



DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General
Dallas Field Office - Audit Division
3900 Karina Street, Room 224
Denton, Texas 76208

August 6, 2003

MEMORANDUM

TO: Gary Jones, Acting Regional Director,
FEMA Region VI

Tonda L. Hadley

FROM: Tonda L. Hadley,
Field Office Director

SUBJECT: Memorial Hermann Hospital
Houston, Texas
FEMA Disaster Number 1379-DR-TX
Public Assistance Identification Number 000-00169-00
Audit Report Number DD-11-03

The Office of Inspector General (OIG) audited public assistance funds awarded to Memorial Hermann Hospital, Houston, Texas (Hospital). The objective of the audit was to determine whether the Hospital expended and accounted for Federal Emergency Management Agency (FEMA) funds according to federal regulations and FEMA guidelines.

The audit was a limited scope audit requested by the Hospital through Region VI. At the time of the audit, the Hospital had received an award of \$137.9 million for 99 projects from the Texas Division of Emergency Management (TXDEM), a FEMA grantee. The OIG audited three Category B (emergency work) large projects¹ totaling \$910,544 for environmental and safety services, abatement, cleanup, and temporary protection of facilities damaged by Tropical Storm Allison that began on June 5, 2001. The award provided 75 percent FEMA funding for eligible costs. The audit covered the period June 5, 2001, to December 7, 2001, during which the Hospital claimed \$910,544 and TXDEM disbursed \$682,908 in direct program costs under the three projects audited (see Exhibit 1).

The OIG performed the audit under the authority of the Inspector General Act of 1978, as amended, and according to generally accepted government auditing standards. The audit

¹ Federal regulations in effect at the time of the disaster defined a large project as a project costing \$50,600 or more and a small project as one costing less than \$50,600.

included tests of the Hospital's accounting records, a judgmental sample of project expenditures, and other auditing procedures considered necessary under the circumstances.

RESULTS OF AUDIT

The Hospital did not follow federal procurement regulations to contract for \$910,544 in disaster work. As a result, FEMA had no assurance that contract costs claimed were reasonable. Further, the Hospital's claim included questioned costs of \$22,500 (\$16,875 FEMA share), consisting of unallowable markups (\$7,928), unsupported contractor labor costs (\$5,594), non-disaster related costs (\$4,134), unsupported contractor material costs (\$3,343), overstated contractor labor costs (\$1,010), and ineligible sales tax (\$491). The Hospital provided a written response to these findings (see Exhibit 2).

The OIG performed this audit at the request of the Hospital to determine the adequacy of its record keeping early in the restoration process. During the audit, the OIG counseled Hospital personnel at length on the provisions of the Code of Federal Regulations (CFR), Office of Management and Budget (OMB) Circular A-122, and FEMA guidelines regarding federal procurement procedures, record keeping requirements, and allowable costs. Additionally, the OIG allowed the Hospital approximately 12 months to acquire and organize source documents to support its claim.

The amount audited was less than 1 percent of the cost of work yet to be performed, and the amount questioned was not material. However, a secondary audit objective was to effect future cost savings by reporting actual examples of questioned costs resulting from the Hospital's failure to follow federal regulations and FEMA guidelines. The OIG is confident that, if the Hospital heeds the guidance given during this audit, significant cost savings will result from compliance with federal regulations and FEMA guidelines as the Hospital progresses to larger projects.

Finding A: Unallowable Contract Procedures

The Hospital did not follow federal procurement regulations or FEMA guidelines in awarding contracts totaling \$910,544 for abatement and cleanup of facilities. As a result, FEMA had no assurance that contract costs claimed were reasonable.

Federal regulations at 44 CFR 13.36 place the following requirements on federally funded procurements:

- Require procurement transactions to be conducted in a manner providing full and open competition unless certain conditions are met.

- Require a cost or price analysis in connection with every procurement action including contract modifications.
- Prohibit the use of time and material type contracts unless no other contract is suitable and the contract includes a ceiling price the contractor exceeds at its own risk.
- Prohibit the cost-plus-a-percentage-of-cost and percentage-of-construction-cost methods of contracting.
- Require profits to be negotiated as a separate element for noncompetitive procurement.

