office of Acquisition and Assistance's Overhead, Special Costs, and Closeout Branch will review the indirect costing practices related to security contracts in Iraq to ensure they are reasonable and equitable. It is important to note, however that indirect costing is not a uniform process and individual organizations have wide latitude under the governing OMB Circulars to choose a methodology that best allocates costs to all its final cost objectives and not just those in one country or for one program. All of the selected non-profit organizations for this audit were in compliance with governing regulations.

Thank you for the opportunity to respond to the SIGIR final report and for the courtesies extended by your staff in the conduct of this audit review.



USAID
FROM THE AMERICAN PEOPLE

If you have any questions concerning this report, please feel free to contact me.

Sincerely,

Mara Rudman
Assistant Administrator for the Middle East

Appendix E—SIGIR Mission and Contact Information

SIGIR’s Mission

Regarding the U.S. reconstruction plans, programs, and operations in Iraq, the Special Inspector General for Iraq Reconstruction provides independent and objective:

- oversight and review through comprehensive audits, inspections, and investigations
- advice and recommendations on policies to promote economy, efficiency, and effectiveness
- deterrence of malfeasance through the prevention and detection of fraud, waste, and abuse
- information and analysis to the Secretary of State, the Secretary of Defense, the Congress, and the American people through Quarterly Reports

Obtaining Copies of SIGIR Reports and Testimonies

To obtain copies of SIGIR documents at no cost, go to SIGIR’s Web site (www.sigir.mil).

To Report Fraud, Waste, and Abuse in Iraq Relief and Reconstruction Programs

Help prevent fraud, waste, and abuse by reporting suspicious or illegal activities to the SIGIR Hotline:

- Web: www.sigir.mil/submit_fraud.html
- Phone: 703-602-4063
- Toll Free: 866-301-2003

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