



U. S. Department of Agriculture
Office of Inspector General
Audit Report

**National Fluid Milk Processor
Promotion Program**

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Audit Report No.
01001-3-Ch
SEPTEMBER 1998



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: **SEP 23 1998**

REPLY TO

ATTN OF: 01001-3-Ch

SUBJECT: National Fluid Milk Processor Promotion Program

TO: Enrique E. Figueroa, Ph.D.
Administrator
Agricultural Marketing Service

This report presents the results of our audit of the National Fluid Milk Processor Promotion Program. The response to the official draft report, dated July 10, 1998, is included as exhibit A, with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report. (Because they were so voluminous, we did not include copies of all of the attachments provided with AMS' response.) We also have included our comments to excerpts of AMS' response to the official draft report as exhibit B.

We have not reached a management decision on any of the recommendations in this report. Management decisions can be reached once you have provided the additional information outlined in the report section, OIG Position.

We understand that your Report to Congress to be dated July 1, 1998, has not yet been released. We believe that the transmittal memorandum, which should be an integral part of the Report to Congress, must inform the readers of said report that: (1) The financial statement audit was not performed using generally accepted Government auditing standards, (2) expenditures were made without the U.S. Department of Agriculture's approval, and (3) a \$350,000 contingent liability was not properly disclosed in the Board's financial statements.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation of the recommendations. Please note the regulation requires a management decision to be reached on all findings and recommendations within 6 months from report issuance.

ROGER O. VIADERO
Inspector General

TABLE OF CONTENTS

CHAPTER 1 - EXECUTIVE SUMMARY	iv
Results in Brief	iv
Key Recommendations	vi
Agency Position	vi
OIG Position	vii
<hr/>	
CHAPTER 2 - INTRODUCTION	1
Background	1
Results of Management Alert	4
Objectives	6
Scope	7
Methodology	7
<hr/>	
CHAPTER 3 - FINDING NO. 1 - AMS AND THE FLUID MILK BOARD NEED TO STRENGTHEN THEIR CONTROL OF THE PROGRAM ...	9
Recommendation No. 1a	18
Recommendation No. 1b	20

TABLE OF CONTENTS

CHAPTER 4 - CONTRACT PROCEDURES DID NOT COMPLY WITH REQUIREMENTS OF THE ACT AND/OR ORDER	21
FINDING NO. 2 - THE BOARD MADE CONTRACT PAYMENTS THAT WERE NOT APPROVED BY AMS	21
Recommendation No. 2a	24
Recommendation No. 2b	25
FINDING NO. 3 - CONTRACTS DID NOT INCLUDE CERTAIN REQUIRED LANGUAGE	25
Recommendation No. 3a	29
Recommendation No. 3b	29
FINDING NO. 4 - PROGRESS REPORTS WERE NOT SUBMITTED AND EXPENSE LIMITS WERE EXCEEDED	30
Recommendation No. 4a	32
Recommendation No. 4b	32
FINDING NO. 5 - CONTRACT TERMS WERE NOT BEING MET	33
Recommendation No. 5	34

TABLE OF CONTENTS

FINDING NO. 6 - THE BOARD USED SOLE-SOURCE CONTRACTORS WITH NO EVIDENCE OF OTHER CONTRACTORS BEING CONSIDERED	34
Recommendation No. 6	37
FINDING NO. 7 - FINANCIAL STATEMENTS WERE INCORRECT	38
Recommendation No. 7a	42
Recommendation No. 7b	42
Recommendation No. 7c	42

EXHIBITS

A - AMS' RESPONSE TO THE DRAFT REPORT	44
B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE	56
C - ADVERTISING AGENCY'S MEMORANDUM TO OIG	72
D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS	84
E - ADVERTISING AGENCY'S MEMORANDUM TO ITS SUBSIDIARY	91

CHAPTER 1 - EXECUTIVE SUMMARY

Results In Brief

This report presents the results of our audit of the Agricultural Marketing Service's (AMS) National Fluid Milk Processor Promotion Program (Program). AMS requested an audit of this new Program to ensure that it was being administered in compliance with the Fluid Milk Promotion Act of 1990 (Act) and the Fluid Milk Order (Order).

Our review disclosed serious problems with the National Fluid Milk Processor Promotion Board's (Board) management structure and with the manner in which expenditures were made. The Board remained detached from the day-to-day operations of the Program, delegating all administrative tasks to contractors and taking no independent actions to ascertain the effectiveness of the Program. According to the Board Administrator (Person A), he did not believe anyone was interested in knowing whether the Board's activities influenced milk consumption. Concurrently, AMS provided little active oversight of the Board's activities.

Our review disclosed that the Board's controls over contracts were inadequate or were not working. The Board entered into sole-source contracts without any competition to ensure the most cost-effective procurement and without obtaining AMS' approval prior to the effective date of the contracts. The administrative reports required by contracts, such as monthly progress and performance reports and overall project evaluation reports, were not being delivered, leaving the Board in a weakened position to manage the contracts. Payments were made which exceeded contract limits. These overpayments indicated that the

internal controls were either inadequate or were not working. In addition, the terms of contracts were not being enforced. One contract requires that a reserve of approximately \$350,000 be established (to be paid as an incentive bonus if fluid milk sales increased) and maintained; that reserve has not been established.

We identified payments made for 108 contracts; however, neither AMS nor the Board could provide us with copies of 37 of these contracts. (We found no evidence to cause us to question the existence of the 37 contracts as we found documentation in the files that indicated funds appeared to be expended for program-related purposes.) As a result, we could not ascertain if funds spent for these goods/services met contract specifications. Of the 71 contracts available for review, 33 were not signed by at least one of the contracting parties prior to the contracts' effective dates. Also, AMS had not approved 68 of these 71 contracts prior to the contracts' effective dates.

The Board presented audited financial statements which did not accurately reflect its financial condition. The financial statements as of March 31, 1995, and as of April 30, 1996, contained material omissions and questionable statements that, in the aggregate, were significant enough to affect the decisions of its users.

Because of the magnitude of the problems we identified at the outset of our audit, we issued a Management Alert on May 6, 1997. In the Management Alert, we raised concerns dealing with the very limited amount of AMS oversight of Board activities. We were also particularly concerned with the Board's control structure, its reliance on contractors to run day-to-day operations, and its contracting procedures, including ownership of copyrights developed with assessments collected as a result of the Act.

In response to our Management Alert, AMS advised that it had taken a number of corrective actions. These actions included personnel changes to ensure better AMS oversight, the approval of a new contract review process, the request for and receipt of an opinion from the Office of the General Counsel concerning the ownership of property developed with assessment funds, and continuing to review all minutes kept of Board meetings. We were also advised that the Board has taken a number of actions to strengthen control over the Program by increasing the amount of time required of its Administrator from an average of 9 hours per week to 23 hours per week, establishing a new contract review procedure with AMS, and retaining outside legal counsel to aid in contract review and taking minutes of Board meetings.

While we acknowledge that certain changes have been made, we continue to have serious concerns over the management structure of the Board and contracting procedures.

***Key
Recommendations***

We recommend that AMS suspend the operations of the Board until AMS and the Board jointly restructure the management of Board activities to ensure full compliance with the Act and the Order. The Board needs to establish guidelines for awarding contracts and subcontracts to ensure that goods and services are not sole-sourced. In addition, we recommended that AMS continue to increase its oversight of Board activities.

Agency Position

AMS did not agree to suspend the Board's activities. Although AMS has made proposals to restructure the management of the Board's activities, there have been no definitive plans presented to date. AMS agreed with most of the recommendations, though in some cases they proposed alternative actions or did not give sufficient details of the corrective actions they were

proposing. AMS's response is included as exhibit A. The AMS response included voluminous attachments which are not included herein.

OIG Position

AMS should suspend the Board's activities until AMS and the Board develop a plan to restructure the management of Board activities. Many of the corrective actions proposed by AMS did not adequately address the audit recommendations. We do not agree with many of the comments made in AMS' response to our draft report. (See exhibit B for assertions made by AMS and our response).

CHAPTER 2 - INTRODUCTION

Background

The Agricultural Marketing Service (AMS) has responsibility for the National Fluid Milk Processor Promotion Program (Program), which was authorized by the Fluid Milk Promotion Act of 1990 (Act) (Public Law 101-624) and the Fluid Milk Promotion Amendments Act of 1993 (Public Law 103-72). The Program is designed to fund promotion, research, and consumer education. The Act directed the Secretary of Agriculture (Secretary) to issue a Fluid Milk Order (Order) to implement the Program. The Order became effective on December 10, 1993, and the Secretary appointed the first National Fluid Milk Processor Promotion Board (Board) on June 6, 1994.

The Program is funded by a mandatory 20-cents-per-hundredweight assessment on all fluid milk products processed and marketed commercially in consumer-type packages in the 48 contiguous United States and in the District of Columbia. The Act defines a fluid milk processor as “* * * any person who processes and markets commercially more than 500,000 pounds of fluid milk products in consumer-type packages per month.”

AMS’ oversight responsibilities include reviewing and approving the Board’s budgets, contracts, advertising campaigns, and investment plans. AMS is also responsible for evaluating the Program’s effectiveness and for ensuring that promotion funds are collected and spent consistent with the enabling legislation.

Assessment revenues from approximately 370 processors totaled \$168,729,598 from December 10, 1993, through June 30, 1997. We found no problems in the system of collecting and depositing assessments. Program expenses during that period were \$131,225,781, and Board expenses were \$288,329. (The Order required the Board to return \$16,446,385 to the California Fluid Milk Processor Promotion Board. For this audit, we verified only that the funds were transferred to the California Fluid Milk Processor Promotion Board. We did not review the use of these funds.)

The Board has a contract with the Milk Industry Foundation (MIF) to perform various management and administrative services. Because MIF does not have employees to perform these services, it contracts for them with the International Dairy Foods Association (IDFA), its parent organization. (The chief executive officer, Person B, of both MIF and IDFA is a registered lobbyist with the U.S. Congress.) MIF also subcontracts most of the advertising and public relations activities.

The Board's contract with MIF requires MIF to conduct promotion and research activities and to provide administrative services for the Milk Processor Education Program. The administrative services are to include planning and coordinating Board meetings and providing onsite support personnel for Board and committee meetings. The MIF contract with IDFA requires IDFA to perform all tasks detailed in the contract between the Board and MIF.

The Board also has two contracts with the certified public accounting (CPA) firm in which Person A, the Board Administrator, is a principal. One contract is for overseeing the collection of assessments and

performing accounting services; the other is for contractor compliance reviews.

In addition, the Board has a contract with Person A, as an individual, to perform services as a part-time administrator for the Board. Finally, the Board also has a contract with a law firm for legal services.

The Board contracted with MIF to use MIF resources to pay bills on a reimbursable basis. This procedure changed in 1995, when advertising expenses became too great. At that point, MIF decided it would only review and approve expenses and submit them through Person A's CPA firm to the Board for payment. The procedure changed again in 1997, at which point the advertising agency began sending its invoices directly to the CPA firm, while submitting duplicates to MIF for approval.

The highly recognized milk-mustache advertising campaign has been the Board's primary method of promoting milk since the Board's inception. Although these advertisements are highly recognized in the marketplace, the Board has not determined whether the advertising campaign has resulted in increased milk consumption.

We reviewed the Board's activities in 1994 because of congressional concerns about the propriety of the Board's dealings with a lobbying organization. Concern centered around (1) the propriety of IDFA's having an executive director for the Board before the Board itself had been sworn in and seated, and (2) the payment of Program funds to organizations (IDFA and MIF) whose chief executive officer and vice presidents were registered as lobbyists with the U.S. Congress. The use of Board funds for lobbying purposes is a violation of the Act.

We concluded that the Board had not prematurely hired an executive director and that no Program funds had been expended for lobbying purposes. We also concluded that a combination of the Board's hiring or contracting for staff, the Board's use of independent audits, and AMS' normal control structure of reviewing and approving Board-recommended activities should have provided reasonable control measures to ensure that promotion funds were used only for lawful purposes. However, during this audit we found that these measures were not properly taken. We found problems with the Board's management structure, independent audits, and AMS' oversight.

Results Of Management Alert

Our survey (01001-1-Ch) noted that the controls originally intended to be implemented by the Board were either not implemented or not implemented as planned. As a result, we issued a Management Alert, dated May 6, 1997, in which we recommended the AMS Administrator take corrective actions.

- We recommended that the AMS Administrator require the Board to take full control of day-to-day operations for all Program activities. AMS responded that by May 30, 1997, it would (1) send a letter to the Board outlining AMS' position regarding the Board's responsibilities, and (2) work with the Board to develop a staff and structure to take full control of operations. AMS asked the Board to consider hiring a full-time administrator and support personnel.
- We recommended that the AMS Administrator require that all contracts, subcontracts, and agreements that commit Program funds be timely approved. AMS responded that it would (1) direct the Board to stop paying for work that AMS

had not approved, (2) require that the Board submit all contracts and subcontracts to AMS for review, and (3) reevaluate its policy on reviewing and approving contracts and subcontracts within 90 days.

- We recommended that title to all products acquired with Program funds become the property of the Board. AMS responded that it would obtain an opinion from the Office of the General Counsel (OGC). (See page 28.)

In response to our Management Alert, the Board increased the Board Administrator's responsibilities and contracted for outside legal counsel; we continue to believe that more involvement by the Board and its Administrator is necessary. Most of the Board's expenditures (advertising expenses) are still being managed by subcontractor personnel without active involvement or oversight by the Board and with only limited oversight by its Administrator. AMS initially agreed to have all contracts, subcontracts, and agreements submitted for review prior to their effective dates. However, AMS subsequently reached an agreement with the Board that only nine contracts would be submitted for approval; all remaining contracts, subcontracts, and agreements would be kept on file at the Board Administrator's office for AMS' review. We do not concur with this agreement between AMS and the Board; AMS should, on a timely basis, receive all contracts, subcontracts, and agreements for review. Finally, the Board has revised the language in a subcontract with a photographer for the Board to obtain title to the assets produced. However, under the revised language in the subcontract, the subcontractor will retain physical possession and be paid a royalty for any use other than the original contract period. In form, it appears that the Board has obtained title to the

assets; in substance, the subcontractor still retains all substantive property rights.

Although we have not verified them, we were recently advised of the following corrective actions taken by AMS and the Board.

- MIF is now submitting progress reports to the Board.
- Certain unspecified changes have been made in the Board's meeting procedures and the Board now meets privately with its Administrator and legal counsel during each Board meeting.
- Outside legal counsel (Person C) is to oversee contract development and compliance by contractors with contract provisions.
- The Board changed the way its meeting minutes were to be taken, prepared, and maintained.
- The Board developed a checklist of provisions required for contracts and agreements.
- New procedures have been implemented to assure that celebrities sign agreements prior to their photographs being taken.

Objectives

Our objectives were to: (1) Evaluate AMS' procedures for overseeing the Program, including actions to address deficiencies identified in the OIG Management Alert dated May 6, 1997; (2) evaluate the Board's policies and procedures for administering the Program and assess whether internal controls were adequate to ensure funds were used only for authorized purposes; (3) evaluate the contractors' performance of their

responsibilities to the Board; and (4) evaluate the effectiveness of the independent CPA firm's performance of its responsibilities to the Board.

Scope

The audit covered the Program from its inception in December 1993 through June 30, 1997. We reviewed and tested a judgmental sample of transactions, documents, and other records relating to assessments totaling \$168 million and the associated expenditures and investments. We compared AMS' reported milk production with the assessments and found them to be reasonable. We evaluated AMS' procedures for overseeing the Program, the Board's policies and procedures for administering the Program, selected contractors' compliance with contractual responsibilities, and the Board's independent auditor's responsibility to the Board. We identified internal controls through interviews and tested their effectiveness. Audit work was performed at AMS Headquarters in Washington, D.C.; the Board Administrator's office in Bethesda, Maryland; the Board's major contractors in Washington, D.C., and Bethesda, Maryland; the advertising agency's offices in Chicago, Illinois, and New York, New York; and the Board's independent auditor in Reading, Pennsylvania. We performed fieldwork from May through September 1997. We also referred to survey (Survey No. 01001-1-Ch) fieldwork conducted from January through May 1997. We conducted the audit in accordance with Government Auditing Standards.

