

**ADVISORY REPORT ON
FY 1999 COST ALLOCATION STUDY**

ADVISORY REPORT NUMBER A1-01

December 7, 2000

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**U.S. Small Business Administration
Office of Inspector General
Washington, DC 20416**

Advisory Report
Issue Date: December 7, 2000
Report Number: A1-01

TO: Joseph P. Loddo, Chief Financial Officer

Robert G. Seabrooks

FROM: Robert G. Seabrooks, Assistant Inspector General for Auditing

SUBJECT: Advisory Report on FY 1999 Cost Allocation Study

We performed a limited review of SBA's Fiscal Year (FY) 1999 Activity Based Costing Study (Cost Allocation Study) as it relates to the Small Disadvantaged Business Certification (SDB) program. You requested this review to justify FY 1998 and FY 1999 overhead rates in response to an audit finding from the Audit of Small Disadvantaged Business Certification Program Obligations and Expenditures (Audit Report 00-19). In that finding, we reported that the Small Business Administration (SBA) charged \$2.8 million in overhead to SDB funds for FYs 1998 and 1999 based on unsupported percentages.

The SDB program provides federal procurement benefits to small disadvantaged businesses bidding on federal contracts by giving them up to a 10 percent price preference on their bids. In 1998, SBA started certifying that small disadvantaged businesses met specific social, economic, ownership, and control eligibility criteria. Under the authority of the Economy Act, various federal agencies reimbursed SBA for its actual costs to certify these companies.

SBA developed its first Cost Allocation Study for FY 1997 and made incremental improvements in its FY 1998 and FY 1999 models. SBA used the study to determine all costs, both direct and indirect, for each cost object. For FY 1999, the Cost Allocation Study results were used to allocate SBA's recorded obligations to cost objects based on how resources were consumed within the Agency. SBA incorporated the SDB program in the Cost Allocation Study in FY 1999. Also, starting with the FY 1999 Cost Allocation Study, SBA surveyed employees in headquarters and field offices to accumulate cost data on employees' activities, capturing cost data based on where employees actually worked rather than to which program code they were assigned.

OBJECTIVE AND SCOPE

The objective of this review was to test and validate the accuracy of the results of SBA's FY 1999 Cost Allocation Study, as it related to the SDB program. We reviewed a sample of surveys from the following offices: Detroit District Office (DO), Montpellier DO, New York DO, Philadelphia DO, San Francisco DO, Chief Financial Officer (OCFO), HUBZone Empowerment Contracting Program, Office of Inspector General, Office of General Counsel, Entrepreneurial Development, Minority Enterprise Development, Native American Affairs, and Small Disadvantaged Business Certification & Eligibility. We interviewed SBA employees in the offices noted above, and the contractor who developed the Cost Allocation Study. We traced SBA's FY 1999 recorded obligations to the model to ensure that the model was using SBA's accounting data correctly. We also analyzed the model to determine whether the allocation methodologies were reasonable and calculations were correct.

RESULTS OF AUDIT

The FY 1999 Cost Allocation Study overstated SDB certification expenses by \$3.9 million. Additionally, since the Cost Allocation Study was based on obligations, which included unliquidated balances on closed obligations, the model did not show actual SDB expenditures, though the Economy Act requires SBA to determine the actual cost of the SDB program. Lastly, SBA did not clearly document the model, as required by OMB Circular A-127.

Finding 1: The FY 1999 Cost Allocation Study Overstated the SDB Certification Expense

The Cost Allocation Study overstated SDB costs because some offices/individuals charged their time to the wrong activities or to activities that did not accurately allocate the time they spent on SDB activities; offices that were unrelated to the SDB program had costs flowing to the SDB program; and cost driver calculations contained errors. In some instances, more costs were allocated to the SDB program than appropriate, and in other instances, less. Cumulatively, these errors overstated SDB certification expenses by \$3.9 million, reporting SDB expenses as \$14.6 million rather than \$10.7 million.

These errors occurred because SBA did not review the model and survey results for accuracy, some offices did not give their employees sufficient time to properly complete the surveys, and the written guidance SBA provided to employees was not explicit enough in describing what the activities represented. Also, the SBA official overseeing this project did not have sufficient training on SBA's organizational structure and the software used to create the model, which hindered her ability to test and validate the model. Since other Federal agencies reimburse SBA for its actual cost to certify SDBs and SBA intends to use the Cost Allocation Study to justify future SDB certification costs, errors in the Cost Allocation Study could result in SBA undercharging or overcharging the contributing agencies.