In addition, FEMA’s Public Assistance Guide (FEMA Publication 322) states:

- Time and materials contracts should be avoided, but may be allowed for work that is necessary immediately after the disaster has occurred when a clear scope of work cannot be developed.
- If applicants use time and materials contracts, they must carefully monitor and document contractor expenses, and a cost ceiling or “not to exceed” provision must be included in the contract.
- Cost-plus-a-percentage-of-cost contracts are not eligible.

The Hospital awarded time and material contracts without competition. The OIG did not question the necessity of noncompetitive time and materials contracts because the work began during the first 4 days after the disaster and consisted of cleanup or monitoring of hazardous debris requiring specialized expertise. However, federal regulations and FEMA guidelines mandated the Hospital use sound procurement practices to contain costs even under exigent circumstances. The Hospital failed to perform the following required actions:

- Include cost ceilings in time-and-materials contracts.
- Analyze proposed contract costs.
- Monitor contract performance.
- Negotiate profit as a separate element of cost (two of the three contracts contained the prohibited cost-plus-a-percentage-of-cost component).

Under 44 CFR 13.43(a)(2), failure to comply with applicable statutes or regulations can result in the disallowance of all or part of the costs of the activity or action not in compliance. Because the Hospital disregarded federal procurement regulations and FEMA guidelines, FEMA had the authority to disallow all of the \$910,544 claimed costs. However, except for the \$22,500 questioned in Findings B through G, the OIG did not recommend disallowance of costs because the Hospital incurred the majority of costs for eligible work. Further, there was no way to quantify the impact of the Hospital’s non-compliance with federal regulations and FEMA guidelines related to procurement.

The Hospital's written response to this finding stated that they received a memorandum, dated November 21, 2002, from FEMA Region VI addressing FEMA's approval of noncompetitive contracts for Texas Medical Center (TMC) applicants. Further, they stated the Hospital assumed these allowances from the "Government" were in recognition of actions necessary to allow for the continuity of quality medical care under emergency circumstances. The Hospital said its procedures in the immediate aftermath of Tropical Storm Allison were predicated on the circumstances and needs; however, all controls (which were practical at the time) were used in the prudent selection of all emergency workers.

The OIG reviewed the November 21, 2002, memorandum from FEMA Region VI (see Exhibit 3) and concluded that it was too general in nature to be interpreted as FEMA's approval of any specific action or to justify the Hospital's noncompliance. For example, in the memorandum, Region VI discusses three factors considered in deciding to allow "some" TMC applicants to use noncompetitive contracts. The memorandum also states, "these factors were all reviewed and it was determined that noncompetitive contracting was allowable and that the contract prices paid were reasonable and necessary." However, the memorandum does not identify the applicants, contracts, type of work (temporary or permanent), or duration (first 72 hours, first month, first year, etc.) to which this waiver applied. Further, the memorandum does not describe the basis for determining that contract costs were reasonable.

Additionally, the memorandum cited a portion of 44 CFR 13.36(d)(4) and stated FEMA staff "applied" this criterion in the Project Worksheet approval process. However, this cite omitted subparagraph (ii) that specifically requires a "cost analysis, i.e., verifying the proposed cost data, the projections of the data, and the evaluation of the specific elements of costs and profits," even though procurement is by noncompetitive proposals.

The memorandum concluded, "FEMA has determined that the use of certain noncompetitive contracts was both appropriate and reasonable." However, the OIG concluded that this memorandum is too general and vague to be used as a blanket approval for TMC applicants to disregard sound procurement practices, even under exigent circumstances.

Finding B: Unallowable Markups

The Hospital's claim included \$7,928 in unallowable contractor markups of 15 and 20 percent applied to contractor-billed supplies and subcontractor invoices. These markups represented an administrative handling charge. However, the contractor billed for the time and mileage to travel to the local Home Depot, Federal Express drop-box, laboratory, travel agent, etc.; and, therefore, earned its regular overhead and profit on

these transactions through its hourly labor rates without an additional markup. Further, the Hospital's contractors declined to provide data detailing the amount of overhead and profit included in their labor costs, which comprised 93 percent of the total claim. According to 44 CFR 13.36(f)(4), the cost-plus-a-percentage-of-cost method of contracting shall not be used. Therefore, the OIG questioned the \$7,928 in unallowable markups on costs.