Methodology

To accomplish the audit objectives, our examination consisted of:

- Reviewing Federal laws, regulations, policies, and procedures relating to the Program,
- interviewing AMS officials, the Board and its Administrator, the Board's major contractors, the major advertising subcontractor, and the Board's outside auditor,
- testing receipt and deposit of assessments and the related expenditures and investments,
- visiting the Board's major contractors and subcontractor for the purpose of examining the contractors' accounting and other financial records,
- examining and analyzing AMS' oversight documents and contract review policy, and
- visiting the Board's outside auditor to examine his audit workpapers.

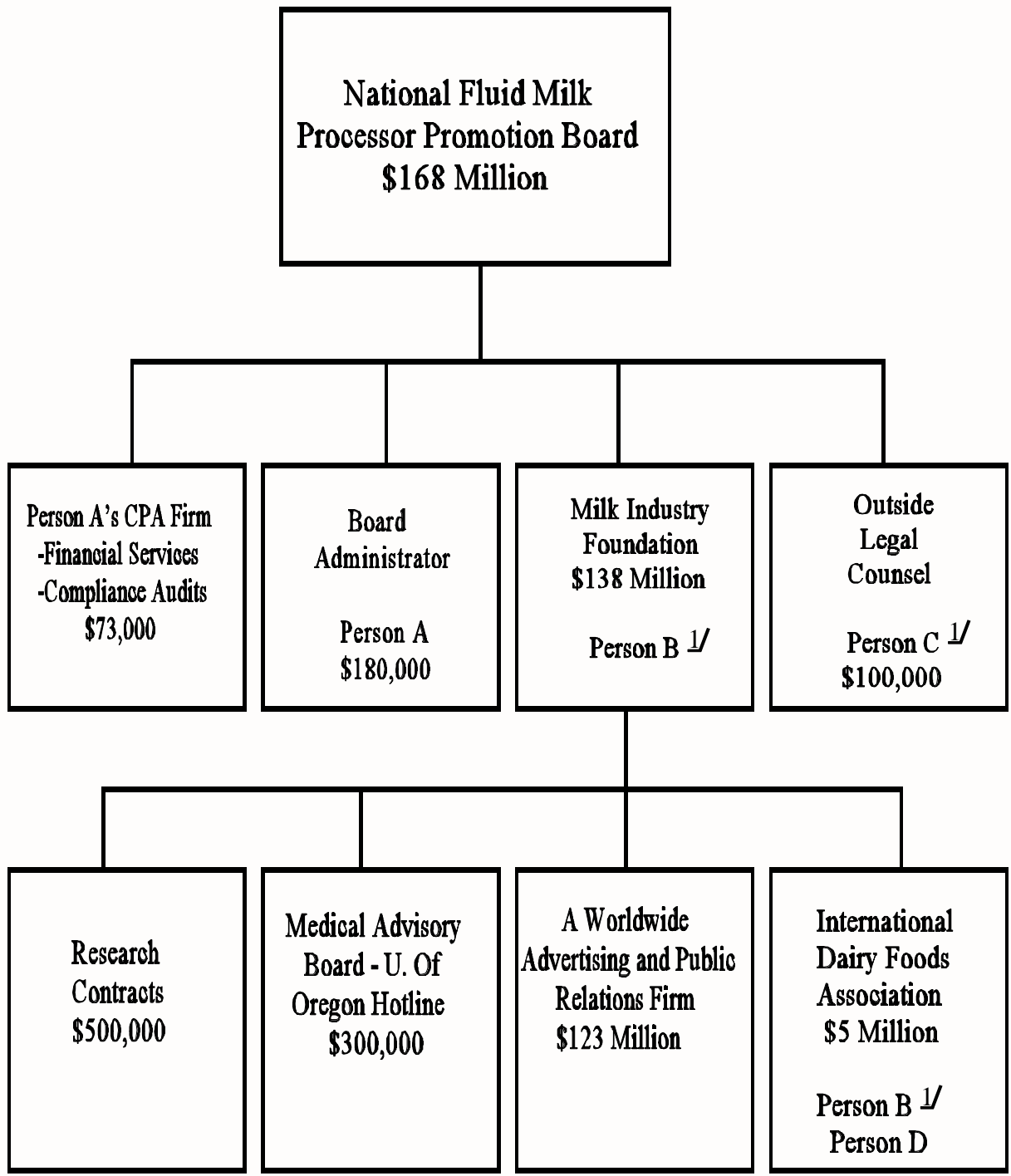
CHAPTER 3 - FINDING NO. 1
AMS AND THE FLUID MILK BOARD NEED TO
STRENGTHEN THEIR CONTROL
OF THE PROGRAM

AMS effectively left all oversight responsibilities to the Board, and the Board, because it had no employees, left its oversight responsibilities to the contractors it relied on for administrative services. We concluded that because AMS did not provide proper oversight and direction, the Board (1) allowed the payment of over \$127 million in expenses that were not supported by AMS-approved contracts (see Finding No. 2), (2) surrendered its ability to enforce compliance by contractors and subcontractors (see Findings Nos. 4 and 5), and (3) had not maintained approved minutes of Board meetings (see Finding No. 4). Other than the opinions of its contractors/subcontractors, the Board had little information as to the effectiveness of its Program. Another responsibility of both AMS and the Board was to analyze the advertising, promotion, and research activities carried out with Program funds to determine whether they had increased fluid milk consumption. As of the time of our audit, neither entity had done this.

Section 1999H of the Act defines the powers and duties of the Board, including the requirement that all contracts and agreements be approved by the Secretary. It also states that the Board must keep minutes, books, and records that reflect all of the acts and transactions of the Board and promptly report minutes of each Board meeting to the Secretary. Section 1999B of the Act states that the purpose of the Program is to carry out an effective program of promotion, research, and consumer education to

strengthen the position of the dairy industry in the marketplace and to maintain and expand markets and uses for fluid milk products. Section 1990O(b) of the Act states that the Secretary shall terminate or suspend the operation of the Order whenever he finds that the Order does not effectuate the declared policy of the Program. Section 1999C of the Act defines advertising as a program directed toward increasing the general demand for fluid milk products.

The Board has chosen to use contractors to perform its managerial and administrative functions instead of hiring its own staff. The Board did not consider the Program to be permanent and did not want the obligations of hiring a permanent staff. Thus, the responsibility of ensuring contract compliance rests largely with the contractors themselves. We question the independence of some of the key contractor employees who have been assigned responsibility for Board activities; it is sometimes unclear whether these employees' concerns lie primarily with the Board or with their own employer, the contractor. The following flow chart shows the major contractors used by the Board.

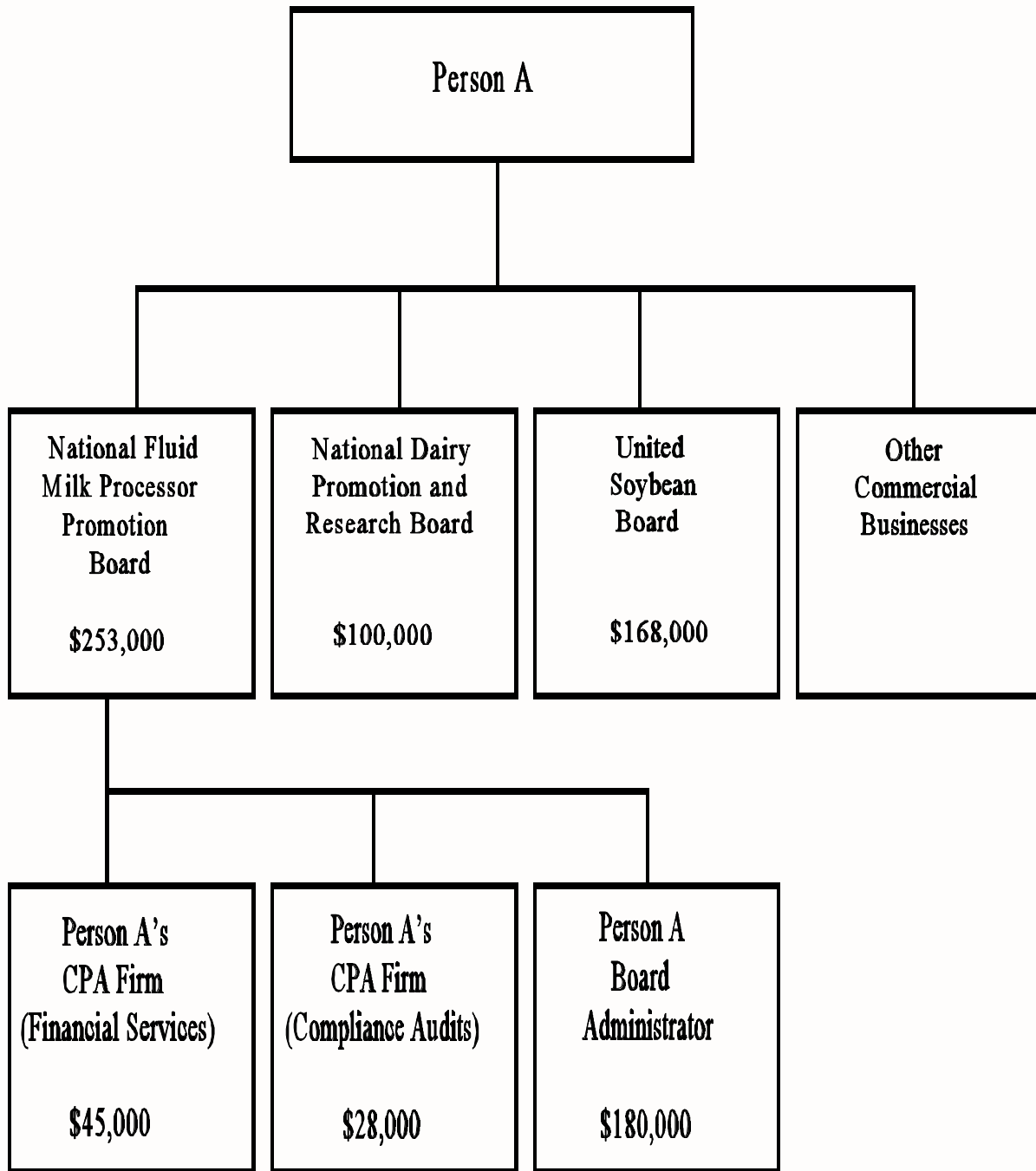


1/ Registered with the U.S. Congress as a lobbyist.

When we issued our Management Alert in May 1997, the contract for the Board's Administrator was \$75,000 per year. Beginning in July 1997, it changed to \$100,000 per year. (At the exit conference, we were advised that the contract increased in February 1998 to \$180,000 for 23 hours of work per week.) The contract also allowed the Board's Administrator to charge related expenses, such as travel, that are in addition to the \$100,000 for his personal services. The Board's Administrator bills for his services at a rate of \$150 per hour (which would equate to an annualized cost of \$312,000). This billing rate and the Board Administrator's contract amount (\$100,000) would allow him to charge 13 hours per week for overseeing the Board's activities. We continue to question whether this 13 hours per week is enough time to properly administer a \$120-million-per-year program.

- The Board's Administrator also has major responsibilities to his CPA firm. This CPA firm has a contract to provide the Board with all required financial and accounting services. The CPA firm has another contract with the Board to provide compliance reviews over other Board contractors. Altogether, the Board's Administrator, either as an individual or through his CPA firm, is a party to three contracts with the Board as a sole-source contractor.
- Person A's CPA firm also provides financial and accounting services to at least two other USDA promotion and research boards.
- Person A also has a commercial business as a financial advisor to other individuals.

The following flow chart illustrates the above:



Because of all these other responsibilities, we question whether this Board Administrator has adequate time to devote to the Board's needs. We question whether these other commitments may have prevented him from ensuring AMS contract approval prior to making payments and from enforcing contractor compliance. Additionally, since Person A is a principle in the CPA firm providing accounting services to the Board, neither the CPA firm nor Person A has the independence required for such services.

The Board's contract with MIF requires that MIF appoint one of its employees as Executive Director of the Milk Processor Education Program (MilkPEP). MIF contracted with IDFA for the services of one of its employees to act as Executive Director of MilkPEP (Person D). We question why the Board would have entered into a contract with MIF for this employee when the Board was fully aware that MIF had no employees.

The MIF contract with IDFA requires IDFA to perform (or have others perform) all tasks detailed in the contract between the Board and MIF. From July 1 through December 31, 1996, the MilkPEP Executive Director charged an average of 47 hours per week to the Program. As Executive Director (Person D), he is responsible for coordinating the creation, development, and implementation of promotion campaigns approved by the Board. We believe that since the Executive Director is working full-time on Board activities, the Board should determine if this is the most effective means of obtaining these services.

About \$127 million in payments were made before the contracts were approved by AMS. (See Finding No. 2.) The Board could have controlled contract payments had it required that its management monitor

compliance with the Act and the Order. Except for Board members, all those reviewing and approving contract expenditures were themselves contractors or contract employees. We believe that this near total reliance on contractors and contractor employees has resulted in a lack of independence which AMS and the Board should address.

The Board's contract with MIF requires that it submit monthly progress reports and authorization requests on all projects that it is overseeing for the Board. (See Finding No. 4.) Although these reports have been required since July 1994, MIF has never submitted these reports. These reports would have provided the project description, the objective of the project, the planned strategy, the expected benefit to the milk industry, the cost, and the method by which the success of the project would be evaluated. Had these reports been submitted to the Board, it would have been able to more effectively monitor progress in the various Program areas.

The Board did not timely monitor Program expenses to determine whether contractual limits were exceeded. (See Finding No. 4.) The Board's contract for an Administrator (Person A) for the period August 30, 1996, through June 30, 1997, had a specified dollar limit, including expenses. Although it was the Board Administrator's responsibility to monitor contract compliance of all contracts to which the Board was a party, he allowed the contract limits for his personal contract as Board Administrator to be exceeded for 2 consecutive months.

The Board relied on IDFA personnel to prepare and maintain official minutes of Board meetings. (See Finding No. 4.) Both IDFA and AMS provided us minutes of Board meetings; however, there were material differences in the two sets of minutes

provided. The Board Administrator told us that he was “reconstructing” the official minutes. Without official Board minutes, we could not determine which contracts and budgets the Board had approved. We question how the Board’s Administrator can “reconstruct” official minutes of Board meetings held since 1994, as he was only appointed to the position in 1996.

Neither AMS nor the Board ensured compliance with the Act or the Order. We found no evidence that an analysis had been performed by either AMS or the Board to determine whether the advertising, promotion, and research activities carried out with Program funds increased consumption of fluid milk. The Board Administrator informed us that a study had not been done and that he did not believe the Board or anyone wanted to know whether the Board’s activities had increased fluid milk consumption.

In its Report to Congress, dated July 1, 1997, AMS reported the results of a study that it had commissioned from the Economic Research Service (ERS). ERS performed an examination of the effects of generic advertising on fluid milk sales. This study showed that fluid milk sales were up 5.9 percent from the period October 1995 through September 1996 when compared to the previous 12 months. The report states “Sales increases due to the Dairy and Fluid Milk Acts stem from increases in advertising dollars, their effectiveness, and a marked upward shift in fluid milk demand in the post-Act period that partially offsets a downward trend in consumption over time. It is possible that factors other than advertising (e.g., increased public concern about calcium intake) caused some shifts in the consumer demand for milk during the post-Dairy Act Period. Thus, the analysis might overstate the actual effect the Dairy and Fluid Milk Acts had on increasing the advertising/sales

response for a given level of expenditures.” The ERS study does not show AMS the specific results of the advertising by the National Fluid Milk Processor Promotion Board.

