



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

Food and Nutrition Service  
National School Lunch Program -  
Food Service Management Companies



Report No.  
27601-9-Te  
March 2001



UNITED STATES DEPARTMENT OF AGRICULTURE  
OFFICE OF INSPECTOR GENERAL  
Southwest Region  
101 South Main  
Temple, Texas 76501



DATE: March 28, 2001

REPLY TO  
ATTN OF: 27601-9-Te

SUBJECT: National School Lunch Program – Food Service Management Companies

TO: Ruthie Jackson  
Regional Administrator  
Food And Nutrition Service  
1100 Commerce Street, Room 5-C-30  
Dallas, TX 75242

ATTN: Ronald Rhodes  
Director  
Special Nutrition Programs

This report presents the results of our audit of the National School Lunch Program – Food Service Management Companies. Food and Nutrition Service Regional Office's (FNSRO) written response to the draft report is included as exhibit B and FNSRO's comments and OIG's position concerning the written response are set forth in the individual audit findings.

We agreed with FNSRO's comments; however, additional information is needed to reach a management decision on the audit recommendations. The information needed to reach an agreement is set forth in the findings and recommendations section of the report.

In accordance with Department Regulation 1720-1, please furnish a reply within 60 days describing corrective actions taken or planned and the timeframe for implementing the recommendations for which management decisions have not yet been reached. Please note that the regulation requires management decisions to be reached on all findings and recommendations within a maximum of 6 months from report issuance. Please follow your internal agency procedures in forwarding final action to the Office of the Chief Financial Officer.

We appreciate the cooperation and courtesies provided during our audit.

/s/ Ralph P. Childs  
for  
ROBERT E. GRAY  
Regional Inspector General  
for Audit

Attachment

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# EXECUTIVE SUMMARY

## FOOD AND NUTRITION SERVICE NATIONAL SCHOOL LUNCH PROGRAM - FOOD SERVICE MANAGEMENT COMPANIES

REPORT NO. 27601-9-Te

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### RESULTS IN BRIEF

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The National School Lunch Program (NSLP) provides Federal assistance to help public and nonprofit private schools, as well as public and nonprofit private residential child-care institutions, serve nutritious lunches to children. We performed this audit as part of a nationwide review of Food and Nutrition Service (FNS), NSLP – Food Service Management Companies (FSMC). We selected two FSMC's conducting business with School Food Authorities (SFA) in New Mexico since the other FSMC's operating in the Southwest Region Food and Nutrition Service Regional Office (FNSRO) have been reviewed by other Office of Inspector General (OIG) regional offices. The objective of this audit was to determine whether sufficient controls existed to ensure that the selected FSMC's properly credited SFA's for United States Department of Agriculture (USDA) donated commodities, purchase discounts, rebates, or other credits applicable to NSLP/School Breakfast Program (SBP).

During school year (SY) 1999<sup>1</sup>, FSMC1 failed to credit the value of donated commodities used during its first-year contract with SFA1. As a result, FSMC1 overcharged SFA1 \$3,733 for the value of the donated commodities. We also determined during calendar years (CY) 1997 to May 2000, FSMC2 billed SFA2 and SFA3 \$44,739 for certain semivariable costs calculated on a prohibited "percentage of gross sales" method.

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### KEY RECOMMENDATIONS

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We recommend that the New Mexico State Agency (SA) recover the overcharges totaling \$48,472 from FSMC's. In addition, ensure that FSMC's only charge fees for which there is a basis in the requests for proposal (RFP) and contracts.

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### AGENCY RESPONSE

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FNSRO's written response to the draft report (exhibit B) concurs with the findings and recommendations.

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<sup>1</sup> SY is for the period from August to June of the following year.

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## OIG POSITION

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action will be completed

We agree with the response; however, to reach management decision we need documentation showing specific corrective action to be taken and the timeframe within which the corrective

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# INTRODUCTION

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## BACKGROUND

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The NSLP provides Federal assistance to help public and nonprofit private schools, and public and nonprofit private residential child-care institutions, serve nutritious lunches to children.

The USDA offers payment of general and special assistance to States based upon the numbers and categories of lunches served, and special cash assistance for lunches served under the NSLP/SBP to school-age children eligible for free, reduced-price, and paid lunches. Eligibility of children for free or reduced-price lunches is based upon the family's household size and income, as listed in the FNS Income Eligibility Guidelines, which are revised annually.

The FNSRO's provide technical assistance to SA's and monitor them by conducting management evaluations. They also monitor and control the flow of Federal funds to the States through a review of reports which detail the financial expenditures of the States and the number of free, reduced-price, and paid meals served.