In response to this finding, the Hospital stated that time-and-materials contracts normally allow a percentage to cover the contractor's or subcontractor's overhead, which is supported and encouraged by FEMA-approved estimating methods.

The OIG contends that because the contractors' labor costs made up 93 percent of the total claim and the contractors declined to provide data detailing the overhead and profit contained in their labor rates, they must have included sufficient overhead and profit in these rates to meet their needs. Further, 44 CFR 13.36(f) states that (1) a cost analysis will be necessary when adequate price competition is lacking and (2) grantees and subgrantees will negotiate profit as a separate element of the price for each contract in which there is no price competition. The Hospital did not perform either of these steps for the contracts containing markups. Therefore, the OIG maintained its position that these were ineligible costs.

Finding C: Unsupported Contractor Labor Costs

The Hospital's claim included \$5,594 for contractor labor hours billed in excess of supporting documentation such as time sheets and progress reports. According to 44 CFR 13.20(b)(2), a subgrantee must maintain records that adequately identify the source and application of federal funds. Additionally, 44 CFR 13.20(b)(6) provides a list of specific source documentation, including cancelled checks, paid bills, payrolls, contracts, etc., that are acceptable as supporting documentation for the accounting records. Because the Hospital did not provide acceptable source documentation to support these costs, the OIG questioned \$5,594.

The Hospital's written response to the draft OIG report included documentation that supported a portion of the labor costs initially questioned. Therefore, the OIG reduced the initial questioned costs accordingly. Regarding the remainder of the questioned costs, the Hospital stated it was reasonable to assume that someone in a management role reviewed the invoices before they were paid and determined that services were performed.

The OIG delayed the audit for approximately 1 year to allow the Hospital ample time to locate source documents to support vendor invoices. Federal regulations require claimed costs be supported by source documentation. Therefore, the OIG did not agree that the Hospital's assumptions were adequate to support the remaining \$5,594 questioned.

Finding D: Non-Disaster-Related Costs

The Hospital's claim included \$4,134 in contractor costs not related to the disaster. These costs included meals, miscellaneous supplies, and transportation costs (mileage) for contractor employees not in travel status. The Hospital could not substantiate that these costs were required as the result of disaster work performed by the contractor. According to 44 CFR 206.223(a)(1), an item of work must be required as the result of the major disaster event to be eligible for financial assistance. Therefore, the OIG questioned \$4,134 because these costs were not disaster related.

The Hospital's response stated that, in an emergency, it is often more practical to have workers eat on site to decrease downtime and potential overtime. The Hospital further stated that, if the project managers and contractors felt it was reasonable to reimburse employees for such costs, the Hospital incurred and paid such costs. The Hospital also stated that this practice would certainly fall into the category of reasonableness.

The Hospital's response did not address the miscellaneous supplies and transportation costs that were not related to the disaster; and the OIG disagreed with the Hospital's explanation of why the costs of meals not related to the disaster should be considered eligible. In this instance, the need to decrease downtime and potential overtime was not relevant. For example, a contractor employee claimed \$143.75 for meals on July 23, 2001, or an average meal cost of \$28.75 for each of the five employees working that day. Together, the five employees worked only 16.5 hours that day, an average of 3.3 hours per employee. The Hospital provided no documentary evidence that the contractor's employees actually received the food, that any food was actually purchased, or that the food was consumed at the job site. Further, the Hospital provided no credible evidence that these costs related to, or were required as the result of, the disaster event. Therefore, the OIG maintained its position that these costs were ineligible.

Finding E: Unsupported Contractor Material Costs

The Hospital's claim included \$3,343 for contractor supplies and materials not supported by receipts. According to 44 CFR 13.20(b)(2), a subgrantee must maintain records that adequately identify the source and application of federal funds. Additionally, 44 CFR 13.20(b)(6) provides a list of specific source documentation, including cancelled checks, paid bills, payrolls, contracts, etc., that are acceptable as supporting documentation for the accounting records. Of the \$3,343, the OIG questioned \$1,356 because it was claimed based on estimated, rather than actual expense, and questioned \$1,987 because the Hospital did not provide acceptable source documentation to support these costs.

