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Standards and Technology***

***Massachusetts MEP
MEP Award No. 70NANB5H1144***

***Final Audit Report No. DEN-18135
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CONTENTS

Introduction	1
Findings and Recommendations	1
I. Unallowable Subrecipient Costs.....	2
A. Association for Manufacturing Excellence.....	3
B. Associated Industries of Massachusetts	5
C. Summary of Massachusetts MEP Response.....	7
D. OIG Comments.....	7
II. Unallocable Contract Costs	9
A. New England Manufacturing Supply Chain Initiative.....	10
B. Machine Operators Skills Training Grant.....	11
C. Massachusetts MEP Response	12
D. OIG Comments.....	12
III. Questioned Contractual and Other Direct Costs.....	13
A. Summary of Massachusetts MEP Response.....	13
B. OIG Comments.....	13
IV. Excess Program Income.....	13
A. Summary of Massachusetts MEP Response.....	14
B. OIG Comments.....	15
V. Recommendations	16
Summary Results of Financial Audit.....	17

Appendix A: Objectives, Scope, and Methodology	18
Appendix B: Summary of Source and Application of Funds	20
Appendix C: Summary of Financial/Compliance Audit	21
Appendix D: Massachusetts MEP Response to Draft Audit Report	23

INTRODUCTION

In September 2005, the National Institute of Standards and Technology (NIST) awarded Manufacturing Extension Partnership Cooperative Agreement No. 70NANB5H1144 to the Massachusetts Manufacturing Extension Partnership (MEP) to continue operating an existing MEP center. The center had been operating for several years under a prior NIST cooperative agreement, with an award period of February 9, 1998, through June 30, 2005. The September 2005 award approved funding for the period of July 1 through December 15, 2005. The award was later amended to extend the award period for 12 months from July 1, 2005, through June 30, 2006. Total estimated project costs for the 12-month award period were \$7,094,313, with the federal government's share not to exceed \$2,364,771, or 33 percent.

During the award period of July 1, 2005, through June 30, 2006, Massachusetts MEP submitted financial reports to NIST claiming total project costs of \$9,392,908 and received federal reimbursements totaling \$2,364,771.

FINDINGS AND RECOMMENDATIONS

We questioned \$5,086,998 in costs, as follows:

- \$4,167,430 claimed for two Massachusetts MEP subrecipients who could not provide documentation that their claims were based on actual costs incurred under their subawards
- \$908,823 (including associated indirect costs) incurred under two procurement contracts received by Massachusetts MEP for services that the procuring entities used and benefitted by but that did not accomplish NIST cooperative agreement objectives
- \$[REDACTED] in consultant costs for services provided prior to the July 1, 2005, starting date of the award
- \$[REDACTED] of indirect costs associated with the preaward consultant costs

In addition to questioned costs, we found Massachusetts MEP reported that it had earned program income exceeding its nonfederal matching share expenditures by \$1,093,495 for the year ended June 30, 2006, but did not request required NIST approval to carry the undisbursed program income forward to be applied to nonfederal expenditures in the subsequent award period. Without carry-forward approval, the undisbursed program income must be used to reduce the federal share of Massachusetts MEP's expenditures, in accordance with cooperative agreement

terms and conditions and federal regulations.

Because of the questioned costs and excess program income, Massachusetts MEP ultimately received \$1,294,073 in excess federal funding.

A summary of the results of our financial audit appears on page 17.

On September 20, 2008, Massachusetts MEP provided a written response to our draft audit report, which we had issued on August 21, 2008. We summarize that response in the appropriate sections of this report and have attached it in its entirety (excluding supplemental supporting data) as appendix D.

I. Unallowable Subrecipient Costs

Massachusetts MEP's claimed project costs for the period July 1, 2005, through June 30, 2006, included \$4,167,430 for costs incurred by two subrecipients, the Association for Manufacturing Excellence (AME) and Associated Industries of Massachusetts (AIM). Massachusetts MEP provided summaries of the costs claimed for both subrecipients, showing total expenditures of \$[REDACTED] for AME, and \$[REDACTED] for AIM, under their respective subawards. These figures total \$4,209,781, but Massachusetts MEP's cost claims to NIST were \$4,167,430 for the two subawards, a difference of \$42,351. The MEP's financial records did not indicate a basis for the difference, which amounts to about 1 percent of total costs claimed for the two subawards. We used \$4,167,430 as the basis for determining questioned costs.