Management has already taken corrective action to address some of the problems noted above. The OCFO made changes to the model as recommended by the OIG and revised the FY 1999 SDB program cost to \$10.7 million. For the FY 2000 Cost Allocation Survey, SBA sent an e-mail (SBA Procedural Notice 2000-567) directly to all SBA employees, rather than only to senior office managers, asking employees to complete the survey. The notice provided employees over one week to respond to the survey, which should allow employees enough time to properly complete the surveys. Also, the survey guidance and activity descriptions were clarified in the FY 2000 Cost Allocation Survey to address the weaknesses noted in the FY 1999 Survey.

Recommendation

1A: We recommend that the Chief Financial Officer implement internal controls to verify the accuracy of future surveys and the models.

Management's Response:

The Chief Financial Officer stated that procedures for the FY 2000 Cost Allocation Study included internal control improvements that the OCFO believes address the OIG's concerns. See Attachment 1 for the full text of the response.

OIG Evaluation of Management's Response:

The Chief Financial Officer's comments are partly responsive to the recommendation. While the procedural changes implemented for the FY 2000 Cost Allocation Study should improve the accuracy of future cost allocation studies, the CFO did not address verifying the model to detect and correct potential errors.

Finding 2: Other Areas Requiring Management Action

Obligations from SBA's Accounting Records do not Capture Actual Cost

SBA used the obligation records rather than the actual expenditures from the Federal Financial System (FFS) as a source to allocate costs, although the obligations included unliquidated balances on completed contracts. SBA did not de-obligate unliquidated balances in the SDB program's completed projects/contracts immediately after the project/contract were completed and all payments had been made. The OCFO reported that on October 3, 2000, 21 percent of the FYs 1998 and 1999 obligations that we questioned in the SDB Obligations and Expenditures Audit were unliquidated balances on completed projects where all payments had been made. These were ultimately de-obligated. While other Federal agencies are supposed to be reimbursing SBA for its actual cost to certify SDB's under the authority of the Economy Act, these agencies could end up reimbursing SBA for more than its actual expenses if the Cost Allocation Study includes unexpended obligations on completed projects. The Cost Allocation Study model was developed without taking into consideration the unique reimbursement requirements of the SDB program.

Model's documentation was insufficient

SBA did not have sufficient documentation on the logic and decision making that went into developing the cost allocation model. OMB Circular A-127, "Financial Management Systems," requires system user documentation to be sufficiently detailed to permit a person, knowledgeable of the agency's program and of systems generally, to obtain a comprehensive understanding of the entire operation of the system. This Circular defines financial system as an information system that is used for: collecting, processing, maintaining, transmitting, and reporting data about financial events; supporting financial planning or budgeting activities; accumulating and reporting cost information; or supporting the preparation of financial statements. The Cost Allocation Study is used for all these purposes.

The contractor developing the study knew how he derived his computations and formulas and maintained various calculations in his own personal file. The contractor did not, however document why certain cost drivers were selected and why the model allocated costs to selected cost objects in the prescribed manner, nor did he provide SBA with the various calculations he documented until requested to by the auditor. Without such documentation, SBA could not verify the accuracy or reasonableness of the logic behind the model, and SBA would be unable to justify the model should the contractor become unavailable. We found some errors contained in this report directly as a result of reviewing the file provided by the contractor.

Recommendations

We recommend that the Chief Financial Officer:

- 2A: Enforce procedures that ensure that unliquidated obligations remaining on completed projects/contracts are de-obligated immediately after the project/contract is completed, and prior to allocating costs.
- 2B: Document the logic and methodology behind the cost allocation model as required by OMB Circular A-127.

Management's Response:

In addition to obtaining a written response from the Chief Financial Officer (CFO), we met with the Deputy CFO to discuss the findings, recommendations, and management's response. For recommendation 2A, we initially recommended in our draft report that the CFO implement procedures that ensure unliquidated obligations on completed project/contracts are de-obligated immediately after the project/contract is completed. The CFO's written response indicated that SBA already has procedures in place for de-obligating unliquidated obligations. In our meeting with the Deputy CFO, he agreed that it would be appropriate to recommend that the existing procedures should be enforced rather than implemented. In response to recommendation 2B, the CFO stated that the contractor would provide the recommended

documentation as part of the deliverables for the FY 2000 Cost Allocation Study. See Attachment 1 for the full text of the CFO's written response.

OIG Evaluation of Management's Response:

Since SBA has procedures to liquidate obligations in a timely basis, we revised recommendation 2A to "enforce procedures" rather than "implement procedures." The comments provided by SBA management are responsive to the two recommendations in this finding.