Within each State, the responsibility for administration of the NSLP/SBP in schools normally should be in the State's education or human service agencies. Each SA is required to enter into a written agreement with FNS for the administration of the NSLP/SBP. Through written agreements with each SA, SFA's administer the NSLP/SBP at the local school district level or qualifying institutions under the Federal or State regulations. The SA monitors the SFA's participation in the programs and reimburses SFA's at established per-meal rates with NSLP/SBP funds on the basis of monthly meal count claims filed by SFA's.

A SFA is allowed to contract with FSMC's to manage the food service operation. However, the SFA is still responsible for program integrity and must adhere to Federal and State requirements. Contracts between SFA's and FSMC's may include a fixed rate per meal or a reimbursement of costs. Both types of contracts require that certain types of benefits accrue back to SFA. In fixed-rate-per-meal contracts, the FSMC is required under the contract to credit the SFA the full value of commodities donated by USDA to the FSMC and used in the NSLP/SBP. For cost-reimbursable contracts, the value of USDA denoted foods used should be itemized in the regular monthly billings to SFA to document savings resulting from commodity usage. However, the FSMC may receive volume purchase discounts and rebates, which entitle the SFA to share in the cost savings.

In New Mexico for SY 1999-2000, there were 25 SFA's representing 94 schools, which contracted with a FSMC to manage their school food service operation. There are five FSMC's currently operating in New Mexico.

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## **OBJECTIVE**

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The objective of this audit was to determine whether sufficient controls existed to ensure that the selected FSMC's properly credited SFA's for USDA-donated commodities, purchase discounts, rebates, or other credits applicable to NSLP/SBP.

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## **SCOPE**

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Audit coverage included review of CY 1997 through May 2000 RFP's, contract approval procedures, contract documents, the FSMC monitoring procedures, and meal accountability systems. We visited FNSRO in Dallas, Texas, and two SA's (the New Mexico State Department of Education Student Programs Unit in Santa Fe, New Mexico; and the Texas Education Agency in Austin, Texas).

In New Mexico, we selected and visited two FSMC's and all six contracted SFA's (SFA's 1 – 6). The criteria for selecting FSMC2 was based upon the selection of 14 States that either had the highest percentage use of FSMC or had over 40 FSMC contracts. Then we had to ensure that each region reviewed a different FSMC. The SA recommended we visited FSMC1. We did not visit any SFA's in Texas. According to Texas SA official and Texas law, Texas required school districts to use a State consortium to process their orders and purchases for all school products. Since one of the major audit reviews involved purchase discounts and rebates, this would not be an issue in Texas. Fieldwork was performed June 13, 2000, through January 10, 2001.

We conducted the audit in accordance with the Government auditing standards issued by the Comptroller General of the United States.

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## **METHODOLOGY**

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To accomplish our objective, at the FNSRO located in Dallas, Texas, we interviewed officials and reviewed records to obtain background information pertaining to the NSLP and the food distribution programs. We also evaluated policies, procedures, and controls for issuing RFP's, contracting with FSMC's, and distribution of commodities.

At the New Mexico SA, we reviewed and evaluated CY's 1997 through May 2000 RFP's, contract approval procedures, contract documents, SFA monitoring procedures, and meal accountability systems. We also documented and reviewed the number of free, reduced-priced, and paid lunches SFA's claimed.

At the SFA's, we interviewed officials and reviewed and evaluated the bidding, issuing, and contracting with FSMC's. We further evaluated the

SFA's handling of USDA-donated commodities and procedures used to ensure accuracy of meal claims.

At the FSMC's, we reviewed and evaluated procedures FSMC's followed to submit claims to SFA's, and procedures followed to ensure that USDA donated commodities were properly credited to SFA's. We reviewed and evaluated contracts with food suppliers and performed tests to determine if discounts and rebates were given. We also performed random testing of invoices to determine whether adequate supporting documentation was obtained.



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## FINDINGS AND RECOMMENDATIONS

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### CHAPTER 1

### FSMC's NONCOMPLIANCE WITH REGULATIONS AND CONTRACTS

Although required by NSLP regulations and as stipulated in the contract between the FSMC and the SFA's, FSMC1 did not credit SFA1 for \$3,733 in donated commodities used during SY 1999. Also, FSMC2 used a prohibited "cost-plus-a-percentage-of-income" method to claim \$44,739 against SFA's 2 and 3 during January 1997 through May 2000.

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#### **FINDING NO. 1**

#### **THE VALUE OF USDA-DONATED COMMODITIES NOT CREDITED TO THE SCHOOL**

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The FSMC1 consumed USDA-donated commodities in SFA1's school lunch program but did not credit SFA1 for the value of the USDA-donated commodities. This occurred because SFA1 failed to exercise its oversight responsibility to ensure that FSMC1 complied with the terms of the contracts and Federal regulations. This resulted in the FSMC1 over-

billing SFA1 in the amount of \$3,733.