Neither subrecipient could provide documentation supporting that its claims were based on actual costs incurred under the Massachusetts MEP's subawards. In fact, neither subrecipient tracked costs under its subaward for a detailed accounting and audit trail.

NIST's operating plan guidelines for MEP centers, issued in March 2005, require all MEP subawards to include the applicable administrative requirements and all general and special award conditions imposed on the recipient. The administrative principles contained in 15 CFR Part 14 are incorporated by reference into Massachusetts MEP's cooperative agreement with NIST. These requirements flow down to subrecipients, pursuant to 15 CFR Sec. 14.5. Minimum requirements for recipient and subrecipient accounting systems, as established in 15 CFR Sec. 14.21, include

- accurate, current, and complete disclosure of the financial results of each federally sponsored project or program (Sec. 14.21(b)(1)),

- comparison of outlays with budget amounts for each award (Sec 14.21(b)(4)), and
- written procedures for determining the reasonableness, allocability, and allowability of costs in accordance with applicable cost principles and the terms and conditions of the award (Sec. 14.21(b)(6)).

Neither the AME nor the AIM subaward was in compliance with these requirements. Rather than tracking and reporting actual costs incurred, both simply reported large portions of their annual operating expenses as costs under the subawards. Neither subrecipient provided a subaward budget based on estimated costs against which it could compare actual outlays. In addition, neither had written procedures in place to determine whether amounts reported to Massachusetts MEP met allowability criteria established by applicable federal cost principles. Instead, the subrecipients had excluded broad cost categories from reports to the Massachusetts MEP at the partnership's instruction. The processes the subrecipients used are described below.

A. Association for Manufacturing Excellence

AME's outside accountants provided unaudited financial reports for the year ended June 30, 2006. The reports showed total expenses of \$ [REDACTED], accumulated in 12 broad categories (see table 1). In the two categories noted with the asterisk (*), "General & Administration" and "Regional Summary," Massachusetts MEP reduced the total amount reported by removing certain line items not included in its financial reports to NIST.

Table 1. Total AME Expenditures for the Year Ended June 30, 2006 (Unaudited)

Category	Included in MEP claim?	Amount
General & Administration	Yes*	\$ [REDACTED]
Development	Yes	[REDACTED]
Annual Conference	Yes	[REDACTED]
Future Year Conference	No	[REDACTED]
IW Conference	Yes	[REDACTED]
Conference Support Team	No	[REDACTED]
Canadian Kitchener	No	[REDACTED]
AME Institute	Yes	[REDACTED]
Target Magazine	Yes	[REDACTED]
Champion Income	Yes	[REDACTED]
International Income	No	[REDACTED]
Regional Summary	Yes*	[REDACTED]
Total		[REDACTED]

In the "General & Administration" category, Massachusetts MEP excluded \$[REDACTED] in bad debts, bank charges, credit card fees, and depreciation from AME's expenses for the year ended June 30, 2006. In the "Regional Summary" category, the partnership excluded \$[REDACTED] related to Canadian and other international activities. After making the adjustments as explained by Massachusetts MEP, the amount AME claimed for the subaward should have been \$[REDACTED]. However, Massachusetts MEP's cost summaries show expenses of \$[REDACTED] for the AME subaward, a difference of \$32,872. Massachusetts MEP did not explain the reason for the difference.

In addition to our concerns about the overall allowability of costs reported under the AME subaward, we have concerns about AME's subaward reporting of program income and indirect costs.

AME's unaudited financial reports showed revenue figures for each of the 12 cost categories. Total revenue reported for the Massachusetts MEP subaward categories was about \$[REDACTED]. None of AME's revenue is included in program income reported to NIST by Massachusetts MEP.