In its 1997 Annual Report To Congress, AMS reported that fluid milk sales increased 5.9 percent from October 1995 through September 1996 when compared to the previous 12-month period. In its 1996 Report To Congress, AMS reported fluid milk sales of 23.3 billion pounds from October 1994 through September 1995 and in its 1997 Report To Congress, AMS reported sales of 23.5 billion pounds from October 1995 through September 1996; that is an increase of only 0.85 percent. AMS officials could not explain this apparent conflict (5.9 percent reported versus 0.85 percent calculated by OIG) to us. We then made similar comparisons for previous periods and found similar discrepancies in sales increases reported by AMS, as shown below:

ANNUAL REPORT PERIOD	AMS REPORTED FLUID MILK SALES (BILLION POUNDS)	FLUID MILK OIG COMPUTED SALES INCREASE FROM PREVIOUS YEAR TO NEXT (SALES DECREASE)	AMS SALES INCREASE IN ANNUAL REPORT
10/93 - 9/94	22.9	<u>1/</u>	4.7%
10/94 - 9/95	23.3	1.75%	4.2%
10/95 - 9/96	23.5	0.85%	5.9%
10/96 - 9/97	23.4	(0.42%)	<u>2/</u>

1/ Data unavailable for calculation.

2/ The 1997 report was not completed at the time of our review.

The above chart shows wide variances between what AMS reported each year in its annual report and our calculations when comparing one year’s report to the next. AMS officials could not explain these differences to us. We believe this demonstrates that an independent study of the effect of the fluid milk

assessments and subsequent advertising is needed to support the continuation of the program. In addition, since no payments were made from the reserve account described in Finding No. 5, we believe this provides further evidence of the questionable extent of sales increases.

ERS officials informed us that a separate study could be performed; however, it would have to be designed properly and would take a greater effort than they have previously been performing. More specifically, in its letter to AMS dated April 15, 1998, ERS stated that, "Any current attempt to evaluate the two campaigns separately would require advertising variables that were unique to each campaign and based upon consumer responses to each program. Such a model would require sampling and estimation procedures which are beyond the time and resources of the (ERS) Evaluation Committee."

***Recommendation
No. 1a***

Suspend Board activities until AMS and the Board jointly develop a plan for restructuring its management of Board activities.

AMS' Response

AMS officials did not agree to suspend Board activities. Rather, they, along with the Board, developed a plan for restructuring the management of the Board's activities. AMS advised that the Board agreed to hire a full-time employee to oversee all Board activities. AMS discussed several other corrective actions in its response including: The possibility of having a CPA firm audit the Board's internal control system, requesting the Board to terminate all contracts with MIF, and requesting the Board to identify all lobbyists and lobbying organizations in all Board contracts and subcontracts. AMS' target date is December 31, 1998.

OIG Position

AMS should suspend the Board's activities until a specific plan has been developed to restructure the Board's management of Board activities. The response provided does not contain specific corrective actions to enable us to reach management decision on this recommendation.

In order to reach management decision, AMS needs to suspend Board activities until they have developed and provided us a detailed corrective action plan regarding (1) a restructured Board and its operating plan; (2) termination of the MIF contracts; and (3) revision of the contract/subcontract provisions to require disclosure of lobbyists and lobbying organizations. Since we are recommending that the Board be restructured, we do not believe it is appropriate to conduct a review of the Board's internal control system.

We support the Board's resolution to hire a full-time "employee" (Administrator) to oversee all activities. To ensure independence, the Administrator needs to be organizationally and physically independent of all external impediments. The Administrator should have sole responsibility to the Board and be responsible for all Board management and administrative functions. In addition, AMS needs to advise us as to the future role of the current Board Administrator, including his duties and responsibilities, if any.

AMS has advised that the target date for implementation is December 31, 1998. However, AMS needs to develop intermediate action dates since all the actions cannot be accomplished simultaneously and some are dependent on others. AMS should provide a timeline for the proposed corrective actions.

**Recommendation
No. 1b**

Require the Board to determine the effectiveness of its promotion and research activities in increasing fluid milk consumption.

AMS' Response

AMS recognized the importance of evaluating the effectiveness of the promotion programs and that such evaluations were required by the enabling legislation. AMS agreed to develop a request for proposals to consider new or revised methodologies for evaluating the effectiveness of the advertising campaigns conducted by the Board and it will include the feasibility of evaluating the programs of the Board separately from other dairy promotion programs. AMS' target date for the evaluation contract is February 27, 1999.

OIG Position

In order to reach management decision, AMS needs to provide us with its final plan for evaluating the program and the timeframe for the evaluation.

**CHAPTER 4 - CONTRACT PROCEDURES
DID NOT COMPLY WITH REQUIREMENTS
OF THE ACT AND/OR ORDER**

The Board, with limited AMS involvement, assumed the authority to determine the activities it contracted for, the vendors it used, and the price it would pay for the services it received. In most cases, the Board contracted for services without AMS approval. In May 1997, we issued a Management Alert which discussed this issue. In response, AMS and the Board made changes which we do not believe fully address our concerns as described below.

***Finding No. 2
The Board Made
Contract Payments
That Were Not
Approved By AMS***

- AMS allowed the Board to commit and/or expend Program funds for 108 contracts, even though it had approved only 3 of these contracts prior to the contracts' effective dates. AMS had not provided proper oversight, as evidenced by the numerous contracts, obligations, and payments made by the Board without AMS' approval. In the absence of AMS constraints, the Board operated the Program as it saw fit. The former Board Chairman told us that the Board was responsible for the milk promotion funds and that it could spend the funds as it felt was appropriate. Between December 10, 1993, and June 17, 1997, the Board collected over \$168 million in processor assessments. During the same period, the Board authorized the expenditure of \$127 million, 75 percent of the total assessments, without AMS' approval.

Section 1999H(c)(8) of the Act and Section 1160.209(g) of the Order require that AMS approve all contracts prior to the expenditure of Program funds.

In a 1992 audit (01099-2-Ch) of a similar dairy board, we reported deficiencies similar to those identified here, and AMS agreed to correct them. AMS agreed to discontinue retroactively approving contracts. That board had entered into contracts involving work done prior to AMS' approval. It was agreed that this was acceptable so long as there was no actual or implied obligation of the board prior to AMS' approval of the contract. That board's current procedure is to submit all of its contracts and subcontracts to AMS for review. We believe that AMS should use the same policy and procedures for overseeing the Fluid Milk Board.

The Board's first contract with MIF was for the period July 28, 1994, through December 31, 1996. This was the primary contract through which the Program would operate and AMS did not give its approval until 2 years and 8 months later. The Board signed this contract on August 26, 1994; MIF signed it on September 19, 1994. The Board did not obtain AMS' approval of this contract until April 16, 1997; this was after we had begun our audit and over 3 months after the contract had expired. Although the contract stated that, "MIF and Board agree that this Agreement shall become effective only upon the approval of this Agreement by the United States Department of Agriculture," AMS did not approve the contract until after we questioned whether the contract had been approved. By that time, the Board had paid MIF over \$3 million and MIF, in turn, had contracted with an advertising firm which had spent over \$123 million. AMS, the Board, and MIF were all aware that, according to the Act and the Order, no payments were permitted until AMS had approved the contract.

The subsequent contract between the Board and MIF for the period January 1, 1997, through December 31, 1998, was not signed by the Board until February 3, 1997, or by MIF until February 5, 1997. Again, AMS did not approve this contract until April 16, 1997, subsequent to the initiation of our audit.

Even though it did not have the authority to do so, MIF entered into an agreement with a major advertising agency to provide most of the Board's advertising, public relations, and research. The agreement between MIF and the advertising agency was effective on May 1, 1994, almost 3 months before the Board was seated on July 27, 1994, and almost 3 years before AMS post-approved the MIF contract on April 16, 1997.

MIF and the advertising agency entered into a subsequent agreement for the period July 1, 1996, through December 31, 1998. AMS post-approved this contract over 10 months later on May 8, 1997, and for a different period (July 1, 1996, through July 31, 1998). None of the \$123 million paid to the advertising agency should have been paid until AMS approved the contracts.

Other expenditures made prior to AMS' contract approval included payments to Person A's CPA firm, an attorney for the Board (Person C), and for promotional expenses.

We identified payments made for 108 contracts; however, neither AMS, the Board, MIF, nor IDFA could furnish us with copies of 37 of these contracts. We have no evidence to cause us to question the existence of the 37 contracts, many of which were for individual celebrities to be

photographed for the milk- mustache advertising campaign. We found celebrity photographs and other evidence that Program funds were expended for Program-related expenses; however, we could not locate the specific contracts. We believe the Board's inability to furnish the 37 contracts in question is further evidence of its lack of internal controls over contracting. Of the 71 contracts available for review, 33 were not signed by at least one of the contracting parties prior to the contracts' effective dates. AMS had not approved 68 of the 71 contracts we reviewed prior to the contracts' effective dates.

In its response to our Management Alert, dated May 6, 1997, AMS stated that it would direct the Board to cease payments for contracts, subcontracts, and agreements that had not been approved by AMS. AMS also stated that it would require that the Board submit all contracts and subcontracts for its review. This requirement was included in the AMS letter to the Board Administrator, dated August 15, 1997. However, on September 17, 1997, AMS agreed with a Board counterproposal that AMS' prior approval would only be required for nine contracts.

***Recommendation
No. 2a***

Require the Board to obtain AMS approval on all contracts, subcontracts, and agreements before any funds are obligated or expended.

AMS' Response

AMS agreed to revise its September 17, 1997, contract approval process to require that it review and approve all of the Board's contracts and subcontracts. Also, all of the Board's contracts and subcontracts are to contain language that no payments are to be made prior to Secretarial approval of the contract or subcontract. AMS did

not agree to require the Board to submit sub-subcontracts or purchase orders to AMS. AMS' target date is September 30, 1998.

OIG Position

We did not recommend that purchase orders be submitted for AMS' review and approval. However, we continue to believe that AMS should obtain and approve all contract documents (including contracts, subcontracts, sub-subcontracts, etc.) for this Board, just as it does for the dairy producers' board. AMS needs to develop criteria, based on the vulnerabilities, to determine the extent of the review which it will perform on each of the proposed contracts. To reach a management decision, AMS needs to provide us with its plan to implement a contract review and approval process which will ensure proper oversight of Board contracting activities.

Recommendation No. 2b

Require the Board to establish a contract control system that will ensure compliance with the Act, the Order, and AMS guidelines.

AMS' Response

AMS agreed with this recommendation and will work with the Board to develop a system to track contracts, subcontracts, and sub-subcontracts by September 30, 1998.

OIG Position

We agree with the proposed corrective actions. To reach a management decision, AMS needs to provide us with an outline or overview of the system and Board concurrence to implement the system.

***Finding No. 3
Contracts Did Not
Include Certain
Required Language***

- We reviewed 71 contracts and subcontracts and determined that 61 did not contain specific language required by the Act and the Order. Adequate oversight had not been provided by AMS or the Board to ensure that these specific

required terms and conditions were included in all contracts and subcontracts. Because the required language was not included in contracts, the Board did not obtain title to some assets developed with Program funds, records were not required to be made available for audit, and contractors were not informed that Secretarial approval was required prior to contract execution.

Section 1999H of the Act states that the Board's duties include entering into contracts and agreements with the approval of the Secretary. Section 1160.209(g) of the Order states that any such contract or agreement shall provide that the plan or project shall be adopted upon approval of the Secretary and that the Secretary periodically may audit the records of the contracting party. The guidelines for AMS oversight of commodity research and promotion programs, signed by the AMS Administrator on April 19, 1994, state that "* * * AMS will require boards to formally notify potential contractors that any work they undertake prior to contract approval by USDA is at their own risk, as boards are not financially liable if the contract is not approved by USDA."

Section 1160.505 of the Order states that any patents, copyrights, trademarks, or publications developed through the use of Program funds are the property of the U.S. Government as represented by the Board.

The Board's contract with MIF, and MIF's subcontract with the major advertising agency, contain the necessary language which states that the Board will take title of said assets, etc. However, the subcontract between the major advertising agency and the photographer did not have the necessary asset ownership language.

We addressed this issue in our Management Alert.

The Board has primarily used one photographer for the highly recognized milk-mustache advertising campaign. The contract allows for the Board to have the right to use one photograph taken during a photography session for 15 months. Any usage of that photograph after the 15-month period requires that the photographer receive an additional royalty. The “customary and usual” royalty which the photographer requires for such renewals is \$12,500 for 15 additional months.

About \$129,000 has been expended for renewing royalties on photographs for which the Board had not taken title. If the advertising agency’s contract with this photographer had contained the required language, the Board would have owned the photographs and no additional fee to the photographer would have been required. Person A’s CPA firm informed the Board of this deficiency in a 1995 compliance review; however, as of our audit fieldwork completion date, the Board still had not required that contracts be revised to ensure that the Board assumed its rightful ownership of these assets.

On August 15, 1997, the Agricultural Marketing Service (AMS) sent a memorandum to OGC asking them to review a revised contract being proposed for subsequent photography sessions. AMS asked OGC to review the proposed contract to determine if it was “legally sufficient.” OGC concurred that the revised contract was “legally sufficient.” In our discussions with OGC, we were told that “legally sufficient” means requiring the Secretary’s approval of budgets and contracts

before payment can be made and requiring that the Department have the authority to audit contractors' records. The question properly phrased to OGC would have been whether the proposed contract adequately addressed requirements in the Order that the Board must assume title of assets developed or acquired using Board funds. During our audit fieldwork, we concluded that the Board still has not taken control of assets developed with Program funds. The Board still has to pay royalties for photographs after 15 months of usage. The photographer still has control and possession of the photographs and negatives which were developed with over \$2.7 million of Program funds.

On February 10, 1998, OGC issued an opinion which stated that the photographs were owned by the photographer because the contract between the photographer and the advertising agency had no provisions regarding the Government's ownership of the property. If the contract for the photographs provided that the ownership of the photographs belonged to the Board, then the owner would not be the photographer. OGC further stated that the Board could negotiate away its rights to the property if it was in its interest to do so. We concluded that the contract with the photographer should have had language similar to language in the contract between MIF and the advertising agency, which provided that the Board would have ownership of the assets. Appropriate oversight by AMS would have noted the deficiency in this contract.

Audit Requirements

Although we were not denied access to any records at contractors or subcontractors, 57 of the 71 contracts, subcontracts, etc., we reviewed

did not contain language requiring that records be made available to USDA for audit. All contracts should contain the mandatory language.

Without the required language, contractors and subcontractors may not be aware that, without Secretarial approval, the Board is not authorized to pay expenses incurred under these contracts and subcontracts, and that their records are subject to review by USDA.

***Recommendation
No. 3a***

Require that contracts, subcontracts, etc., contain all provisions mandated by the Act and/or Order.

AMS' Response

Other than the ownership issue, AMS did not address the provisions mandated by the Act and/or Order, such as the access to records for audits and required Secretarial approval of all contracts.

OIG Position

To reach management decision, AMS needs to address all provisions mandated by the Act and/or Order, including Secretarial approval of the contracts and access to records by USDA.

***Recommendation
No. 3b***

Require the Board to obtain title and possession of all assets developed or acquired with Program funds.

AMS' Response

In response to Recommendation No 3a, AMS disagreed with the Report's interpretation as to the ownership of copyrights. To prevent further misinterpretation, the Board submitted a proposed change to the Order that would clarify the ownership issue. The public comment period on the proposed rule ended June 22, 1998, and AMS is preparing a final rule.