Under the provisions of 7 Code of Federal Regulations (CFR) 210.16(a)(6), dated January 1, 1998, any SFA that employs a FSMC shall ensure that all Federally donated foods received by a SFA and made available to a FSMC accrue only to the benefit of the SFA's nonprofit school food service. The contract contained this regulatory provision. The regulations further state that FSMC would fully utilize the donated commodities.

Also, Contracting with Food Service Management Companies Guidance for School Food Authority, dated June 1995, states that in fixed-price contracts, in order to establish and document the commodity value-pass-through, the contract should specify that the credits or reductions would be indicated on the invoices to the SFA.

New Mexico SA records show SFA1 had been credited \$3,733 in donated commodities for SY 1999. This was the first year SFA1 had contracted with FSMC1. The contract was a fixed-rate contract. Our interview with FSMC1 official confirmed that the commodities had been used for the school lunch program. We reviewed FSMC1's monthly invoices submitted to the school and determined the value of the donated commodities had not been credited to SFA1. Furthermore, the official stated that the value of the commodities

was included in calculating the bid rate per meal. The FSMC1 officials could not provide documentation supporting the bid-rate-per-meal calculation because they merely used the calculation established by the previous FSMC.

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## **RECOMMENDATION NO. 1**

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Require the New Mexico SA to recover the overcharges totaling \$3,733 from FSMC1.

### **FNS Response**

FNSRO's written response to the draft report (exhibit B) expresses concurrence with the finding and recommendation.

### **OIG Position**

We agree with the response; however, to reach management decision, we need documentation showing specific corrective action to be taken and the timeframe within which the corrective action will be completed.

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## **FINDING NO. 2**

### **OTHER DIRECT COSTS OR SEMI-VARIABLE COSTS UNAUTHORIZED**

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The FSMC2 billed SFA2 and SFA3 for unauthorized costs. This occurred because FSMC2 billed other direct costs based on a prohibited "percentage of gross sales" method. The SFA's did not detect the problem because they did not review or request documentation from FSMC2 on variable costs. As a result, FSMC2 overcharged SFA2 and SFA3 \$44,739

from January 1997 through May 2000.

Regulations prohibit contracts that permit (1) all income and expenses to accrue to FSMC, and (2) "cost-plus-a-percentage-of-cost" and "cost-plus-a-percentage-of-income" charges<sup>2</sup>.

FSMC2 entered into school lunch agreements (contracts) with SFA2 and SFA3 to provide food service operations. FSMC2 was to be paid for the service based on a reimbursement of its direct cost plus a general administrative expense and a management fee. The contracts state that FSMC2, as a direct cost of operation, shall employ and maintain an adequate staff of employees at school to operate the food service under this agreement, and shall provide administrative, dietetic, purchasing, and personnel advice and supervision; however, the cost of FSMC2's offsite personnel shall not be included as a direct cost of operation. FSMC2 shall receive for its services a general administrative expense of \$.082 and a management fee of \$.05 for all reimbursable and equivalent meals served. Amendment 1 of the contracts between the SFA's and FSMC2 states that a

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<sup>2</sup> 7 CFR 210.16(c) revised January 1, 1998.

“cost-plus-a-percent-of-cost or income” has neither been nor will be implemented at the schools. The RFP also stated that all gas, maintenance, repairs, and other expenses for the food transportation vehicle must be paid by the successful offerer.

From our review of the general ledgers and monthly billings to the schools, we found that FSMC2 also charged the schools semi-variable costs or other direct costs beside those described in the contracts under the categories of direct costs, administrative fee, and management fee. Some of the semi-variable costs could not be traced to the voucher numbers. We questioned FSMC2 officials on these costs and how they were calculated. FSMC2 officials stated that depreciation expense, vehicle expense, food school director (FSD) compensation, and franchise fees were prorated to each SFA on a percent of gross sales times the number of meals served during the month. For example, the schedule of allocation showed vehicle expense was allocated monthly upon percentage of gross sales (2 percent of gross sales). The other expenses were prorated based upon percentage of gross sales divided by 180 operating school days in a year to derive at a set dollar amount, then multiplied by the number of days in operation during the month<sup>3</sup>.