Program income, as defined in 15 CFR Sec. 14.2(aa), is gross income directly generated by a supported activity or earned as a result of an award. We cannot determine from the information provided exactly how much AME revenue falls within the definition of program income. AME's financial reports indicate that at least \$2.4 million was generated by conferences, and those associated costs were included in Massachusetts MEP's cost claims to NIST. Since Massachusetts MEP did not recognize program income generated by AME, total program income reported to NIST is significantly understated.

AME reported subaward costs of \$[REDACTED] in the "General & Administration" category (\$[REDACTED], less the \$[REDACTED] of adjustments made by Massachusetts MEP). Neither AME nor Massachusetts MEP adjusted that category to account for the portion of these costs applicable to the categories not included in the subaward cost claim. For example, AME's claimed subaward costs do not include the \$[REDACTED] in the Canadian Kitchener category. However, no adjustment was made to reduce general and administration expenses applicable to the excluded costs. The subaward cost claim is overstated because it includes general and administration costs associated with activities Massachusetts MEP directed to be excluded.

Although we understand the process AME was directed to use to report subaward costs to Massachusetts MEP, AME's practice does not comply with 15 CFR Sec. 14.21 because it does not (1) accurately disclose actual costs incurred under the subaward, (2) compare actual outlays with budgeted amounts, and (3) rely on written procedures for determining allowability of costs. Instead, the claimed costs simply reflect a major portion of the costs AME incurred while performing its

regular operations—operations it appears would have been performed regardless of any subaward relationship between AME and Massachusetts MEP. We questioned all costs claimed by Massachusetts MEP related to its subaward to AME. If NIST allows any of these costs, then it should also address the issues of unreported program income of up to \$[REDACTED] and “General & Administration” expenses allocable to costs not included in the MEP claim.

B. Associated Industries of Massachusetts

Massachusetts MEP’s cost summaries included \$[REDACTED] for the AIM subaward. The partnership gave us schedules showing AIM’s calculations for the period July 1, 2005, through March 31, 2006, but did not provide support for AIM subaward cost claims for the period April 1, 2006, through June 30, 2006. We found AIM reported expenditures that are not *actual costs* but *estimates* based on the organization’s lobbying activities and membership mix. AIM calculated its subaward cost claim by accumulating all costs incurred in three line items: salaries and benefits, taxes and insurance, and rent and utilities. AIM then reduced the figure by a factor to account for the percentage of its total costs related to lobbying activities. AIM claimed that [REDACTED] percent of its operations were dedicated to lobbying activities during the subaward performance period. Finally, AIM multiplied the calculated amount by a factor to reflect the percentage of AIM member companies that are manufacturers, which it claimed was [REDACTED] percent. Table 2 illustrates AIM’s calculation of estimated subaward expenditures, using the month of January 2006 as an example.

Table 2. Illustration of AIM Subaward Cost Claim for the Month of January 2006

Operating Expense Category	Amount/Calculation
Salaries and benefits	\$ [REDACTED]
Taxes and insurance	[REDACTED]
Rent and utilities	[REDACTED]
<i>Subtotal</i>	\$ [REDACTED]
Less lobbying factor ([REDACTED] % x \$ [REDACTED])	[REDACTED]
<i>Subtotal</i>	[REDACTED]
Percentage of manufacturers ([REDACTED] % x \$ [REDACTED])	[REDACTED]
<i>Subaward claim for January 2006</i>	\$ [REDACTED]

AIM’s method of calculating the cost of its participation under the Massachusetts MEP subaward is not in compliance with 15 CFR Sec. 14.21, because it does not (1) accurately disclose actual costs, (2) allow for comparison of actual outlays with budgeted amounts, or (3) rely on written procedures for determining allowability of costs incurred.

We questioned whether Massachusetts MEP’s relationship with AIM was a valid subaward. When we met with AIM’s chief financial officer to discuss the organization’s participation under the subaward, he adamantly insisted AIM was

not a subrecipient of Massachusetts MEP. The CFO stated that his organization had a memorandum of understanding to work with the partnership. The CFO stated he was aware that Massachusetts MEP received funding from the federal government, but he did not know the specific details of the NIST cooperative agreement. The CFO also stated that he had made it clear to Massachusetts MEP throughout the course of his organization's working relationship with the partnership that AIM had no desire to be a subrecipient.