The Hospital agreed that the \$1,356 questioned was unsupported because it was claimed based on estimated, rather than actual expense. However, they did not agree with the \$1,987 questioned, stating that, during the emergency phase of this disaster, some of the contractors' receipts were probably misplaced or not obtained because many organizations have rules regarding receipts for \$25 or less. The Hospital also stated that it was reasonable to assume that someone in a management role reviewed the invoices for the \$1,987 before they were paid and determined that services were performed and supplies were purchased.

As stated above, federal regulations require claimed costs be supported by source documentation. Therefore, the OIG did not agree that the Hospital's assumptions were adequate to support the \$1,987 questioned. Additionally, less than \$50 of costs included in the \$1,987 was comprised of purchases of \$25 or less.

Finding F: Overstated Contractor Labor Costs

The Hospital's claim included \$1,010 for contractor labor costs billed at hourly rates in excess of those established by the contract. Accordingly, the OIG questioned \$1,010 in overstated costs. The Hospital agreed with this finding.

Finding G: Unallowable Taxes

The Hospital's claim included \$491 for contractor-billed sales tax on materials. According to OMB Circular A-122, Attachment B, paragraph 51.a, only those taxes that a governmental entity is legally required to pay are allowable. Because the Hospital is a tax-exempt entity, the OIG questioned \$491 in unallowable sales taxes.

In response to this finding, the Hospital stated that they provided contractors with tax exemption certificates for purchasing materials and, in most instances, they did not reimburse contractors for sales tax paid. The Hospital further stated that, in a few instances early in the disaster, the contractors paid sales tax on items purchased before receiving the tax exemption certificates.

The OIG maintains that because the Hospital was not legally required to pay the sales tax, these costs were not allowable, and therefore ineligible for FEMA reimbursement.

RECOMMENDATIONS

The Office of Inspector General recommended that the Regional Director, in coordination with the Texas Division of Emergency Management:

1. Ensure that, for other projects in this disaster and all future disasters, subgrantees are provided guidance on federal regulations and Federal Emergency Management Agency guidelines related to procurement.
2. Disallow \$22,500 of questionable costs.
3. Provide clarification of the November 21, 2002 memorandum to each Texas Medical Center (TMC) applicant. This clarification should:
 - Correct the possible misconception that FEMA has waived all federal procurement regulations for all TMC applicants on all contracts for any type work for the duration of the Tropical Storm Allison recovery.
 - Specify the timeframe immediately after the disaster in which the necessity for noncompetitive, time-and-materials contracts was justified.
 - Stipulate that any FEMA approval for noncompetitive procurements do not apply to permanent work.
 - Inform the applicants they must still perform the requisite cost analysis.
 - Inform the applicants that profit on a noncompetitive contract must be negotiated as a separate element.
 - Inform the applicants that, if they use time-and-materials contracts, they must:
 - Include a cost ceiling in the contract that the contractor exceeds at its own risk.
 - Perform and document adequate monitoring of the contractor's work.
 - Obtain and maintain source documents equivalent to those required to support force account labor and equipment.
 - Not award contracts that contain cost-plus-a-percentage-of-cost components, including arbitrary percentage markups.

DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOWUP

The OIG discussed the results of the audit on May 13, 2003, with Hospital officials who provided a written response. That response was discussed within this report and included in its entirety as Exhibit 2. The OIG discussed the results of the audit with TXDEM on May 13, 2003, and with FEMA on June 18 and June 26, 2003.

Please advise this office by September 5, 2003, of the actions taken or planned to implement the recommendations, including target completion dates for any planned actions. If you have questions concerning this report, please contact me at (940) 891-8900. Major contributors to this report were Daniel Benbow, Doug Denson, and Jerry Meeker.