OIG Position

While AMS disagreed with this recommendation, its action taken in response to Recommendation No. 3a, preparation of an amendment to the Order addressing the ownership issue, resolves this issue. The proposed amendment will require that an agreement on ownership be reached between the contracting parties and included in the contract. However, this action was unnecessary because the OGC opinion dated February 10, 1998, states that the Board can negotiate ownership rights. To reach a management decision, AMS needs to provide its plan for assuring that it will require the Board to document said negotiations and that the results thereof will be included in its contracts.

Finding No. 4 Progress Reports Were Not Submitted and Expense Limits Were Exceeded

- The Board did not require contractors to provide deliverables specified in contracts and did not establish controls to prevent contractual expenditure limits from being exceeded. In addition, the Board's Administrator submitted and was paid for two claims for personal services that exceeded contract limits.

The guidelines for AMS oversight of commodity research and promotion programs, signed by the AMS Administrator on April 19, 1994, state that “* * * AMS will require boards to monitor contracts for compliance with all provisions.”

The Board's contracts with MIF required three specific reports: Monthly progress and performance reports, requests for the obligation of funds, and overall evaluation reports for each individual project administered by MIF. However, MIF did not submit these reports to the Board. These reports would enable AMS and the Board to evaluate the effectiveness of the projects and the progress being made on them.

The Board's contract with MIF also required that it provide secretarial support for the Board and its officers. Since MIF did not have any employees, it relied on IDFA employees to prepare and maintain the official minutes of Board meetings. The copy of the "official" minutes we obtained from the IDFA employee differed from the copy of the "official" minutes we obtained from AMS. From our review of the Board minutes provided to us, we could not determine which contracts and budgets the Board had approved. The Board Administrator told us that he was "reconstructing" the official minutes and that the reconstructed minutes would be available within "a couple of months." Given the passage of time and conflicts within the copies of minutes already prepared, we question how the Board's Administrator would be able to construct accurate Board minutes from a period prior to his appointment. Subsequent to the completion of our audit fieldwork, we were advised that the Board minutes would be recorded by the outside legal counsel and the official copy would be maintained by the Board's Administrator.

The Board's contract for its Administrator for the period August 30, 1996, through June 30, 1997, was for \$75,000, including expenses, for 9 hours of work per week. The Board's Administrator claimed and received two payments totaling \$14,381 in excess of the contract limits. These overpayments indicated that the internal controls were either inadequate or were not working. We brought these overpayments to the attention of AMS and the Board's Administrator. The Board's Administrator then requested, and the Board and AMS approved, a retroactive increase in the contract limit subsequent to the end of the contract period.

**Recommendation
No. 4a**

Establish controls to ensure that (1) the Board requires contractors to fully comply with contracts, (2) the Board does not allow contractors to exceed contractual budget limits, and (3) the Board requires submission of deliverables.

AMS' Response

AMS agreed with this recommendation. The Board has reviewed and revised its contract approval and payment system. Payments are made after a thorough review by the Board Administrator to ensure compliance. AMS has established a system to ensure compliance and receipt of deliverables. AMS also will require the Board to submit a report within 60 days to ensure provisions in contracts and subcontracts are being met.

OIG Position

We agree with the proposed corrective action. However, to reach management decision, we need to be advised of the specifics of the proposed plan for the Board's system to verify payments and deliverables. We also need more specific information on how AMS will review and test the Board's contract controls and not rely solely on self-certifications provided by the Board. The value of a one-time report prepared by the Board stating that provisions in its contracts and subcontracts are being met is not sufficient.

**Recommendation
No. 4b**

Discontinue retroactive approval of the Board's contracts, subcontracts, and amendments.

AMS' Response

AMS agreed that it will notify the Board that contracts, subcontracts, etc., should contain provisions indicating that any work performed prior to AMS' approval is at the risk of the

contractor. This is to be accomplished by September 30, 1998.

OIG Position

To reach a management decision, we need a copy of the AMS notification to the Board.

**Finding No. 5
Contract Terms Were
Not Being Met**

- Some Board contracts and subcontracts had provisions that were not being complied with. As a result of the material contract breaches, either party to the contracts could terminate them. Consequently, the Board might not be able to enforce contract terms, and important deliverables, advertising campaigns, and research analyses might not be provided.

MIF's subcontract with the advertising agency requires that MIF establish and maintain a reserve for the potential payment of an incentive commission of approximately \$350,000. This incentive commission was to be paid if milk sales increased over the previous year because of the advertising campaign. MIF has never paid an incentive commission and has never established such a reserve account. Similarly, the Board has not established a reserve account to reflect this liability.

MIF's contract with the Board requires that MIF pay its subcontractors and claim reimbursement from the Board. As these expenses increased, rather than paying the expenses and seeking reimbursement, MIF began submitting all invoices from the advertising agency directly to Person A's CPA firm for payment. The procedure changed again in 1997, at which point the advertising agency began sending its invoices directly to Person A's CPA firm, while submitting duplicates to MIF for approval.

**Recommendation
No. 5**

Require the Board to enforce contractors' compliance with the terms of their contracts.

AMS' Response

AMS did not address the issues developed in this finding.

OIG Position

We cannot reach management decision until AMS adequately addresses the establishment of the contingent liability and the payment of bills.

**Finding No. 6
The Board Used Sole-
Source Contractors
With No Evidence of
Other Contractors
Being Considered**

- The Board had not followed good business practices by competitively negotiating for contractual services. There was no evidence that the Board made an analysis to ensure that it was obtaining its contracted goods and services in the most cost-effective manner. For example, we found that a subcontract for the Board's advertising and public relations activities with a major advertising agency was let without competition. Of the Board's \$131 million in Program expenses, \$123 million (93 percent of Program expenses) was spent with this advertising agency. As a result, the Board may have overpaid for services and may not be obtaining the objective, professional opinions and services it expects to receive.

In a 1992 audit of another dairy board (01099-2-Ch), we reported that goods and services were being obtained without competitive bidding. We recommended that AMS ensure that the board obtain goods and services in the most cost-effective manner, and AMS agreed in principle with this recommendation.

The Board's largest contract is for MIF to handle its day-to-day operations. However, there is no evidence that the Board solicited bids, or considered other vendors for this service. Since

Program inception, the Board has paid MIF over \$3 million for its services. We believe the Board should have explored other options for obtaining these services rather than issuing a contract without competition.

We were recently advised that, according to the Order, the Board was required to select MIF to carry out Program functions during the initial fiscal period. Our review of the implementing regulations disclosed that they allowed, but did not require, the Board to select MIF for the initial 30-month fiscal period. The order required that if an organization such as MIF were selected, the Board had to determine that its selection was “practicable” and also obtain the approval of the Secretary. We found no evidence that an evaluation was done to determine whether the selection of MIF was practicable. In addition, the Board did not obtain the Secretary’s approval for its contract with MIF until April 16, 1997, which was after the initial fiscal period had expired. Even after the initial fiscal period, there is no evidence that the Board considered any other options for obtaining these services.

Most of the Board’s advertising and public relations activities (\$123 million) are handled by a large worldwide advertising agency. Again, we found no evidence that the Board considered any other advertising agency before this contract was executed or renewed. In June 1998, we were provided information which stated that the Board considered other advertising agencies before selecting the contractor used. The evidence provided was in the form of a letter on a dairy company letterhead to MIF dated March 15, 1991, discussing potential advertising agencies which MIF should consider. However, this is

irrelevant because the Secretary did not appoint the first National Fluid Milk Processor Promotion Board until June 6, 1994.

It was recently pointed out that Board minutes dated August 30, 1994, confirmed the Board's selection of the advertising agency. However, the minutes indicated that representatives from only one advertising agency were present and there is no documentation of cost data being presented for analysis. Those minutes indicate that the Board approved the advertising plans which the advertising agency had developed. No evidence was provided which showed that the Board considered awarding the advertising contract to other advertising agencies.

When the Board wanted to develop an Internet WEB site, the advertising agency had one of its wholly-owned subsidiaries develop the site. The advertising agency provided us with documentation that requests for proposals were sent to four prospective WEB site developers, including their own wholly-owned subsidiary. Three, including the subsidiary, responded. However, based on our review of the information provided, the advertising agency gave insider information to its subsidiary enabling it to be awarded the contract. It was clear that there was no competition for the contract. The advertising agency instructed its subsidiary, after the due date for submitting proposals and after the other prospective vendors submitted their proposals, on how much money was available and how to proceed to revise its initial proposal. (See exhibit E.) Further correspondence from the advertising agency to its subsidiary dated June 13, 1996, advised that, "We have \$225,000 in the budget that must cover all of (the

subsidiary's) professional time and out-of-pocket expenses for creating and maintaining the Web site during Phase 1 (launch), Phase 2 and Phase 3.” Essentially, the advertising agency set the contract amount.

The Board has three contracts (all of which have been renewed) with the Board's Administrator (Person A) and/or firms in which he has an interest. In addition to its contract for his services as Board Administrator, the Board has another contract with Person A's CPA firm for overseeing the collection of assessments and providing accounting services for the Board. Person A's CPA firm also has a contract to perform compliance reviews of the Board's major contractors: MIF, IDFA, and the major advertising agency. These close relationships raise questions about the independence of the various firms/organizations involved and whether the Board paid a fair price for the services obtained. We were not provided documentation which showed that the Board considered any other contractors to perform these services or that these fees were compared to fees charged by other firms.

***Recommendation
No. 6***

Require the Board to discontinue awarding sole-source contracts, subcontracts, etc., and establish guidelines for awarding contracts to ensure that competition is sought and that contracted goods and services are obtained in the most cost-effective manner.

AMS' Response

AMS agrees in principle with this recommendation and will notify the Board that it should document a competitive process to select contractors to carry out the program. The selection should be based on the Board's

judgment of costs versus benefits and of other relative factors and considerations, but will not be required to select the lowest bidder.

OIG Position

To reach a management decision, we need the AMS notification to the Board requiring a competitive process for contracts. The process must include documentation of selection criteria and require an explanation of cost and technical evaluation for awards.

***Finding No. 7
Financial Statements
Were Incorrect***

- The Board's financial services contractor presented financial statements that did not accurately reflect the Board's financial condition, and the Board's contract with its independent auditor did not require audits to be performed using generally accepted Government auditing standards (GAGAS). AMS required that the Board audit be performed using generally accepted auditing standards. AMS did not require that the audit include tests for compliance with laws and regulations.

The Board presented financial statements that did not reflect the actual financial condition of the Board. This was caused by misrepresentations made by the Board's financial services contractor, Person A. Had the Board disclosed in its statements that it was spending Program funds without the Secretary's approval, we question whether the readers of those statements would have let the Board continue to make payments without this approval. Had the independent auditor known that the Board had not secured AMS contract approval prior to making payments, it would have changed the results of its audit reports. Representatives of the independent auditor told us they would have

issued a qualified opinion or, at a minimum, they would have disclosed these irregularities.

The financial statements as of April 30, 1996, and as of March 31, 1995, contained material omissions and questionable statements that, in the aggregate, were significant enough to affect the decisions of its users, including the Secretary, members of the U.S. Congress, and milk processors. These financial statements were in the "USDA Report to Congress on the National Dairy Promotion and Research Program and the National Fluid Milk Processor Promotion Program," dated July 1, 1997, and July 1, 1996. Examples of material omissions and misleading statements include the following.

The contingent liability of over \$350,000 for the incentive commission due to the advertising agency was omitted from the balance sheet. (See Finding No. 5.)

The notes to the financial statements did not disclose the \$127 million in expenditures made without the Secretary's approval or any of the related-party transactions. (See Findings Nos. 2 and 6.)

In management representation letters dated June 8, 1995, and August 9, 1996, to the outside CPA firm, the financial services contractor (Person A's CPA firm) to the Board made questionable assertions regarding internal controls and compliance with the Act and the Order. He (Person A) asserted that:

The Board had complied with all aspects of contractual agreements that would have a material effect on the financial statements

in the event of noncompliance. However, although required by language within the contracts and/or the Act and the Order, we determined that AMS had not approved 68 of the 71 contracts available for our review.

No payments had been made which exceeded the AMS-approved contract amounts. However, we found the Board Administrator's contractual limit of \$75,000 for the period of August 30, 1996, through June 30, 1997, was exceeded in two consecutive months by a total of \$14,381.

All contracts contained the key elements required by the Act and the Order. We concluded that several key elements were omitted from contracts, such as USDA's right to audit contractor records and the requirement that expenses could not be paid prior to the Secretary's approval, etc. (See Finding No. 3.)

The Board did not require audits of its records to be performed using GAGAS; AMS did not require that audits be conducted using GAGAS. As a result, the audits did not reflect the actual financial condition of the Board.

Section 1999H(h)(2) of the Act requires the Board's books and records to be audited by an independent auditor at the end of each fiscal year and to submit the audit to the Secretary. Paragraph 1.1 of the 1994 revision of the Government Auditing Standards requires non-Federal auditors to comply with GAGAS when they audit Federal programs. These standards pertain to auditors' professional qualifications and the quality of audit effort. Paragraph 4.15 states

that auditors should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in the financial statements. Paragraph 4.18 states that the term “noncompliance” has a broader meaning than illegal acts. “Noncompliance” includes not only illegal acts, but also violations of provisions of contracts. Using GAGAS, auditors have the same responsibilities for detecting material misstatements arising from other types of noncompliance as they do for detecting those arising from illegal acts. Paragraph 4.19 states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material noncompliance with provisions of contracts.

None of the audits of financial statements issued since the inception of the Program have been performed using GAGAS. The Board contracted for audits of its financial statements for the fiscal periods ending June 30, 1997, April 30, 1996, and March 31, 1995; however it did not require that GAGAS be used. At the time of our review, we found no evidence that AMS had approved any of the audit contracts.

The Board’s agreement with Person A’s CPA firm to conduct compliance audits of the Board’s two largest contractors does not require that the audits be conducted using GAGAS, as they should. AMS approved these contracts on July 11, 1997, at a funding level not to exceed \$28,000. Person A’s firm conducted two contractor compliance audits in 1995 that also did not comply with GAGAS.

**Recommendation
No. 7a**

Ensure that the Board's audited financial statements are issued using GAGAS.

AMS' Response

AMS did not agree to reissue past financial statements under GAGAS, but agreed to have the Board's next financial audit conducted under GAGAS.

OIG Position

We agree with AMS' corrective actions to require the Board's next audit to be conducted using GAGAS. To reach a management decision, we need a copy of the notification to the Board that all future audits will be performed using GAGAS.

**Recommendation
No. 7b**

Establish controls to ensure that future management representation letters addressed to outside CPA firms correctly state the status of the Board's financial, contractual, and legal position.

AMS' Response

AMS agreed to this recommendation by requiring that the Board's Chairman and Administrator both sign the management representation letters to CPA firms regarding the Board's financial, contractual, and legal position. In addition, AMS will request copies of such letters for review.

OIG Position

We agree with AMS' proposed corrective actions. To reach management decision, AMS needs to provide us with the notification to the Board establishing this requirement.

**Recommendation
No. 7c**

Require the Board to ensure that contractor compliance audits are conducted using GAGAS.

AMS' Response

AMS agreed to this recommendation by advising the Board Chairman and the Board Administrator that a GAGAS audit will be required for the fiscal year ending June 30, 1998. AMS also is

reviewing its policy requiring audits for all research and promotion boards.