We also are concerned about the form and structure of the alleged subaward agreement with AIM, which as the CFO stated is titled "Memorandum of Understanding." NIST's 2005 operating plan guidelines for MEP centers required certain provisions to be included in all MEP subaward agreements, such as identification of the NIST cooperative agreement number and program number in the *Catalog of Federal Domestic Assistance*, a detailed object class budget for the subaward, and notification of terms, conditions, and other award principles that flow down from the cooperative agreement to the subaward. We found the written agreement between AIM and Massachusetts MEP met none of these requirements.

The subaward agreement between Massachusetts MEP and AIM does not mention NIST funding. The agreement refers to "the federally funded Manufacturing Extension Partnership program" but does not identify NIST as the funding agency. The agreement references a subaward only once, in Schedule A, which states that Massachusetts MEP is providing a subaward of state funds—not MEP cooperative agreement funds—in the amount of \$[REDACTED] per month to AIM.

We also found no detailed budget included in the agreement, as required by NIST's MEP operating plan guidelines. Other than the mention of \$[REDACTED] per month in state funding from Massachusetts MEP to AIM, there is no mention of any financial commitment by either party. Special Award Condition No. 6.a.3 of Massachusetts MEP's cooperative agreement, signed by the NIST grants officer and accepted by the MEP in September 2005, approved a subaward to AIM in the amount of \$[REDACTED] for the period July 1, 2005, through June 30, 2006. There was nothing in either the agreement between Massachusetts MEP and AIM, or in NIST's cooperative agreement terms and conditions that indicated AIM would incur more than \$[REDACTED] in subaward expenses during the 1-year performance period.

We found the agreement did contain a list of federal laws and regulations with which the parties agreed to comply. However, the applicable administrative and cost principles of 15 CFR, Part 14 (administrative), and OMB Circular A-122 (cost principles) of the AIM subaward were not included.

Based on the issues we found, we questioned all the costs claimed by Massachusetts MEP related to its subaward with AIM. If NIST were to conclude that any of these costs are allowable, it should not accept more than the \$[REDACTED] approved in the

terms of Massachusetts MEP's cooperative agreement for the period July 1, 2005, through June 30, 2006.

C. Summary of Massachusetts MEP Response

Massachusetts MEP disagreed that costs reported by AME and AIM are unallowable, stating that Section 3003(a)(3)(C) of the America COMPETES Act of 2007 (Public Law 110-69) directs MEP centers to enter into partnerships with nonfederal entities and gives the centers authority to determine which costs incurred by these partners are reasonable and allocable as nonfederal matching share costs. Although the America COMPETES Act became law after the OIG audit period, Massachusetts MEP stated that the act simply clarifies existing law—rather than creating new law—and should be retroactively applied. The MEP therefore contended that we improperly questioned \$4,167,430 in claims associated with these partnerships.

Unaccepted AME claims. The MEP stated that NIST approved its collaboration with AME and the associated costs when approving the MEP's operating plan for the year beginning July 1, 2005. It disagreed that AME's claims do not meet regulatory requirements and stated that all AME costs are verifiable, that annual budgets are developed and reviewed, and actual costs are compared with budgets monthly and quarterly. Massachusetts MEP reiterated its contention that the America COMPETES Act gives the center authority to determine allowability of costs reported by its subrecipients.

Massachusetts MEP explained that it did not report AME's program income of \$ [REDACTED] because AME used this revenue to fund MEP activities. It further stated that AME generated an excess of MEP-related revenues over expenses of about \$ [REDACTED], but these funds would be expended on project-related costs during the subsequent subaward period, so the MEP did not report the amount to NIST.