The following table shows FSMC2’s billing for the unauthorized semi-variable costs:

School	Date	Depreciation Expense	Vehicle Expense	FSD Compensation	Franchise Fee	Grand Total
SFA2	January 2000 to May 2000	\$ 331.76	\$ 594.26	\$ 2,816.00		
	January 1999 to December 1999	1,424.31	1,610.33	4,265.00	\$318.00	
	January 1998 to December 1998	1,567.02	1,606.73	4,612.14	0	
	January 1997 to December 1997	1,769.83	1,545.73	4,642.58	0	
SUBTOTAL		\$5,092.92	\$5,357.05	\$16,335.72	\$318.00	\$27,103.69
SFA3	January 2000 to May 2000	\$ 251.22	422.80	\$ 1,855.71	0	
	January 1999 to December 1999	\$10.82	1,133.44	3,233.30	\$212.00	
	January 1998 to December 1998	870.76	926.46	3,011.89	0	
	January 1997 to December 1997	1,113.71	798.45	3,094.37	0	
SUBTOTAL		\$2,946.51	\$3,281.15	\$11,195.27	\$212.00	\$17,634.93
Total		\$8,039.43	\$8,638.20	\$27,530.99	\$530.00	\$44,738.62

As stated earlier, the costs in the table above were billed as separate line items in addition to the agreed-to charges (direct costs, administrative expense, and management fee) in the contracts. The costs were unauthorized because they were calculated on a percentage of gross sales (same as income) that was prohibited by the contracts and Federal regulations. Since these expenses applied to more than one SFA, there was not a separate expense voucher to support these charges as direct costs. Therefore, if the costs are allowable and are to be claimed by FSMC2, they

<sup>3</sup> We were not able to obtain the specific percentages for these other expenses.

would have to be incorporated into the administrative and/or management fee rates in the contract.

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## **RECOMMENDATION NO. 2**

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Require the New Mexico SA to recover the overcharges totaling \$44,739 from FSMC2.

### **FNS Response**

FNSRO's written response to the draft report (exhibit B) expresses concurrence with the finding and recommendation.

### **OIG Position**

We agree with the response; however, to reach management decision, we need documentation showing specific corrective action to be taken and the timeframe within which the corrective action will be completed.

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## **RECOMMENDATION NO. 3**

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Require New Mexico SA, in their review of contracts and SFA's to ensure that FSMC's only charge fees for which there is a basis in the RFP's and contracts.

### **FNS Response**

FNSRO's written response to the draft report (exhibit B) expresses concurrence with the finding and recommendation.

### **OIG Position**

We agree with the response; however, to reach management decision, we need documentation showing specific corrective action to be taken and the timeframe within which the corrective action will be completed.

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<sup>4</sup> 7 CFR 210.24, January 1, 1998

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## GENERAL COMMENTS

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The New Mexico SA and SFA's lacked internal controls. We noticed school officials violated the Federal bidding requirements. For example, SFA's did not solicit bids through the newspaper until after the deadline to solicit bids had expired and SFA5 had signed a contract with FSMC1. The New Mexico SA official was aware of the situation but still instructed the school to publicize the bid in the newspaper. This limits open and free competition.

We also determined that New Mexico SA officials were not aware that SFA4 had contracted in SY1999 for a first-year contract award with FSMC1 to provide food service operations. During our fieldwork at the New Mexico SA, we obtained a listing of all SFA's who had contracted with FSMC's. This list did not include SFA4 contracting with FSMC1. We became aware of the circumstances when we visited and reviewed the other two SFA's who also contracted with FSMC1. Although SFA4 would have still contracted with FSMC1, the SA was unable to exercise oversight and ensure SFA4 was in compliance with all the provisions <sup>5</sup>.

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<sup>5</sup> 7 CFR 210.16, January 1, 1998

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## EXHIBIT A – SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Value of USDA-donated commodities not credited to the school	\$ 3,733	Questioned Costs, Recovery Recommended
2	2	Other direct costs or semi- variable costs unauthorized	44,739	Questioned Costs, Recovery Recommended
<b>TOTAL</b>			<b>\$48,472</b>	

## EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT



United States Department of Agriculture  
Food and Nutrition Service  
Southwest Region

15 MAR 2001

Reply to  
Attn of: SWSN-220

Subject: National School Lunch Program - Food Service Management Companies, Audit  
27601-9-Te

To:  
Robert E. Gray  
Regional Inspector General

This is to provide our concurrence with the findings and recommendations in Audit  
27601-9-Te.

Thank you for the opportunity to comment on this audit report.

  
RONALD J. RHODES  
Regional Director  
Special Nutrition Programs

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## ABBREVIATIONS

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CFR	Code of Federal Regulations
CY	Calendar Year
FNS	Food and Nutrition Service
FNSRO	Food and Nutrition Service Regional Office
FSMC	Food Service Management Companies
NSLP	National School Lunch Program
OIG	Office of Inspector General
RFP	Requests for Proposal
SA	State Agency
SBP	School Breakfast Program
SFA	School Food Authority
SY	School Year
USDA	United States Department of Agriculture