Schedule of Audited Projects
Memorial Hermann Hospital
FEMA Disaster Number 1379-DR-TX

<u>Project Number</u>	<u>Amount Claimed</u>	<u>Questioned Costs</u>	<u>Finding Reference</u>
1412	\$ 563,518	\$ 8,415	A,B,C,E,G,
1413	265,086	14,085	A,B,C,D,E,F
1416	<u>81,940</u>	<u>0</u>	A
Total	<u>\$ 910,544</u>	<u>\$ 22,500</u>	

Memorial Hermann

FOR YOUR WHOLE LIFE.

May 22, 2003

Mr. Daniel Benbow
Office of Inspector General
via
Mr. Vincent Franco
Texas Department of Public Safety
Division of Emergency Management
P.O. Box 4087
Austin, Texas 78773-0001

Ms. Karen Phillips
Texas Department of Public Safety
Division of Emergency Management
2575 W. Bellfort St., Suite 300
Houston, Texas 77054-5025

RE: OIG Draft Audit letter to Memorial Hermann Hospital
 Dated May XX, 2003

Memorial Hermann Hospital System requested an audit by the Office of Inspector General (OIG) related to FEMA Disaster Number 1379-DR-TX. The OIG audit was performed to determine the adequacy of MHHS's record keeping early in the restoration process. Following are MHHS's responses to the OIG findings.

Finding A: Unallowable Contract Procedures

Federal Regulations at 44 CFR 13.36 state:

"Procurement by noncompetitive proposals may be used only when the award of a contract is infeasible under small purchase procedures, sealed bids or competitive proposals, and one of the following applies... (B) The public exigency or emergency for the requirement will not permit a delay resulting from competitive solicitation. (C) The awarding agency authorizes noncompetitive proposals".

MHHS received a memorandum dated November 21, 2002 from FEMA Region VI (attached) addressing FEMA's approval of noncompetitive contracts for Texas Medical Center applicants, and a copy of this memo was provided to the OIG auditors during the audit process.

MHHS assumes these allowances from the Government are in recognition of that which is necessary to promptly allow for the continuity of quality medical care or other such emergency circumstances. MHHS's procedures in the immediate aftermath of Tropical

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Memorial Hermann Healthcare System
9401 SOUTHWEST FREEWAY ■ HOUSTON, TEXAS 77074

Storm Allison were predicated on the circumstances and needs; however all controls (which were practical at the time) were used in the prudent selection of all emergency workers.

Finding B: Unsupported Contractor Labor costs

During the audit, MHHS provided time sheets for \$20,790 of the \$25,734 questioned costs, but they covered multiple invoice time periods and copies were not attached to each of the invoices covered by that timesheet. A schedule for PW 1413 showing specific invoices and time sheets is attached. Copies of the timesheets are also attached. Of the remaining \$4,944 of questioned costs, it is reasonable that someone in a management role reviewed the invoices before they were paid, and determined that services were performed.

Finding C: Unallowable Markups

The time-and-materials contracts normally allow a percentage to cover the overhead of the contractor or subcontractor, which is supported and encouraged in the development of FEMA's CEF's, as well as other FEMA-approved estimating methods (e.g. RS Means).

Finding D: Non-Disaster Related Costs

In an emergency, it is often more practical to have workers eat on site, in order to decrease downtime (and potential overtime). This would certainly fall into the category of reasonableness. MHHS incurred costs that we felt were reasonable to complete the job. If project managers and contractors felt it was reasonable to reimburse employees for such costs, we then by extension incurred and paid such costs.

Finding E: Overstated Contractor Labor Costs

There were isolated instances where the labor rate billed and paid slightly exceeded the hourly rate in the contract.

Finding F: Unsupported Contractor Material Costs

During the emergency phase of this disaster, some of the contractor's receipts were probably misplaced or not obtained since many organizations have rules regarding receipts for \$25 or less. It is reasonable to assume that someone in a management role reviewed the invoices before they were paid, and determined that services were performed and supplies were purchased.

Finding G: Unclaimed Credits

MHHS requested credit from the vendor prior to the OIG audit.