Disputed status of MEP's relationship with AIM. Massachusetts MEP stated that OIG should not have treated AIM as a subrecipient. Instead, AIM is a third-party in-kind contributor and therefore is not required to meet the financial management standards of 15 CFR Sec. 14.21. Instead, according to the MEP, OIG should have assessed the allowability of AIM's cost claims under the standards for in-kind contributions, which appear in 15 CFR Sec. 14.23. Furthermore, the MEP contended that NIST approved AIM's methodology for allocating portions of its operating expenses to Massachusetts MEP when accepting the MEP's annual operating plan.

D. OIG Comments

America COMPETES. The Massachusetts MEP's belief that a change to the MEP

statute resulting from the America COMPETES Act gives the centers authority to determine the reasonableness and allocability of contributions is not supported by a straightforward analysis of the amendment in question. The critical sentence of the relevant change reads as follows:

All non-Federal costs, contributed by such entities and determined by a Center as programmatically reasonable and allocable under MEP program procedures are includable as a portion of the Center's contribution. 15 U.S.C. §278k(c)(3)(C).

There is no question that this provision authorizes MEP centers to make determinations as to the reasonableness and allocability of contributions they receive. That those determinations are not final is evidenced by use of the permissive word "includable," as opposed to mandatory language such as "shall be included" or "must be included." Such determinations must also be made pursuant to MEP program procedures—a critical requirement that the grantee omitted when quoting this provision. MEP program procedures explicitly call for the centers to determine what costs to *claim* and not what costs to *allow*, state that the cost principles apply and provide for program review of a recipient's claimed costs, with authority to make final determinations of reasonableness and allowability resting with the government. In light of the foregoing, the only reasonable interpretation of this sentence is that centers make initial determinations about contributed costs that can be claimed, but those determinations, pursuant to MEP program procedures, are subject to review by the government. Nothing in this language or any other provision of the act gives the centers authority to make final and unreviewable determinations regarding whether costs claimed by third-party partners are reasonable or allocable.

Because the relevant change to the MEP statute clarifies congressional intent without materially altering the rights and obligations of grantees, the change can be retroactively applied. It should be noted that had the interpretation suggested by Massachusetts MEP been correct, then under well-established principles of law it would not be eligible for retroactive application, as it would constitute a significant change in law and would materially alter grantees' rights and obligations under the program.

Unaccepted AME claims. OIG does not dispute that AME provided supporting documentation for reported costs and that the MEP engaged in some level of review of those submissions. Our contention remains that the costs were not allowable subaward costs because AME did not distinguish its subaward activities from its other business operations. The AME subaward budget mentioned in Massachusetts MEP's response did not reflect proposed costs for subaward activities, but rather broad classes of AME's projected firm-wide operating costs. Since Massachusetts MEP failed to provide any documentation showing that AME accumulated and

reported costs allocable to its subaward, separate and distinct from costs incurred through its regular annual operations, we continue to question \$ [REDACTED] claimed for this subaward.

Massachusetts MEP's rationale for not reporting AME's revenues as program income does not excuse its failure to report. Program income is gross revenue generated by a recipient or subrecipient as a direct result of the award. Notwithstanding OIG's position that none of AME's claimed costs are allowable, Massachusetts MEP should have reported as program income all revenue associated with the claimed costs—\$ [REDACTED] according to the MEP's response. After applying program income of \$ [REDACTED] to claimed AME expenses, undisbursed program income of about \$ [REDACTED] should have been reported to NIST.

Disputed status of MEP's relationship with AIM. Regarding Massachusetts MEP's assertion that OIG should have treated AIM as a third-party in-kind contributor, it was the MEP—not the auditors, as suggested in the MEP's response—that identified AIM as a subrecipient. The MEP's annual operating plan for the period July 1, 2005, through June 30, 2006, clearly refers to AIM as a subrecipient. Based on the operating plan, the NIST grants officer approved, in the special award conditions of the cooperative agreement, AIM as a subrecipient.