OIG Position

AMS agreed that it would require that its fiscal year 1998 audit be performed using GAGAS; however, it did not address the issue of compliance audits being performed using GAGAS. To reach management decision AMS needs to provide us with a copy of its notification to the Board establishing this requirement for all future compliance audits.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT



United States
Department of
Agriculture

Agricultural
Marketing
Service

P.O. Box 96456
Washington, DC
20090-6456

TO: James R. Ebbitt
Assistant Inspector General for Audit
Office of Inspector General

FROM: Enrique E. Figueroa, Ph.D. July 24, 1998
Administrator

SUBJECT: Response to Official Draft OIG Audit Report No. 01001-3-Ch, National Fluid
Milk Processor Promotion Program, July 10, 1998

This memorandum provides the response of the Agricultural Marketing Service (AMS) to the official draft audit report (Report) on the audit of the National Fluid Milk Processor Promotion Program (Fluid Milk Program). As you will see, we agree with most of the recommendations, though in some cases we propose alternative actions. AMS has taken action and in this response pledges additional steps to ensure the proper oversight of the National Fluid Milk Processor Promotion Board (Board).

AMS has already implemented changes in response to your May 1997 Management Alert (Alert). Without question, the Alert exposed problems with the oversight of the Board, including the fact that AMS failed to approve certain contracts of the Board. Since that Alert, AMS has changed personnel in charge of oversight, imposed a new contract approval process, and worked with the Board to restructure the management of Board activities.

1. AMS Oversight.

AMS provides oversight of the Board activities. Laying the foundation for the Board's expenditures for its various programs, the Board submits to AMS its budget and program plans annually including detailed project descriptions and authorization requests for review and approval. AMS reviews and approves all budgets as well as any amendments. Additionally, the contract approval process established on September 17, 1997, dictates how AMS approves and monitors contracts. By reviewing the billings, books, records, and subcontracts at the offices of the Board Administrator and other Board contractors, AMS monitors expenditures to ensure that contracts are executed properly.

The Board has increased the responsibilities of its Administrator including more responsibility in the contract approval process, preparation of meeting minutes, and overall administrative and managerial matters. The Board has retained its own outside counsel to assist in contract development and compliance by contractors with contract provisions. Board members are now more engaged in day-to-day operations. Meetings were extended from 1 day to 2 days, and standing committees now meet sequentially instead of concurrently. This allows Board members to attend each committee meeting and to stay better informed. Also during Board meetings, the Board schedules private meetings with its Administrator, legal counsel, and the USDA

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

2

representative, without contractors present, to review Board issues and policies. The Board also changed audit firms from a small certified public accountant (CPA) firm to one of the larger CPA firms familiar with the regulatory requirements of research and promotion programs.

NOTE
A

To satisfy the concerns of the OIG, AMS will institute additional changes. The Board will hire a full-time administrator to oversee the entire program, addressing the Report's concerns regarding structure. Additionally, while the audit uncovered no instance of checkoff monies funding lobbying, AMS will request that all Board contracts and subcontracts identify registered lobbyists and organizations that have registered lobbyists that would be utilized as a resource on the contract/subcontract. AMS will permit the Board to contract with lobbyists and their organizations only if they consent to examination of their records to ensure that no checkoff funds are used for lobbying.

NOTE
B

Throughout the audit process and in particular since the Alert, AMS has repeatedly informed the OIG of changes instituted to address the OIG's concerns. Nevertheless, the initial Report truncates its review 1 month after the Alert. We wonder why the OIG was seemingly uninterested in evaluating current oversight and judging both current practices and the adequacy of AMS' reaction to the Alert. The second draft of the Report does note these changes, but continues to base many of its recommendations on past practices. Because a Management Alert is to spark action, it is disappointing that the Report does not fairly evaluate the responses taken by AMS and the Board.

2. The Report Is Based on Misinterpretation of Law and Mis-readings of Fact.

NOTE
C

The Report criticizes the Board for not owning the photographs taken by a renowned photographer. However, a legal opinion from the Office of the General Counsel (OGC) (Tab 1) states that Federal copyright law holds that the Board owns the copyright to the advertisement while the artist retains the copyright to all photographs. Though AMS has repeatedly shared this opinion with the OIG, the Report steadfastly avoids this conclusion. When the law is correctly interpreted, the Board contracted for exactly what it wanted and what it got -- photographs to use in its milk mustache advertising campaign.

Instead of acknowledging that the photographer retains ownership of the photographs, the Report simply states the truism that had the Board contracted to purchase the rights to the photographs, it would have owned them (*Report at 24*). The Report never reveals why the Board should purchase what it does not need. Any contract to purchase full title would have had an added cost; in this case, the photographer has never relinquished the copyright on her photographs so an exact dollar estimate of the added cost is not possible. The Board simply bought what is needed to produce the advertisement. In the end, the Report simply disagrees with a business judgment of the Board, asserting in effect that the Board should have paid more money to the photographer to produce the same advertising campaign.

Based on its erroneous conclusion that the Board owns the photographs, the Report then makes a series of findings, such as understating the Board's assets, overstating the Board's expenses, and mis-classifying assets as expenses. Similarly, the Report misinterprets the statutory language on approving contracts, suggesting a magnitude of failure that is not there. Admittedly, AMS failed to review certain contracts. However, though the statute only requires the Secretary to approve

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

3

the contracts of the Board, the Report faults AMS for not approving all contracts between contractors and subcontractors and even further down the chain to sub-subcontractors. Only with this extra-legal counting may the Report reach its total number of unreviewed contracts.

NOTE
D

The Report also claims to have found no evidence that AMS or the Board separately evaluated the effectiveness of its programs (*id.*, at 9). In this regard, it is important to note that the statute that requires evaluation also mandates that it be "carried out . . . in conjunction with the evaluation of the National Dairy Promotion and Research Board . . ." (Fluid Milk Promotion Act of 1990, as amended (Act), 7 U.S.C. Section 6407(m)). Additionally, the Economic Research Service (ERS), which evaluates the effectiveness of the fluid milk advertising of this Board and the National Dairy Promotion and Research Board, has stated that it is impractical to segregate the two programs promoting fluid milk consumption. AMS provided this letter (Tab 2) to the OIG. The Report also ignored the third-party evaluations the Board has initiated.

NOTE
E

Similarly, the Report claims that the Board failed to seek bids for its web site, despite the 1997 memorandum (Tab 3) the Board provided the OIG detailing its solicitation and evaluation of bids, and the Report's discussion of sole-source contracting seems to assume that the Federal

NOTE
F

Acquisition Regulations apply to promotion programs. In response to our inquiry on the subject, OGC has provided a legal opinion (Tab 4) stating that as a matter of law, promotion programs are not bound by these restrictions. This OGC opinion was made available to OIG.

NOTE
G

AMS' changes to its oversight of the Board combined with its repeated attempts to correct the Report's misstatements demonstrates the Agency's commitment to strong oversight and an accurate, dispassionate review of AMS activities. Our criticisms of the Report do not suggest we dismiss the substance of the audit, nor the duty to assure checkoff funds are spent legally. Indeed, our request for this audit and actions taken since the Management Alert demonstrate our commitment to strengthen oversight. However, by ignoring changes that have occurred since the issuance of the Alert, by misstating legal and factual issues, and by extrapolating from unsupported assertions, the draft Report paints an inaccurate portrait of the Board as well as of AMS' oversight.

3. Responses to individual recommendations.

Recommendation 1a:

Suspend Board activities until AMS and the Board jointly develop a plan for restructuring its management of Board activities.

Agency Response:

We do not agree with this recommendation. Had AMS not acted after receiving the Alert or if OIG had found misuse or abuse of Board resources, perhaps this would be an appropriate recommendation. However, AMS and the Board have jointly developed a plan for restructuring management of the Board's activities.

AMS continues to work closely with the Board to change the current management structure. The issues raised by OIG require action on behalf of the Board with input from AMS as to an acceptable management structure. At the July 8-9, 1998, Board meeting, the Board passed a

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

4

resolution authorizing the Executive Committee to hire a full-time employee of the Board to oversee all activities. The details of this arrangement will be finalized within 60 days.

AMS will discuss with the Board an in-depth focused audit by a CPA firm on the Board's internal control system. We believe this review would be extremely useful in helping the Board define the best possible structure and the appropriate division of functions between contractors, Board staff, and the Board itself. Such a review would give the Board and USDA the confidence we need in the controls over the Board's activities.

In response to the concerns expressed in the Report about the Milk Industry Foundation (MIF) not having employees, AMS will request the Board to terminate all MIF contracts within 120 days and replace them with contracts with an organization(s) that will directly carry out program activities.

As a result of the lobbying issues raised in the Report, AMS will request that all Board contracts and subcontracts identify registered lobbyists and organizations that have registered lobbyists that would be utilized as a resource on the contract/subcontract. AMS will permit the Board to contract with lobbyists and their organizations only if they consent to examination of their records to verify that no checkoff funds are used for lobbying.

AMS and the Board took the OIG Alert very seriously and immediately began the implementation of changes to address the points raised. AMS' actions included:

- AMS appointed a new Branch Chief for the Promotion and Research Branch, which oversees the Fluid Milk Program, immediately after receipt of the Alert during May 1997.
- AMS conducted an updated training/orientation session at the July 1997 Board meeting. This session included presentations by the OGC and AMS' Compliance Staff about the regulatory "do's and don'ts" of the Board.
- AMS approved a new contract review process on September 17, 1997 (Tab 6). Under this process, AMS reviews and approves all Board contracts and certain subcontracts. Contracts below the subcontract level are kept at the Board Administrator's office and reviewed periodically by AMS.
- AMS asked for and received an OGC written opinion (Tab 1) concerning the Board's ownership of certain property developed with Board funds. In addition, to address OIG's concern that the independent analysis of the effectiveness of milk promotion was inadequate, AMS discussed with ERS and received a letter (Tab 2) concerning the possibility of separately analyzing the two dairy promotion programs.
- AMS has reviewed all Board minutes as kept by the Board's Administrator. These minutes are complete from the inception of the program.

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

5

Board actions included:

- The Board members are now more engaged in day-to-day operations. Meetings were extended from 1 day to 2 days, and standing committees now meet sequentially instead of concurrently. This allows all Board members to attend each committee meeting and to stay better informed.
- The Board changed audit firms from a small CPA firm to a larger CPA firm familiar with the regulatory requirements of research and promotion programs.
- The Board's program contractor resumed, in March 1998, its monthly report on activities. This report is provided to all Board members, the Board Administrator, and USDA.
- The Board has submitted all budgets and budget amendments for approval.
- The Board now requires that final versions of the minutes of its meetings be signed by its secretary.
- The Board has reviewed its internal billing structure and addressed the issues raised in the Alert and the Report.

Target date for the management structure change, MIF contract changes, and in-depth internal control review: December 31, 1998.

Recommendation 1b:

Require the Board to determine the effectiveness of its promotion and research activities in increasing fluid milk consumption.

Agency Response:

NOTE
H

We agree that the Fluid Milk Promotion Act of 1990, as amended (Act), requires an independent evaluation of the effectiveness of the fluid milk promotion program, but we disagree that this is not currently done. In making this recommendation, the Report misconstrues the law and the opinion of the ERS (Tab 2). First, despite the Report's criticism, the statute mandates that this evaluation occur in conjunction with the evaluation of the producer funded dairy promotion program. Second, it is the opinion of ERS which (1) has experience in evaluating advertising and promotion programs, (2) has knowledge of the econometric models and data available to evaluate advertising programs, and (3) has evaluated dairy advertising programs since 1988, that it is not practical (given current resources) to evaluate separately the effects of the two programs.

In sum, since the inception of generic dairy advertising under the producer funded dairy promotion program and fluid milk advertising under the Fluid Milk Program, generic advertising for fluid milk and dairy products has been the subject of annual independent evaluations (Tab 5 for the most recent evaluation).

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

6

Nonetheless, recognizing the importance of evaluation and desiring to fulfill our legislative mandate to evaluate properly the effectiveness of promotion programs, AMS, with assistance from the Board, will develop a request for proposals to consider new or revised methodologies for evaluating the effectiveness of the advertising campaigns conducted by the Board. This will include the feasibility of separately evaluating the programs of the Board and the producer funded dairy promotion program.

Target date for evaluation contract: February 27, 1999.

Recommendation 2a:

Require the Board to obtain AMS approval on all contracts, subcontracts, and agreements before any funds are obligated or expended.

Agency Response:

We require the Board to obtain AMS approval on all of its contracts, as required by law. In addition, we will require all subcontracts to be approved by AMS. In the past, AMS failed to approve certain Board contracts in a timely fashion. Since the OIG audit ended shortly after the issuance of the Alert, the Report does not reveal the extensive changes made to the contract approval process.

NOTE
I

The review and approval of Board budgets, program plans, and project descriptions by AMS lays the framework for the program and administrative expenditures. The contract approval process further formalizes the budgetary process to implement the approved campaigns and projects of the Board. Contracts in which the Board is a party now are submitted to AMS for review and approval prior to the contract becoming effective. Such contracts state that the agreement shall become effective upon the approval by USDA. Subcontracts, MIF/IDFA contracts for resources, as identified in the September 17, 1997, approval process, are sent to AMS for approval. All contracts, subcontracts, and sub-subcontracts are reviewed, approved, and retained by the Board Administrator. Copies of all purchase orders and invoices are maintained on file in the Board Administrator's office.

While AMS now approves all contracts and some subcontracts of the Board, AMS questions the Report's assertion that the law requires AMS' approval of contracts of contractors and subcontractors. The statute requires AMS to approve contracts of the Board and we will be approving all contracts of the contractors. To reach below those subcontracts and approve contracts of subcontractors, would require the submission and approval of approximately 3,000 sub-subcontracts, sub-sub-subcontracts and purchase orders per year. A requirement that all of these contracts be submitted to AMS for review and approval prior to the activity would so hamper the implementation of the program that it would be unable to function. The process agreed to by AMS and the Board provides access by AMS to all of the agreements and a record of all purchase orders and magazine-insertion orders on file with the Board Administrator. AMS has a process for examining the files at the Administrator's office.

NOTE
J

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

7

AMS will revise its September 17, 1997, contract approval process with the Board to require that, in addition to all Board contracts, all contracts of the Board's contractors be reviewed and approved by AMS. As with contracts, these subcontracts will be required to contain language stating that prior to approval of the Secretary no payments will be made to contractors.

Target date: September 30, 1998.

Recommendation 2b:

Require the Board to establish a contract control system that will ensure compliance with the Act, the Order, and AMS guidelines.

Agency Response:

As discussed above (Recommendation 2a), the issue has been addressed, but not recognized by OIG in its Report. We agree with this recommendation. The contract approval process approved by AMS on September 17, 1997, fulfills this recommendation.

The Agency will work with the Board to develop an adequate tracking of contracts and subcontracts, sub-subcontracts, etc., awarded by the Board. A contract numbering system will be established by the Board with sufficient detail that program officials, either Board or USDA, can track the relationship of all contracts, subcontracts and expenditures of funds collected by the Fluid Milk Program.

Target date: September 30, 1998.

Recommendation 3a: (Same as Recommendation 5a)

Require that contracts and subcontracts contain all provisions mandated by the Act and/or Order.

Agency Response:

NOTE
K

We agree that all contracts and subcontracts must contain the provisions mandated by the Act and the Fluid Milk Promotion Order (Order). AMS -- and OGC -- disagree with the Report's interpretation of the legal mandates. We disagree with the assertion by OIG that the Board has inappropriately handled the ownership of the photographs prepared for the program. Even though the OGC opinion was provided to OIG well in advance of releasing the Report, OIG has chosen to disregard it.

To prevent future misinterpretation, the Board has submitted a proposed change to the Order that would clarify the ownership issue. The proposed change would add a paragraph to Section 1160.505 that states, "Should patents, copyrights, inventions, or publications be developed through the use of funds collected by the Board under this subpart, and funds contributed by another organization or person, ownership and related rights to such patents, copyrights, inventions or publications shall be determined by the agreement between the Board and the party contributing funds towards the development of such patent, copyright, invention, or publication in a manner consistent with paragraph (a) of this section. The Board may dispose of

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

8

property for good cause and with the approval of the Secretary." The public comment period on the proposed rule (Tab 7) ended June 22, 1998. AMS is preparing a final rule.