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The findings and recommendations in this report are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up.

Any questions or discussion of the issues contained in the report should be directed to Robert Hultberg, Director, Business Development Programs Group, at (202) 205-7204.



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: DEC 1 2000
TO: Robert G. Seabrooks, Assistant Inspector General for Auditing
FROM: Joseph P. Loddo, Chief Financial Officer *J. L. Loddo*
SUBJECT: Draft Report on FY 1999 Cost Allocation Study

Thank you for the opportunity to provide comments to the Office of the Inspector General (OIG) draft report on the application of the SBA's Cost Allocation Study (cost study) to the determination of the costs for the Agency's Small and Disadvantaged Business (SDB) program for FY 1999. Your independent review was helpful in assisting our refinement of the cost study for FY 2000, our fourth year using the cost study.

As you know, SBA has been recognized as a leader in the Federal government in implementing the activity-based cost accounting methodology. The General Accounting Office recently visited us and commended our efforts in this area, especially as we now evolve the cost study into an activity-based budgeting process. We have improved and refined the cost study each year, and believe that the FY 2000 study, now underway, assimilates your principal concerns, and increases the accuracy of the cost data. The recommendations in your draft report are addressed in the point by point discussion that follows.

Recommendation 1A: Implement internal controls to verify the accuracy of future surveys and the models.

SBA Response: The procedures for the FY 2000 cost study include internal control improvements that we think address the concerns discussed in your findings.

1. Every SBA employee has provided input to the survey in FY 2000 to increase the accuracy of the estimates of time spent in field and headquarters offices on the various SBA programs.
2. Secondly, adequate time, instructions and training were provided to employees to promote accuracy in the employees' estimates of how they spent their time during FY 2000. This included a procedural notice with survey instructions, activity descriptions in the survey itself, as well as training to SBA employees on the survey.
3. Supervisory review was used in the FY 2000 cost survey process to assure that SBA employees understood the guidance provided when they completed their cost estimates.
4. The cost activities used in the FY 2000 study were improved, especially for headquarters activities, to better describe employee work activities and this will improve the accuracy of the cost study.
5. The "drivers" used to relate expenses for other than employee compensation and benefits have been improved based on experience from the FY 1999 cost study.

It is important to remember that an Activity Based Cost (ABC) system, and any cost accounting system for that matter, is designed to provide an estimate of the cost of SBA's program services. We firmly believe that our cost study results provide a reasonable estimate of the costs of the various programs and activities.

The principal problem the OIG encountered with the review of the FY 1999 cost study was directly related to the SDB program, and not necessarily the cost study itself. This review must be considered in context with the newness of the SDB program to SBA. It became clear during the review that there was a disagreement between SBA and the OIG regarding the scope of the SDB program. This resulted in responses to the survey that were inconsistent with the program scope, resulting in some misstatements of costs associated with the SDB program that were corrected. This same problem no longer exists, and in order to increase the accuracy of responses to the FY 2000 survey, we also included activity descriptions, as noted above in response number 2.

Recommendation 2A: Implement procedures that ensure that unliquidated obligations remaining on completed projects/contracts are de-obligated immediately after the project/contract is completed, and prior to allocating costs.

SBA Response: This is really a budget execution issue and not an ABC cost study issue. As part of the SBA's budget execution, the Office of the Chief Financial Officer (OCFO) maintains procedures during the fiscal year to provide reports periodically to SBA program managers on open obligations, with the instruction to review the open obligations and close them for completed projects. Also, the SBA's procedures for yearend processing include instructions to all program managers to closeout unliquidated obligations for completed projects prior to yearend. The OCFO follows up with program managers on questionable open obligations, especially those of large dollar amounts. The budget execution process during FY 2000 provided heightened attention to open obligations, especially those open at yearend.

It should be remembered that the process to obligate funds allows for individual obligations to remain open as long as legitimate work continues on the project or activity. This sometimes extends into multiple years, especially in the case of our grant programs. However, we believe that the use of the above procedures, including monitoring, provide satisfactory internal control to liquidate obligations in a timely manner.

Recommendation 2B: Document the logic and methodology behind the cost allocation model as required by OMB Circular A-127.

SBA Response: The ABC cost contractor will provide documentation as a part of the required deliverables for the FY 2000 cost study. The OCFO has received a draft of this documentation, and the final documentation will be provided with the FY 2000 cost study results. Our review of the draft documentation for the FY 2000 ABC process indicates that it will meet the OMB Circular A-127 requirement for systems documentation.

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