However, even if the MEP's position were acceptable to NIST, we do not believe the AIM claims would be allowable. The MEP Annual Operating Plan Guidelines and the terms and conditions of Massachusetts MEP's cooperative agreement establish specific requirements for documenting third-party in-kind contributions. These include, for contributions of personnel services, a list of personnel and specific projects or tasks they worked on, dates worked, number of hours contributed, hourly salary rates, and certified time and attendance records documenting the contributions. Massachusetts MEP did not provide such documentation related to AIM's claims. Furthermore, since AIM's claims were based, in large part, on percentage estimates of organization-wide salary and benefits costs, we are highly skeptical that AIM, and consequently Massachusetts MEP, could meet the documentation requirements for third-party in-kind contributions.

We continue to question \$ [REDACTED] in claims associated with AIM.

II. Unallocable Contract Costs

Massachusetts MEP's reported project costs include a total of \$908,823 in direct and indirect costs incurred under two contracts awarded to the MEP. It is important to understand that these contracts were *received* by Massachusetts MEP to provide services to the respective procuring entities, rather than *awarded* by Massachusetts MEP as part of its NIST cooperative agreement activities. As procurement contracts, not awards of financial assistance, the services provided by the MEP

under these agreements were for the direct use and benefit of the procuring entities, not for the benefit of the cooperative agreement project. Massachusetts MEP did not accumulate costs for these subcontracts under the cost center established for the cooperative agreement but instead established separate cost accounting centers for each of the subcontracts. Costs incurred under the two contracts must be allocated to the respective contracts, not the MEP cooperative agreement.

A. New England Manufacturing Supply Chain Initiative

In November 2003, officers of MEP Management Services, Inc. (MEP MSI), the partnership's managing agent, signed a "vendor agreement" with Massachusetts MEP to act as a second-tier subcontractor in a deal with the U.S. Department of Defense, which had awarded a contract to [REDACTED] to expand access among small and medium-size manufacturers to Defense Department supply chains. [REDACTED] then awarded a subcontract to MEP MSI, which in turn, awarded a subcontract to Massachusetts MEP.

The subcontract, as amended, requires Massachusetts MEP to (1) identify and establish working relationships with organizations and initiatives that could add value to the program, (2) support Defense Logistics Agency plans to integrate manufacturing capability data from multiple sources and make these data available to Defense Department procurement decision makers, (3) collect capability data from small manufacturers in six New England states and store the data using existing databases, (4) assist capable small manufacturers selected for participation in prototypes to increase their capabilities to become Defense Department suppliers, and (5) collect and report performance metrics to measure the effectiveness of the program.

The subcontract provided for MEP MSI to compensate Massachusetts MEP for services at stated billing rates, plus reimbursement for reasonable expenses in accordance with the *Federal Acquisition Regulation*. The subcontract was amended several times to extend the service period and adjust contract billing rates. On October 28, 2005, a new subcontract was issued to reflect a name change for the first-tier subcontractor from MEP MSI to Time Wise Management Systems, Inc., doing business as MEP Management Services. This subcontract extended the performance period through July 27, 2006.

During the period July 1, 2005, through June 30, 2006, Massachusetts MEP claimed \$[REDACTED] in costs to NIST for services under the Defense Department subcontract. The MEP's financial records indicate it received \$[REDACTED] in revenue under the subcontract. We verified that the revenue was included in program income reported to NIST. (See page 13.)

We examined Massachusetts MEP's operating plan submitted to NIST for the

period July 1, 2005, through June 30, 2006, to determine whether the MEP disclosed the Defense Department subcontract. The manufacturing supply chain initiative is mentioned in the operating plan, but Massachusetts MEP did not disclose that costs associated with the services were funded under a Defense Department subcontract. Costs incurred under the subcontract are allocable to that contract and not the MEP cooperative agreement. We questioned \$ [REDACTED] in costs claimed relative to the subcontract.