Implementation of contract approval process: September 17, 1997.

Target date for order amendment: August 31, 1998.

Recommendation 3b:

Require the Board to obtain title and possession of all assets developed or acquired with Program funds.

Agency Response:

We disagree with this recommendation, choosing instead to follow the law which states: "Any patents, copyrights, trademarks, inventions, or publications developed through the use of funds collected under the provisions of this subpart are the property of the United States Government..." 7 C.F.R. Section 1160.505. The audit, in fact, determined that all "patents, copyrights, trademarks, inventions, or publications" paid for with Board funds remained the property of the Board.

NOTE
L

The Report attempts to exchange "assets" for the carefully crafted language of the law. Immediately after citing the Order language quoted above, the Report states that "according to the provisions in the Order, the Board is required to take title to all assets developed or acquired with Board funds." (Emphasis added.) Clearly, the term "asset" expands the regulatory language. For example, the Report criticizes the expenditure of \$129,000 for royalties for

NOTE
M

photographs to which the Board had not taken title (*id., at 24*). While the Report claims that the Order requires the Board to do so, such photographs are neither patents, copyrights, trademarks, inventions, nor publications. OGC has issued an opinion on this issue, yet the Report ignores this finding (Tab 1).

Recommendation 4a: (Same as Recommendation 5b)

Require the Board to establish controls to ensure that contractors fully comply with contracts, including contractual budget limits and the submission of required deliverables.

Agency Response:

We agree and the Board has taken action to implement the recommendation as noted in the response to Recommendation 1a. The Board has already reviewed and revised its entire contracting approval and payment system. Payments are not being made without a thorough review of the submitted invoices by the Board Administrator to ensure compliance with the terms of the contract. AMS has set up a system to verify payments and deliverables. In addition, payments to the Board Administrator are now being signed by the Board Treasurer who is monitoring compliance with the Board Administrator's contract.

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

9

To verify that contract controls are working, AMS will request the Board to submit a report within 60 days to ensure that all provisions in contracts and subcontracts are being met including deliverables, contractual budget limits, monthly reports, authorization requests, etc.

Target date: September 30, 1998.

Recommendation 4b:

Discontinue retroactive approval of the Board's contracts, subcontracts, and amendments.

Agency Response:

AMS agrees that the Board or Board contractors should not obligate or expend funds prior to AMS approval of projects and contracts. We do not believe, however, that the Board should be precluded from entering into contracts that may involve work performed prior to AMS' approval of the contract so long as there was no obligation by the Board to pay for such work. The Report seemingly approved of this by quoting from a previous OIG report (*id.*, at 19-20).

AMS, once again, will notify the Board that the contract approval process will require that all contracts and subcontracts should contain a provision indicating that any work performed prior to approval is at the risk of the contractor.

Target date: September 30, 1998.

Recommendation 5a: (Same as Recommendation 3a)

Require the Board to ensure that contracts and subcontracts are written in accordance with the Act and the Order.

Agency Response:

We agree to require that the Board ensure that contracts and subcontracts are written in accordance with the Act and the Order. We will work with the Board to revise the contract approval process approved on September 17, 1997, to require AMS' approval of all contracts and subcontracts including a provision in those documents stating that work performed prior to AMS approval is at the contractors' risk. Almost all contracts submitted by the Board contain standard language that has been reviewed by the OGC for legal sufficiency. AMS submits all contracts that contain language that differs materially from previously approved language to OGC for review.

NOTE
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Target date for revising the contract approval process: September 30, 1998.

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

10

Recommendation 5b. (Same as Recommendation 4a)

Require the Board to enforce contractors' compliance with the terms of their contracts.

Agency Response:

We agree and the Board has taken action to implement the recommendation as noted in the response to Recommendation 1a. The Board has already reviewed and revised its entire contracting approval and payment system. Payments are not being made without a thorough review of the submitted invoices by the Board Administrator to ensure compliance with the terms of the contract. AMS has set up a system to examine payments and deliverables.

To assure that contract controls are working, AMS will require the Board to submit a report within 60 days to ensure that all provisions in contracts and subcontracts are being met including deliverables, contractual budget limits, monthly reports, authorization requests, etc.

AMS will require the Board to submit a report within 60 days concerning contractors compliance with all provisions of contracts and subcontracts including compliance with invoicing and payment provisions.

Target date: September 30, 1998.

Recommendation 6:

Require the Board to discontinue awarding sole-source contracts and subcontracts and establish guidelines for awarding contracts to ensure that competition is sought and that contracted goods and services are obtained in the most cost-effective manner.

Agency Response:

AMS agrees in principle with this recommendation.

According to an OGC opinion (Tab 4), the Federal Acquisition Regulations do not, as a matter of law, apply to research and promotion boards.

AMS will notify the Board that it should use and document a competitive bidding process to select contractors to carry out its programs. Selection should be based on the Board's judgment of costs versus benefits and of other relative factors and considerations. This decisionmaking process should be supported by documentation. The Board will not be obligated to select the lowest bidder. In addition, the Board should include language in its contracts requiring contractors to use documented competitive bidding, to the extent practicable, when obtaining services and resources.

Target date: September 30, 1998.

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

11

Recommendation 7a:

Ensure that the Board's most recent audited financial statements are correct and issued using GAGAS.

Agency Response:

AMS will not require the Board to reissue past financial statements under generally accepted government auditing standards (GAGAS). However, we agree to have the Board's next financial audit conducted under GAGAS. In this regard, we do not believe that there is a legal requirement that the Board's audit must be a GAGAS audit. Paragraph 1.1 of the 1994 revision of the Government Auditing Standards states, "This document contains standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations. These standards, often referred to as GAGAS, are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. The standards pertain to auditors' professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports." (Underlines added for emphasis.) Paragraph 1.1 does not apply to the Board. The Board's law does not require a GAGAS audit. The Board's Order specifically states a generally accepted auditing standards audit, not a GAGAS audit, which is consistent with AMS policy.

The OIG indicates that the financial statements included material omissions and misleading statements. As an example, they cite the fact that \$2.7 million in photographs and negatives from the program were omitted from the balance sheet. This is the \$2.7 million relating to the ownership of the photographs and negatives taken by the photographer, discussed in detail above. OIG has assumed that the Board should have "owned all of that property," and therefore its omission from the financial statement was misleading. Because OIG's premise is incorrect, its conclusion is incorrect as well. The Board owns the copyrights to the ads which incorporated the selected photographs. Because the Board received what it paid for -- no more, no less -- it has complied with the Act and Order, and there is no material omission from the financial statements.

NOTE
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OIG also has identified the failure to include a separate contingent liability of \$350,000 for an incentive commission due to the advertising agency. The Board during the period of time in question maintained a reserve of \$1.5 million -- far in excess of the amount needed for this contingent liability. Furthermore, the Board has not made any payments pursuant to this incentive provision.

OIG also asserts that the financial statements did not disclose the fact that \$127 million in expenditures were made without the Secretary's approval. While it is true that AMS did not approve this Board contract in a timely manner, it is also true that the proposed expenditure of these funds was included in the Board's budget which was approved by AMS.

Target date for completion of the next audit: October 15, 1998.

Recommendation 7b:

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT A - AMS' RESPONSE TO THE DRAFT REPORT

12

Establish controls to ensure that future management representation letters addressed to outside CPA firms correctly state the status of the Board's financial, contractual, and legal position.

Agency Response:

NOTE
P We agree. However, once again, the Report fails to recognize actions taken to implement this recommendation (as specified in the Agency Response to Recommendation 1a), which also was part of the Alert issued more than a year ago.

In the future, AMS also will require that the Board's Chairman and Administrator both sign the management representation letters to CPA firms regarding the Board's financial, contractual, and legal position. In addition, AMS will request copies of such letters for review.

Target date: September 30, 1998.

Recommendation 7c:

Require the Board to ensure the audits of its books and records, and its contractor compliance audits, are conducted using GAGAS.

Agency Response:

AMS has advised the Board Chairman and Administrator that a GAGAS audit will be required for the fiscal year ended June 30, 1998.

AMS policy requiring audits for all research and promotion boards remains under review.

Implementation date: July 8, 1998.

Attachments

cc: Michael V. Dunn
Assistant Secretary, Marketing and Regulatory Programs

See exhibit B for OIG's comments relating to Notes A-P.

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

Following are excerpts from AMS' written response (italicized) which OIG feels compelled to address. (The AMS response is in exhibit A. Because they were so voluminous, we did not include copies of all of the attachments provided with AMS' response.) The notes below correspond to the marked sections in exhibit A.

NOTE A: *"To satisfy the concerns of the OIG, AMS will institute additional changes."*

AMS should not institute changes simply to satisfy OIG. Any changes AMS makes should be to assure that the Program is operated in conformity with the requirements of the Act and the Order. Concerns expressed by OIG evolved from AMS' and the Board's nonconformity with requirements in the Act and the Order.

NOTE B: *"Throughout the audit process and in particular since the Alert, AMS has repeatedly informed the OIG of changes instituted to address the OIG's concerns. Nevertheless, the initial Report truncates its review 1 month after the Alert. We wonder why the OIG was seemingly uninterested in evaluating current oversight and judging both current practices and the adequacy of AMS' reaction to the Alert. The second draft of the Report does note these changes, but continues to base many of its recommendations on past practices. Because a Management Alert is to spark action, it is disappointing that the Report does not fairly evaluate the responses taken by AMS and the Board."*

Our audit report, conclusions, and recommendations, by necessity, must reflect the results of our audit testing. We acknowledged unconfirmed corrective actions reported to have been taken, when appropriate.

We did not end our review 1 month after the Alert. Our audit covered the period December 1993 through June 1997; however, our fieldwork continued for several more months. We have recognized changes reportedly made by AMS which we reported as unverified. We have requested many documents which would have had an impact on our audit report; however, these documents have not been provided. We requested eight items from the Board Administrator on June 23, 1997, however, he still has not provided those items. These items included: Program evaluations

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

performed by MIF from 1994 through 1997; authorization request forms from 1994 through 1997; and monthly summary reports of the services provided by MIF from 1994 through 1997. The Board Administrator also has not provided us with documents we requested on June 27, 1997: (1) The officially approved minutes of Board meetings and (2) justification of the costs for the photography sessions and for the development and maintenance of the Board's Web site. Although an official of the Board Administrator's office advised us that all requested items would be provided as soon as possible, we still have not received them. The Board Administrator had an obligation to us to either provide the documents we requested or to advise that the documents did not exist; he did neither.

AMS makes the point throughout its written response (Exhibit A), and in previous meetings held to discuss the audit results, that we did not properly reflect corrective actions taken as a result of our Management Alert, which was issued in May 1997. We acknowledged many actions reportedly made by AMS on pages 5 and 6 and in other places throughout our report.

One of the actions AMS reportedly made in response to our Management Alert, which we recognized, was a change in AMS personnel. During our audit, AMS did make a personnel change; however, when we asked the reason for the change, officials told us that the change was unrelated to our audit. Given the contradictory statements AMS officials have made, we still do not know why changes in personnel were made.

We also acknowledged that a new contract review process had been implemented; however, with the information provided, we were unable to fully assess what the review process is. For example, in response to our Management Alert, AMS agreed on May 19, 1997, to " * * * require that the Board submit all contracts and subcontracts to the Department for review." AMS revised its policy again on September 17, 1997, which included a review and approval of about 9 contracts. In its July 24, 1998, response to our official draft report, AMS stated that it " * * * will revise its September 17, 1997, contract approval process with the Board to require that, in addition to all Board contracts, all contracts of the Board's contractors be reviewed and approved by AMS." We agreed with the change AMS made in

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

response to our Management Alert; however, we advised AMS that we did not agree with the changes made on September 17, 1997. We also disagree with the proposed revision, as stated in AMS' July 24, 1998, memorandum, because it does not include all contracts, subcontracts, sub-subcontracts, etc., which obligate Program funds.

We asked for the officially approved minutes of Board meetings on June 27, 1997, and were told that they would be provided as soon as possible. During the audit we observed two separate sets of Board minutes which contained conflicting information. The Board Administrator advised us that he was "reconstructing" the Board minutes and that he would provide us copies within a few months. We have not acknowledged corrective action taken in this area because we still have not received the copies which AMS advised us they have reviewed. We question how AMS can know that the minutes are accurate and complete when the copies AMS provided to us conflicted with copies provided by Board officials.

Other unconfirmed actions taken or proposed include: Hiring a full time employee (Board Administrator), increased time and responsibilities for the current part-time Administrator, revised contracting requirements (language and approval), and revised methods regarding preparation of minutes of Board meetings.

NOTE C: *"The Report criticizes the Board for not owning the photographs taken by a renowned photographer. However, a legal opinion from the Office of the General Counsel * * * states that Federal copyright law holds that the Board owns the copyright to the advertisement while the artist retains the copyright to all photographs. Though AMS has repeatedly shared this opinion with the OIG, the Report steadfastly avoids this conclusion. When the law is correctly interpreted, the Board contracted for exactly what it wanted and what it got--photographs to use in its milk mustache advertising campaign."*

The real issue here is that, because of the lack of proper oversight by AMS and the Board, a sub-subcontract with a photographer was written so that the Board's interest in the copyrights on the photographs to be produced was not properly

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

protected. The Board's contract with MIF properly addresses property ownership, as does MIF's contract with the advertising agency. However, the advertising agency's contract with the photographer did not expressly provide that the photographs would be considered "work made for hire" nor that the Board would own copyrights to the photographs produced. Because of these contract irregularities, the photographer owns the copyrights to the photographs. The contract for the photographer contained all of the key elements of a "work made for hire." According to the OGC opinion, whenever there is a "work made for hire," the contractor can reserve for itself the copyrights to works produced. Had the contract with the photographer been written correctly, the Board would have owned the copyrights to the photographs.

We did not disregard OGC's opinion. It is evident that the opinion says that, as the contract was written, the photographer owns the copyrights to the photographs.

The February 10, 1998, OGC opinion states that " * * * the agreement with (the photographer) did not expressly provide that the photographs would be considered a 'work made for hire.' If (the photographer) and the Board (through its advertising agency), had expressly provided that the photographs were to be 'work made for hire,' then the copyright to them would not automatically belong to (the photographer)." If the photographer and the Board (through MIF and the advertising agency) had expressly agreed that the Board would own the copyright to the photographs, the Board would not have had to pay the additional royalty rights totaling \$129,000 for the use of the photographs. This is a classic example of why AMS must oversee the entire contracting process. Had the advertising agency's contract with the photographer been properly written, in compliance with the contracts between the Board and MIF, and between MIF and the advertising agency, then the Board would have owned the copyrights to the photographs.

We also question why the Board did not enforce its contract with MIF regarding property ownership. This contract, for the period of July 28, 1994, through December 31, 1996, and renewed through December 31, 1998, states that, "Ownership of materials or assets acquired with Board funds shall be the property of the Secretary of Agriculture as represented by Board and MIF shall take

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

reasonable steps to protect that ownership.” MIF did not fulfill its contractual responsibilities to the Board by taking the steps necessary to protect the Board's interest in the copyrights to the photographs. We also question why the Board's legal counsel is not pursuing legal action against MIF because of its failure to properly protect the Board's interest in the copyrights.

The OGC opinion also stated that the Order does not limit the Board's “* * * ability to contract away any of its rights to the property that it does not own. This means that the government may, in its negotiations, transfer to the contractor any or all of its patents, copyrights, inventions, trademarks and publications, if it is in the government's interest to do so.” There is no evidence of any negotiations for the ownership of copyrights to the photographs.