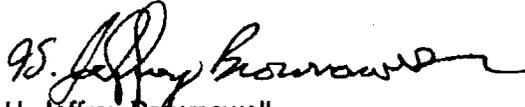
Finding H: Unallowable Taxes

In most instances, MHHS did not reimburse contractors for sales tax they paid, and contractors were given MHHS's tax exemption certificate to use when purchasing materials for this job. However, early in the disaster, there were a few instances in

which the contractor paid sales tax on items purchased prior to receiving the tax exemption certificate.

Please forward this response to Mr. Daniel Benbow from the Office of Inspector General for their review and consideration. If there are any questions, please call Susie Ecklund or myself at 713-448-4155 or 713-448-5715.

Sincerely,

A handwritten signature in black ink, appearing to read "H. Jeffrey Brownawell". The signature is fluid and cursive, with a long horizontal stroke at the end.

H. Jeffrey Brownawell
Vice President, Managed Care

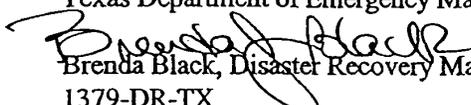


Federal Emergency Management Agency

Region VI
Federal Regional Center
800 North Loop 288
Denton, Texas 76209-3698

November 21, 2002

MEMORANDUM FOR: Deborah Mosley, Alternate State Coordinating Officer
Texas Department of Emergency Management

FROM: 
Brenda Black, Disaster Recovery Manager
1379-DR-TX

SUBJECT: FEMA reimbursement of noncompetitive contracts used by
Public Assistance applicants in response to Tropical Storm
Allison (FEMA-1379-R-TX)

In response to the November 15, 2002 inquiry, from Mr. Rick Patterson (of your staff), concerning the FEMA approval of noncompetitive contracts for some of the Texas Medical Center applicants, the following circumstances must be kept in mind:

1. The majority of the TMC applicants are considered critical facilities whose primary purpose is to save lives. These critical facilities were catastrophically damaged by Tropical Storm Allison floodwaters rendering them inoperable. Therefore a very real public emergency to the entire City of Houston existed at the time of the disaster that did not allow adequate time for competitive contracting.
2. Most of the TMC applicants had contaminated hazardous materials in their facilities requiring specialized remediation contractors to effectively complete critical cleanup and repairs under emergency conditions.
3. Most of the TMC applicants had pre-disaster competitively bid contracts with contractors who had equipment on-site, had construction staff who were familiar with the TMC facility infrastructure and who were technically qualified to address the emergency work and complete repairs in a effective manner.

In FEMA's response to the situation these factors were all reviewed and it was determined that noncompetitive contracting was allowable and that the contract prices paid were reasonable and necessary. Various Project Worksheets have been approved by FEMA for these eligible costs. FEMA staff used various techniques to analyze these contracts and applied the following criteria.

1. FEMA Regulations: 44 CFR 13.36 d (4) Procurement by noncompetitive proposals is procurement through solicitation of a proposal from only one source, or after solicitation of a number of sources, competition is determined inadequate.
 - a. Procurement by noncompetitive proposals may be used only when the award of a contract is infeasible under small purchase procedures, sealed bids or competitive proposals and one of the following circumstances applies:
 - (1) The item is available only from a single source;
 - (2) delay resulting from competitive solicitation.
 - (3) The awarding agency authorizes noncompetitive proposals; or
 - (4) After solicitation of a number of sources, competition is determined inadequate.
2. OMB A-87 C(2): Reasonable costs: A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when governmental units or components are predominately federally funded. In determining reasonableness of a given cost, consideration shall be given to:
 - a. Whether the cost is of the type generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the Federal award.
 - b. The restraints or requirements imposed by such factors as: sound business practices; arms lengths bargaining; Federal, State and other laws and regulations, and, terms and conditions of the Federal award. Market prices for comparable goods and services.
 - c. Whether the individuals concerned acted with prudence in the circumstances considering their responsibilities to the governmental unit, its employees, the public at large, and the Federal Government.
 - d. Significant deviations from the established practices of the governmental unit that may unjustifiably increase the Federal award's cost.

In conclusion, FEMA has determined that the use of certain noncompetitive contracts was both appropriate and reasonable under the circumstances prevailing at the time of the disaster.