B. Machine Operators Skills Training Grant

In August 2005, Massachusetts MEP received a subcontract from Maine MEP, which also retained Time Wise Management Systems (formerly MEP MSI) as its managing agent. According to the vendor agreement signed by officers of the Maine and Massachusetts MEPs, the U.S. Department of Labor awarded a contract¹ to the State of Maine, Department of Economic and Community Development. The state then awarded a subcontract under its Department of Labor contract to Maine MEP, which awarded a subcontract to Massachusetts MEP on August 1, 2005, making Massachusetts MEP a second-tier subcontractor. The subcontract requires Massachusetts MEP to designate a staff member as liaison with the project manager, and to (1) identify small and medium-size manufacturers to participate in the program, (2) work with local career centers to recruit potential machine operator trainees, and (3) identify institutions that can provide training facilities. It also requires the MEP to assist the project manager with other activities deemed necessary for the success of the program. The subcontract pays MEP a fixed amount of \$ [REDACTED] per year made in monthly installments plus reimbursement for reasonable expenses. The performance period for the subcontract was July 1, 2005, through June 30, 2007.

During the period July 1, 2005, through June 30, 2006, Massachusetts MEP claimed \$ [REDACTED] to NIST for services under the Department of Labor subcontract. Massachusetts MEP financial records show that it received \$ [REDACTED] in revenue under the subcontract. We verified that the revenue was included in program income reported to NIST. (See page 14.)

We examined Massachusetts MEP's operating plan submitted to NIST for the period July 1, 2005, through June 30, 2006, to determine whether the MEP disclosed the Department of Labor subcontract. We found no mention of the Machine Operators Skills Training Grant program, or any reference to the Department of Labor-funded training program in the operating plan. Costs incurred under the Department of Labor subcontract are allocable to that contract and not the Massachusetts MEP cooperative agreement. We questioned \$ [REDACTED] in costs claimed by Massachusetts MEP relative to the subcontract.

¹ The vendor agreement between Massachusetts and Maine MEPs identifies the Department of Labor agreement as a contract, although the program's name implies it was a grant.

Also, in the case of the subcontract Massachusetts MEP received from Maine MEP, it is possible that the same costs were reported to NIST under both organizations' MEP cooperative agreements. As Maine MEP had received a procurement contract from the State of Maine, Department of Economic and Community Development, all costs incurred by Maine MEP under that contract—including the costs of the subcontract to Massachusetts MEP—are allocable to Maine MEP's contract with the state, and not to Maine MEP's NIST cooperative agreement. We did not review financial records of Maine MEP in the course of our audit of Massachusetts MEP and therefore did not determine whether Maine MEP claimed, under its NIST cooperative agreement, any costs associated with its contract from the state.

C. Summary of Massachusetts MEP Response

Massachusetts MEP disagreed that \$908,823 in costs claimed under the two contracts should be disallowed, stating that, pursuant to its authority under the America COMPETES Act, the costs were reasonable and allocable to the MEP award:

The costs of the contracts are allocable to the Massachusetts MEP award because the contracts and the work performed thereunder are in furtherance of the Massachusetts MEP's mission. MEP incurred the costs associated with the contracts not because of the contracts themselves but because the contractors were like many other clients who contract with Massachusetts MEP for services.

The MEP cited OMB Circular A-133, which states that funds received as vendor payments from customers should not be considered federal award payments. "Massachusetts MEP is a vendor to Maine MEP" and services performed under the subcontract "are ancillary to the operations of the Federal (NIST MEP) program." Since the prohibition against using federal funds to pay matching share expenses applies to award payments, not vendor payments, the MEP stated that the \$[REDACTED] generated under the subcontract from Maine MEP should be eligible for use as nonfederal matching share.

D. OIG Comments

Again, we point out that the MEP's assertion that the America COMPETES Act gives MEP centers unreviewable authority to make determinations relative to allowability of nonfederal matching share costs is incorrect. Massachusetts MEP's response did not directly address our primary rationale for questioning the costs; namely, that the contracts represent individual and separate accounting cost centers within the MEP, and costs incurred under these contracts are separate and distinct from the NIST MEP award cost center. OMB Circular A-122 states, "A cost

is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received.” As procurement contracts, the services performed by Massachusetts MEP were for the direct benefit of the procuring entities and thus the costs incurred were allocable to those contracts and not the MEP award.