AMS raised the issue that, had the Board wanted to own the copyright to the photographs, there would have been an extra cost. Although we repeatedly asked for evidence of negotiations as to the ownership of the copyrights to the photographs, neither AMS, the Board, nor Board contractors provided such evidence. Because of this, we do not understand how AMS can now conclude what the photographer would have charged if the contract had specified that the Board would retain ownership of the copyrights. In our opinion, the photographer owns the copyrights to the photographs because AMS and the Board failed to meet their responsibility to the milk processors who fund this program.

We consulted with others in the dairy advertising industry about the costs involved with these photography contracts. Those officials advised that the photography costs were very high and that, considering the unusually high cost of the professional fees paid to this photographer, they felt that, had the Board negotiated effectively, it could have obtained ownership rights to the copyrights. We do not agree with AMS' statement that the Board really “* * *bought what is needed to produce the advertisement.” If it had, why did it later pay additional royalty rights totaling about \$129,000?

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

Furthermore, the Board Administrator, under his CPA firm's contract with the Board to perform contract compliance audits, notified the Board Treasurer in a report dated July 13, 1995, that "***the agreement with the photographer was not signed. *** Also, we noted that the photographs are owned by the photographer, pursuant to the terms of Section 14 of the Agreement. This provision appears to violate the terms of the Act and the Order." This same 1995 report further states, "We were unable to determine if the agreements were reviewed/approved by the United States Department of Agriculture." The recommendations in this 1995 report were "*** that the ownership issue of the photographs be satisfactorily resolved. We recommend that the agreement with the photographer be signed by both parties. We recommend that the issue of USDA contract/agreement approval/review of agreements within the subcontract between MIF and (the advertising agency) be resolved." These issues were never addressed by AMS or the Board.

NOTE D: *"The Report also claims to have found no evidence that AMS or the Board separately evaluated the effectiveness of its programs * * *. In this regard, it is important to note that the statute that requires evaluation also mandates that it be 'carried out . . . in conjunction with the evaluation of the National Dairy Promotion and Research Board' (Fluid Milk Promotion Act of 1990, as amended (Act), 7 U.S.C. Section 6407(m)). Additionally, the Economic Research Service (ERS), which evaluates the effectiveness of the fluid milk advertising of this Board and the National Dairy Promotion and Research Board, has stated that it is impractical to segregate the two programs promoting fluid milk consumption. AMS provided this letter * * * to the OIG. The Report also ignored the third-party evaluations the Board has initiated."*

Section H(m) of the Act states "The Secretary shall provide annually for an independent evaluation of the effectiveness of the fluid milk promotion program carried out under this subtitle during the previous year, in conjunction with the evaluation of the National Dairy Promotion and Research Board established under section 113(b) of the Dairy Production Stabilization Act of 1983 * * *." We believe this requires an independent evaluation of each dairy program and that the term "in conjunction" indicates simultaneous evaluations, not one united evaluation.

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

The policy of the Program, according to Section 1999B(b) of the Act, is to carry out an effective program of promotion, research, and consumer education. Unless an independent evaluation of this program is performed, it cannot be determined whether the purpose of the Program has been fulfilled and the use of the assessments justified.

The memorandum dated April 15, 1998, from ERS to AMS did not use the term "impractical" in relation to separate studies of the two dairy campaigns. Rather, ERS said "Any current attempt to evaluate the two campaigns separately would require advertising variables that were unique to each campaign and based upon consumer responses to each program. Such a model would require sampling and estimation procedures which are beyond the time and resources of the (ERS) Evaluation Committee."

The AMS response stated that the Report ignored third-party evaluations the Board had initiated. The Board's unsigned draft letter to AMS dated June 16, 1998, included a list of various evaluation activities/studies/research activities which supposedly had been performed. During our review, we asked the Board Administrator to provide information and copies of any evaluations or studies or similar type reports conducted that would determine the effectiveness of the Program's promotion activities. None were provided. Rather, he stated that no such study had been performed and that he did not believe the Board or anyone else wanted to know whether the Board's activities had increased fluid milk consumption.

NOTE E: *"Similarly, the Report claims that the Board failed to seek bids for its web site, despite the 1997 memorandum * * * the Board provided the OIG detailing its solicitation and evaluation of bids * * *."*

The information contained in this memorandum was not provided to us during the audit. We have been provided two versions of the July 25, 1997, memorandum referenced by AMS. During the audit, the advertising agency sent us the original signed copy of that memorandum. (See exhibit C.) That memorandum did not provide details of the Board's solicitations or how the Board evaluated the bids. In its response to the official draft audit report, AMS provided us a copy of that same

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

memorandum. (See exhibit D.) Attachments to the memorandum provided by AMS differed from the attachments sent directly to OIG by the advertising agency. We noted that the memorandum provided by AMS was a copy of the courtesy copy sent to the Board Administrator. We have been given no explanation for the substantial differences in the two memorandums. It is clear, however, that there was no competition for this contract. The advertising agency went to its subsidiary and told them how much money was available and how to proceed in revising its proposal.

Neither of the memorandums referenced above, nor any other documentation provided during the audit, contained evidence of an evaluation of the bid proposals for the development and maintenance of the Board's WEB site. The documentation provided to us indicated that the advertising agency selected four potential vendors to bid on this project. One of the four did not respond. The other three vendors, one of which was a wholly-owned subsidiary of the advertising agency, submitted proposals. We requested copies of the three bids and were provided copies of bids totaling [], \$225,000, and []. The bids for [] were from outside vendors and were dated April 29, 1996, the due date specified in the request for proposals. The \$225,000 bid from a wholly-owned subsidiary of the advertising agency was prepared after the due date for the bid submissions.

As stated in this report, we obtained a memorandum dated May 7, 1996, from the advertising agency to its wholly-owned subsidiary that detailed the amount in the budget for creating and maintaining the WEB site. (See exhibit E.) This memorandum stated that, " * * * we were able to position (the subsidiary) as the best choice for developing the Milk Web site." It also stated, " * * * the MilkPEP board approved \$225,000 for the design and launch of the site AND subsequent updates through June 1997. Please base your revised proposal on a \$225,000 budget." Note that these instructions from the advertising agency to its subsidiary were after the closing date for bid submissions. This memorandum further stated, "Finally, an internal issue: we must have your assurance that this project will be given the utmost priority in order to be up and running by the program's official launch date * * *. In your original proposal, you noted that you could not make that timing. * * * Please let me know when we can expect to receive your revised proposal to forward to (MIF)." OIG asked for, but never received, the original bid proposal. In our

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

opinion, acceptance of the revised bid proposal from the subsidiary is a clear violation of competitive bidding practices.

It is clear that there was no meaningful competition for the development and maintenance of the Board's WEB site. The advertising agency assured that its subsidiary would be selected as the contractor by providing insider information to its subsidiary and accepting the bid proposal after the due date.

NOTE F: *“ * * * the Report's discussion of sole-source contracting seems to assume that the Federal Acquisition Regulations apply to promotion programs. In response to our inquiry on the subject, OGC has provided a legal opinion * * * stating that as a matter of law, promotion programs are not bound by these restrictions. This OGC opinion was made available to OIG.”*

We did not recommend that the Board comply with the Federal Acquisition Regulations. We first received the OGC opinion, dated June 18, 1998, as an attachment to AMS' response to us dated July 24, 1998. This OGC opinion states that, “The OIG draft report * * * makes no implication that Federal procurement laws apply to the Board. * * * The draft report addresses the wisdom of the Board's business practices and Government oversight of those practices.” This same OGC opinion further states, “* * * the Secretary has an oversight responsibility for contracts entered into by the Board. The Secretary could use this oversight role to apply the policies underlying these Federal statutes and regulations to the Board's contracting process.”

Again, we did not state that the Federal Acquisition Regulations apply to this Program. We continue to recommend that AMS require the Board to discontinue awarding sole-source contracts and subcontracts and establish guidelines for awarding contracts to ensure that competition is sought and that contracted goods and services are obtained in the most cost effective manner.

NOTE G: *“AMS' changes to its oversight of the Board combined with its repeated attempts to correct the Report's misstatements demonstrates the Agency's*

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

*commitment to strong oversight and an accurate, dispassionate review of AMS activities. * * * However, by ignoring changes that have occurred since the issuance of the Alert, by misstating legal and factual issues, and by extrapolating from unsupported assertions, the draft Report paints an inaccurate portrait of the Board as well as of AMS' oversight."*

We have acknowledged changes made since the issuance of the Management Alert. Contrary to AMS' statements, we did not misstate legal or factual issues. AMS made these statements but did not provide support for them. Our report, supported by all the evidence we gathered, accurately reflects the Board's operations and AMS' oversight.

NOTE H: *"We agree that the Fluid Milk Promotion Act of 1990, as amended (Act), requires an independent evaluation of the effectiveness of the fluid milk promotion program, but we disagree that this is not currently done. In making this recommendation, the Report misconstrues the law and the opinion of the ERS * * *. First, despite the Report's criticism, the statute mandates that this evaluation occur in conjunction with the evaluation of the producer funded dairy promotion program. Second, it is the opinion of ERS which (1) has experience in evaluating advertising and promotion programs, (2) has knowledge of the econometric models and data available to evaluate advertising programs, and (3) has evaluated dairy advertising programs since 1988, that it is not practical (given current resources) to evaluate separately the effects of the two programs.*

*"In sum, since the inception of generic dairy advertising under the producer funded dairy promotion program and fluid milk advertising under the Fluid Milk Program, generic advertising for fluid milk and dairy products has been the subject of annual independent evaluations * * *."*

Section H(m) of the Act states "The Secretary shall provide annually for an independent evaluation of the effectiveness of the fluid milk promotion program carried out under this subtitle during the previous year, in conjunction with the evaluation of the National Dairy Promotion and Research Board established under

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

section 113(b) of the Dairy Production Stabilization Act of 1983 * * *.” We believe this requires an independent evaluation of each dairy program and that the term “in conjunction” indicates simultaneous evaluations, not one united evaluation.

The policy of the Program, according to Section 1999B(b) of the Act, is to carry out an effective program of promotion, research, and consumer education. Unless an independent evaluation of this program is performed, it cannot be determined whether the purpose of the Program has been fulfilled and the use of the assessments justified.

The memorandum dated April 15, 1998, from ERS to AMS did not use the term “impractical” in relation to separate studies of the two dairy campaigns. Rather, ERS said “Any current attempt to evaluate the two campaigns separately would require advertising variables that were unique to each campaign and based upon consumer responses to each program. Such a model would require sampling and estimation procedures which are beyond the time and resources of the (ERS) Evaluation Committee.”

The AMS response stated that the Report ignored third-party evaluations the Board had initiated. The Board’s unsigned draft letter to AMS dated June 16, 1998, included a list of various evaluation activities/studies/research activities which supposedly had been performed. During our review, we asked the Board Administrator to provide information and copies of any evaluations or studies or similar type reports conducted that would determine the effectiveness of the Program’s promotion activities. None were provided. Rather, he stated that no such study had been performed and that he did not believe the Board or anyone else wanted to know whether the Board’s activities had increased fluid milk consumption.

NOTE 1: *“Since the OIG audit ended shortly after the issuance of the Alert, the Report does not reveal the extensive changes made to the contract approval process.*

“The review and approval of Board budgets, program plans, and project descriptions by AMS lays the framework for the program and administrative expenditures. The

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

contract approval process further formalizes the budgetary process to implement the approved campaigns and projects of the Board. Contracts in which the Board is a party now are submitted to AMS for review and approval prior to the contract becoming effective. Such contracts state that the agreement shall become effective upon the approval by USDA. Subcontracts, MIF/IDFA contracts for resources, as identified in the September 17, 1997, approval process, are sent to AMS for approval."

We did not end our review 1 month after we issued our Management Alert. Our audit covered the period December 1993 through June 1997; however, our fieldwork continued for several more months. We have recognized changes AMS has reportedly made to the contracting process which we reported as unverified.

We do not agree that AMS' approval of the Board's budget can be substituted for contract review and approval. Budgets are general outlines of planned program expenditures. Budget review and approval can, in no way, substitute for contract review and approval. Each contract, subcontract, sub-subcontract, etc., must be made available for AMS' scrutiny, review, and approval.

We also acknowledged that a new contract review process had been implemented; however, with the information provided, we were unable to fully assess what the review process is. For example, in response to our Management Alert, AMS agreed on May 19, 1997, to " * * * require that the Board submit all contracts and subcontracts to the Department for review." AMS revised its policy again on September 17, 1997, which included a review and approval of about 9 contracts. In its July 24, 1998, response to our official draft report, AMS stated that it " * * * will revise its September 17, 1997, contract approval process with the Board to require that, in addition to all Board contracts, all contracts of the Board's contractors be reviewed and approved by AMS." We agreed with the changes AMS made in response to our Management Alert; however, we did not agree with the changes made on September 17, 1997. We also disagree with the proposed revision, as stated in AMS' July 24, 1998, memorandum, because it does not include all contracts, subcontracts, sub-subcontracts, etc., which obligate Program funds.

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

Note J: *“To reach below those subcontracts and approve contracts of subcontractors, would require the submission and approval of approximately 3,000 sub-subcontracts, sub-sub-subcontracts and purchase orders per year. A requirement that all of these contracts be submitted to AMS for review and approval prior to the activity would so hamper the implementation of the program that it would be unable to function.”*

We have never recommended that purchase orders be submitted for AMS' review and approval. However, we still believe that all contracts, subcontracts, sub-subcontracts, etc., must be submitted to AMS and that AMS must develop the criteria and threshold for determining which of these contracts will require a formal review and approval. AMS' discussion of “3,000 sub-subcontracts, sub-sub-subcontracts and purchase orders” is irrelevant and does not address any issue in this report. The preponderance of the 3,000 figure is purchase orders.

NOTE K: *“AMS--and OGC--disagree with the Report's interpretation of the legal mandates. We disagree with the assertion by OIG that the Board has inappropriately handled the ownership of the photographs prepared for the program. Even though the OGC opinion was provided to OIG well in advance of releasing the Report, OIG has chosen to disregard it.”*

AMS has not provided us a copy of OGC's disagreement with anything in this report; consequently, we cannot comment on any such disagreement. We are not “asserting” that the Board has inappropriately handled the ownership of the photographs prepared for the Program. In Finding No. 3 we stated that both AMS and the Board failed to meet their responsibility for oversight of the contracts with the photographer. Lack of proper oversight by both AMS and the Board is evidenced by: Failure to execute contracts with the photographer, failure to document negotiations (if any negotiations were actually conducted) for the copyrights to the photographs, and failure to obtain AMS' approval.

We did not disregard OGC's opinion. It is evident that the opinion says that, as the contract was written, the photographer owns the copyrights to the photographs.

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

There is no evidence of any negotiations for the ownership of copyrights to the photographs.

The February 10, 1998, OGC opinion states that “ * * * the agreement with (the photographer) did not expressly provide that the photographs would be considered a ‘work made for hire.’ If (the photographer) and the Board (through its advertising agency), had expressly provided that the photographs were to be ‘work made for hire,’ then the copyright to them would not automatically belong to (the photographer).” If the photographer and the Board (through MIF and the advertising agency) had expressly agreed that the Board would own the copyright to the photographs, the Board would not have had to pay the additional royalty rights totaling \$129,000 for the use of the photographs. This is a classic example of why AMS must oversee the entire contracting process. Had the advertising agency’s contract with the photographer been properly written, in compliance with the contracts between the Board and MIF, and between MIF and the advertising agency, then the Board would have owned the copyrights to the photographs.

NOTE L: *“The report attempts to exchange ‘assets’ for the carefully crafted language of the law. Immediately after citing the Order language quoted above, the Report states that ‘according to the provisions in the Order, the Board is required to take title to all assets developed or acquired with Board funds.’ (Emphasis added.) Clearly, the term ‘asset’ expands the regulatory language.”*

We agree that the term “asset” can be used to define a broad range of property. However, in no instance did we refer to any asset other than the copyrights to the photographs. Also, the value of copyrights is always listed on the balance sheet as an asset. We did not err in our use of the word “asset.”

NOTE M: *“While the Report claims that the Order requires the Board to do so, such photographs are neither patents, copyrights, trademarks, inventions, or publications. OGC has issued an opinion on this issue, yet the Report ignores this finding * * *.”*

We did not ignore the OGC opinion. We have never said that photographs are

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

copyrights. However, the photographs are copyrighted items and, because of the way the contract was written, the photographer owns the copyrights to the photographs. As a result, the photographer, and not the Board, controls the use of the photographs. Our concern all along has been who has control and use of the photographs. Without owning the copyright, the Board can use the photographs only with the permission of the copyright owner and must pay additional royalties for additional uses.

NOTE N: *“Almost all contracts submitted by the Board contain standard language that has been reviewed by the OGC for legal sufficiency.”*

We recognized in our report that the contract language had been reviewed by OGC. However, the larger issue is not “legal sufficiency,” but that AMS should ensure that all contracts adequately address requirements in the Act and the Order.

NOTE O: *“The Board owns the copyrights to the ads which incorporated the selected photographs. Because the Board received what it paid for--no more, no less--it has complied with the Act and Order * * *.”*

We recognize that the Board owns the copyright to the advertisements; however, the Board does not own the copyrights to the photographs in those advertisements. The contracts with the photographer only allowed the Board to use the photographs in the advertisements for 15 months, with renewal options available at additional cost. As a result, ownership of the copyrights to the advertisements is of limited value because the photograph is the focal point of those advertisements.

NOTE P: *“ * * * the Report fails to recognize actions taken to implement this recommendation * * *, which also was part of the Alert issued more than a year ago.*

“In the future, AMS also will require that the Board’s Chairman and Administrator both sign the management representation letters to CPA firms regarding the Board’s financial, contractual, and legal position. In addition, AMS will request copies of such letters for review.”

EXHIBIT B - OIG'S COMMENTS RELATED TO AMS' WRITTEN RESPONSE

The issue regarding management representation letters was not included in our Management Alert. Our first recommendation regarding management representation letters was in our draft audit report. The first time we were made aware of any corrective actions taken regarding management representation letters was in AMS' response dated July 24, 1998, to our official draft report.

We agree that the Board's Chairman and Administrator should both sign the management representation letters to CPA firms and that AMS should obtain copies of these letters. However, AMS must also provide assurance that the Board's management representation letters accurately reflect the position of the Board's financial, contractual, and legal position.

EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO OIG

BOZELL SAWYER MILLER GROUP

BOZELL PUBLIC RELATIONS

MEMORANDUM

To: []

From: []

Date: July 25, 1997

Re: Web Site Developer Selection Process

Cc: []

Here is an outline of the process we used to select a Web site vendor for MilkPEP:

- We chose four potential Web site vendors based on extensive research we conducted for other clients on companies providing these services. The four companies we selected all had established reputations of creating high-impact Web sites for well-known companies.
- Once we chose our four potential vendors, we submitted a RFP to each of them with the parameters of the project on April 15, 1996 (attachment 1).
- Based on the RFP, we received proposals from three of the vendors (attachment 2). One, Avalanche Systems, Inc., dropped out of the project because they did not have the resources to handle the job at the time.
- We forwarded those proposals to [] at MilkPEP for his review.
- At a meeting between Bozell and [] it was decided to select Poppe.com as our Web site partner based on their recommended creative approach to the site which we felt was the strongest of all of the proposals submitted.

If you have any questions please let us know

[]

Bozell PR KRC Research Sawyer Miller Consulting Bozell|Eskew Medical & Health Communications
625 N Michigan Avenue Chicago Illinois 60611-3110 312-988-2400 Fax 312-988-2363
PRINCIPAL CITIES AROUND THE WORLD

**EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO
OIG**

Attachment 1

**EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO
OIG**

**BOZELL PUBLIC RELATIONS
REQUEST FOR PROPOSAL**

TO

[REDACTED]

[REDACTED]

FROM

[REDACTED]

[REDACTED]

PROJECT

Develop, design and maintain an interactive Web site for the National Fluid Milk Processor Promotion Board (aka "milk mustache" campaign).

WEB SITE TARGET

Teens and young adults (male and female).

WEB SITE OBJECTIVES

The objectives of the site will be to:

- Educate young adults on the health and nutrition benefits of milk
- Increase milk consumption among those age groups
- Enhance milk's image as a hip, cool drink

EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO OIG

Request for proposal/page 2

PROJECT PARAMETERS

Please bid on creating a milk site on the World Wide Web targeting teens and young adults with:

- Educational information about milk and nutrition
- Monthly news "articles" on health, nutrition and food trends
- Interactive nutrition and pop culture quizzes based on milk facts and the milk mustache campaign
- Animation and other features to add interactivity and appeal to the site
- A brochure "catalog" to show the milk brochures available through the milk 800-number (NO brochures would be fulfilled through the site)
- A moderated bulletin board system allowing teens to submit questions for celebrities and/or fitness and health experts (the answers would be posted as an article)
- A section to unveil new milk mustache ads as they are launched

Please also give an estimate for creating an online chat feature that would allow us to hold monthly or periodic chats with celebrities or fitness/health professionals.

We anticipate updating the site on a regular (ideally monthly) basis. We will need a publishing tool and templates to allow us to update the site from our offices -- including posting new photographs if possible.

TIMING

We have an extremely tight time frame. We need to have a site up and running by **July 10, 1996**, for the New York media launch of the new integrated campaign.

EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO OIG

Request for proposal/page 3

NEED FROM YOU

- o Cost estimate and suggested rough timetable for your services.
 - Please provide itemized cost estimate for all parts of service (i.e., research, development, monthly updates, special chat sessions)
- o Additional background on your company to help us "sell" you to our client, including:
 - Brochures, pamphlets, promotional packets
 - Articles written about your company
 - Demo disks on your company

Our client has would like to review your proposal as soon as possible, so please submit the above information by Thursday, April 25. I'll be calling you shortly to follow up. Thanks.

FOR MORE INFORMATION

[]

EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO OIG

**BOZELL PUBLIC RELATIONS
REQUEST FOR PROPOSAL**

TO

[]

poppe.com
40 W. 23rd. St.
NY, NY 10010

[]

FROM

[]

[]

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EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO OIG

BOZELL PUBLIC RELATIONS
REQUEST FOR PROPOSAL

TO



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FOR MORE INFORMATION

[]

**EXHIBIT C - ADVERTISING AGENCY'S MEMORANDUM TO
OIG**

Attachment 2

OIG NOTE

We did not attach copies of the proposals received from the three vendors because they were voluminous.

EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS

BOZELL SAWYER MILLER GROUP

BOZELL PUBLIC RELATIONS

MEMORANDUM

To: []
From: []
Date: July 25, 1997
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Cc: []

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- We chose four potential Web site vendors based on extensive research we conducted for other clients on companies providing these services. The four companies we selected all had established reputations of creating high-impact Web sites for well-known companies.
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Bozell PR KRC Research Sawyer Miller Consulting Bozell|Eskew Medical & Health Communications
625 N Michigan Avenue Chicago Illinois 60611-3110 312-988-2400 Fax 312-988-2363
PRINCIPAL CITIES AROUND THE WORLD

EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS

MILKPEP WEB SITE BACKGROUND

OBJECTIVE: Develop highly entertaining and educational web site to generate enthusiastic repeat traffic among consumers of college age and younger

WEB SITE DEVELOPERS WHO MADE PROPOSALS:

<u>COMPANY</u>	<u>BID</u>
pope . comm. 40 West 23rd St. NY, NY	\$225,000

CRITERIA FOR SELECTION:

creativity, strategic insight, educational quality and content, appeal to target, program flexibility, value

RESULTS:

- Approaching 40,000 hits a month
- MilkPEP visitor hits 9 to 11 pages versus 3 to 5 Average
- 85% traffic college aged or younger, 70% female
- Web Site has increased to include contests, special announcements, revised programs, etc. - the format is flexible
- Awarded numerous accolades by web site community and critics

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OIG AS SENT BY AMS**

RELATED COST INFORMATION:

- Average "large" web site cost - \$596,975
NetMarketing '96 survey
- Corporate web site range - \$250,000 to \$3.4 mil.
Forrester Research
- Examples:

Eye-Wear Specialist
Development cost: \$262,000
Maintenance cost: \$100,000
TOTAL: \$362,000

Automotive Product Producer
Development cost: \$250,000
Maintenance cost: \$ 96,000
TOTAL: \$346,000

Leading Digital Imaging
Development cost: \$440,000
Maintenance cost: \$ TBD
TOTAL: \$440,000+

Leading Financial Services Provider
Development cost: \$290,000
Maintenance cost: \$120,000
TOTAL: \$410,000

Global Investment Service
Development cost: \$900,000
Maintenance cost: \$451,000
TOTAL: \$1,351,000

WHYMILK.COM
Development cost: \$175,000
Maintenance cost: \$160,000
TOTAL: \$335,000

EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS

MEMORANDUM

BOZELL PUBLIC RELATIONS

April 24, 1997

TO: [REDACTED]

FROM: [REDACTED]

RE: [REDACTED]

CC: [REDACTED]

The following provides an overview of comparison costs for developing and maintaining Web sites targeted to consumers.

After the recent audit, questions were raised about the cost of the Milk Web site. We've done an analysis of industry averages for corporations spending on consumer internet marketing and other Web site costs. Our findings show that the \$335,000 that we're spending on the development and maintenance of the Milk Web site is actually below the cost of other sites of this scope.

As you probably know, Web sites can range anywhere from a novice site created by an elementary school classroom to a high-tech, advanced site created by a Web site development firm. This report compares sites that are similar to *whymilk.com* in business objective and scope.

Because the Web and the business of creating sites are so new, there is limited industry information available on related costs. However, we were able to get solid information from three sources:

- *NetMarketing*, a Web industry supplement in *Advertising Age's Business Marketing* magazine, which published its first study of Web site costs in September 1996
- Forrester Research, Inc., which analyzes and predicts the impact of technology change on large companies
- Poppe Tyson Interactive, a Web site developer

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EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS

Page 2

NetMarketing Study

NetMarketing published its first survey of 25 Web developers in six cities in September 1996 (which is appropriate timing, since the MilkPEP site was launched in July 1996).

According to that study, the average Web site cost, for creation and one year of maintenance, was \$596,973 for "large" sites -- of similar scope to the milk site.

For the *NetMarketing* study, average costs were determined for small, medium and large sites. It's important to draw a distinction among various sites since costs are based on the size and capabilities of the site, which is determined based on goals of the site and the audience for which it is intended.

Small sites were very basic, a way to just get the company on the Web with easy access to information for customers and internal audiences (average cost \$26,100). Medium sites have greater e-mail capabilities than small sites, look nice, are generally intended for clients rather than consumers, and are described as "very, very functional to get users to the data they need (average cost \$102,025). Large sites include "the works" and are created for consumer, with contests and promotions, updates, e-mail, graphics, the latest technology, fast use and special features (average cost \$596,973).

Forrester Research

Forrester Research says that corporate Web sites can have budgets ranging anywhere from \$250,000 - \$3.4 million to build and maintain for a one-year period. The cost range depends on several factors, including graphics and design, technology capabilities and the interactive functions of the site. For example:

- A consumer eye-wear specialist site that is similar in size and content to whymilk.com cost approximately \$362,000 to develop and maintain for one year
- In contrast, a site developed for a bank operation to allow financial transactions on-line was budgeted at \$3.4 million a year

EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO OIG AS SENT BY AMS

Page 3

According to Forrester, companies budget the same amount annually to maintain their site (after the initial site is built). Forrester also says that Web site budgets are expected to increase substantially in 1997. In fact, costs are expected to rise 52% to 231% by 1999.

There are several reasons attributed to the expected cost increases:

- Increasing flood of on-line traffic
- Rising consumer expectations of Web sites
- New Web security
- Improving interactive technologies

Poppe Tyson Interactive Client Information

Below, please find budgets for several sites that are similar in scope to whymilk.com. Please note that all estimates were provided by Poppe Tyson Interactive. (Companies are not normally open to sharing budget figures, and Poppe Tyson has asked that company names remain confidential.)

Consumer Eye-Wear Specialist (promotional site)

Development cost: \$262,000
Maintenance cost: \$100,000
TOTAL: \$362,000

Automotive Product Producer (promotional site)

Development cost: \$250,000
Maintenance: \$ 96,000
TOTAL: \$346,000

Leading Digital Imaging (promotional site)

Development cost: \$440,000
Maintenance: \$ TBD
TOTAL: \$440,000+

Leading Financial Services Provider (transaction site)

Development cost: \$290,000
Maintenance: \$120,000
TOTAL: \$410,000

Global Investment Service (high technology, interactive site)

Development cost: \$900,000
Maintenance: \$451,000
TOTAL: \$1,351,000

**EXHIBIT D - ADVERTISING AGENCY'S MEMORANDUM TO
OIG AS SENT BY AMS**

Page 4

Given these costs, the Milk Web site compares favorable, showing that the costs are in line:

WHYMILK.COM (promotional site)	
Development cost:	\$175,000
Maintenance cost:	\$160,000
TOTAL:	\$335,000

Please let us know if you have any questions. Thanks.

[]

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TOTAL P. 10

EXHIBIT E - ADVERTISING AGENCY'S MEMORANDUM TO ITS SUBSIDIARY

MEMORANDUM

May 7, 1996 BOZELL PUBLIC RELATIONS

TO: [REDACTED] Via Fax
FROM: [REDACTED]
RE: [REDACTED]
CC: [REDACTED]

We had a good meeting with [REDACTED] of MilkPEP this morning and we were able to position Poppe.com as the best choice for developing the Milk Web site. He will make his final decision once he has reviewed your proposal, but we don't anticipate any problems at this point.

[REDACTED] biggest concern is that you show that you can creatively reach teens and young adults on their level. It sounds like your team is prepared to address that issue in your revised proposal. You have the overall objectives of the site (and the targets) which we provided to you at the beginning of this process -- I encourage you to refer back to those.

There are two other issues you should be sure to address in the proposal:

Budget

In June, the MilkPEP board approved \$225,000 for the design and launch of the site AND subsequent updates through June 1997. Please base your revised proposal on a \$225,000 budget.

Creative Concept

[REDACTED] wants to review your initial creative concept for the site before he commits to a contract. Once he has reviewed and approved your ideas, he'll then want to sit down as a team and refine them.

As you're developing your creative, I encourage you to look over the "wish list" of Web site ideas we developed in Chicago (and provided to [REDACTED] on April 10) as well as all of the MilkPEP research and background material we gave to him on April 16. All of this was meant to help you in the creative process.

You might also speak to [REDACTED] to whom we gave several ideas when [REDACTED] [REDACTED] and I met with him on April 24 to discuss this project. (Also of note, [REDACTED] mentioned that he was very impressed with the creative behind your Valvoline site that you showed him in your meeting.)

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A ROBINSON LLER SAWYER MILLER COMPANY

EXHIBIT E - ADVERTISING AGENCY'S MEMORANDUM TO ITS SUBSIDIARY

Account Staffing

Finally, an internal issue: we must have your assurance that this project will be given the utmost priority in order to be up and running by the program's official launch date of July 10. In your original proposal, you noted that you could not make that timing. Therefore, we're assuming that you've made the provisions to now accommodate the July 10 date.

We will be glad to help you in any way. In turn we expect that deadlines and commitments will be honored and that your account team will be responsive to -- and respectful of -- our requests as the intermediary on this project.

Please let me know when we can expect to receive your revised proposal to forward to [. . .] We hope to have this all resolved by Friday so that we can get to work executing the site.

We look forward to working with you. If you have any comments or questions, please don't hesitate to call me at [. . .] or [. . .] We are available to help in any way we can.