III. Questioned Contractual and Other Direct Costs

We identified \$ [REDACTED] in contractual costs for consultant charges for services performed before the July 1, 2005, starting date of the NIST cooperative agreement. The questioned charges include (1) [REDACTED] paid to [REDACTED] [REDACTED] for an invoice dated May 20, 2005, and (2) [REDACTED] paid to [REDACTED] [REDACTED] for consulting services provided in May 2005. Preaward costs are not allowable unless approved in writing by NIST. We found no evidence of NIST approval for preaward costs.

We also questioned \$ [REDACTED] of indirect costs associated with the questioned contractual and other direct costs.

A. Summary of Massachusetts MEP Response

Massachusetts MEP did not challenge OIG’s questioning of \$ [REDACTED] in preaward contractual costs or the associated indirect costs of \$ [REDACTED]. However, our draft audit report also questioned \$ [REDACTED] in conference registration fees—and associated indirect costs of \$ [REDACTED]—paid for staff of other MEP centers. Massachusetts MEP provided documentation that indicates these amounts were not actually included in its cost claims to NIST.

B. OIG Comments

We removed the \$ [REDACTED] in conference registration fees, and associated indirect costs of \$ [REDACTED], from amounts questioned.

IV. Excess Program Income

Our analysis showed Massachusetts MEP generated program income that exceeded its required nonfederal matching share by \$1,093,495 for the 12 months ended June 30, 2006, even after excluding the costs and revenues of the two subcontracts we questioned. The center reported earning \$ [REDACTED] in program income, of which \$ [REDACTED] was required to fund nonfederal expenditures. Program income, as defined in 15 CFR, Sec. 14.2(aa), is revenue generated by a financial assistance recipient as a result of performing work under its award. Two common sources of program income in MEP centers include tuition or other fees paid by manufacturers who attend training classes sponsored by the center and fees paid by manufacturers

for services provided by MEP staff or contractors. NIST usually allows MEP centers to use program income to fund the nonfederal share of project costs.

We reviewed Massachusetts MEP's operating plan for the year ended June 30, 2006, to determine whether the center had advised NIST that it would be generating program income in excess of its nonfederal matching share requirements. The operating plan budget projected that the center would generate \$[REDACTED] in program income that would be applied to nonfederal expenditures, leaving no undisbursed program income.

In May 2006, NIST issued a universal amendment to all MEP cooperative agreements that were in effect as of July 1, 2005, stating that excess program income could be carried over to a subsequent funding period with the grants officer's prior approval.²

We examined the terms and conditions of Massachusetts MEP's cooperative agreement and subsequent amendments and found no NIST approval for retaining undisbursed program income to be applied in future award periods. We also asked the NIST grants office whether it intended to allow Massachusetts MEP to retain a large balance of undisbursed program income for use in future award periods. The NIST grants specialist responsible for the Massachusetts MEP award confirmed that the partnership had never requested such approval.

According to award terms and conditions and federal regulation, the undisbursed program income must be used to reduce the federal share of Massachusetts MEP's expenditures; 15 CFR Sec. 14.24(c) requires amounts "in excess of any limits stipulated" to be deducted from total allowable project costs in computing the amount of federal funds for which the recipient qualifies. Since Massachusetts MEP did not receive approval to carry any of its undisbursed program income forward to the subsequent award period, we reduced total accepted project costs by \$1,093,495 in excess income in computing Massachusetts MEP's federal funds earned for the year ended June 30, 2006, in accordance with 15 CFR Sec. 14.24(c).

A. Summary of Massachusetts MEP Response

In a footnote to its response, Massachusetts MEP stated that adjustment to its financial reports after the end of the audit period reduced undisbursed program income as of June 30, 2006, from \$1,093,495 to \$[REDACTED].

Although not responding directly to our finding that Massachusetts MEP did not

² The purpose of the amendment was to incorporate NIST's revised MEP General Terms and Conditions, dated April 2006, into all active awards. Section 15 F of the revision, "Excess Program Income," states program income in excess of what is required in an operating year to meet the nonfederal share of the award may be carried over to the subsequent funding period with the prior written approval of the grants officer.

obtain NIST approval to carry its undisbursed program income forward to the award period beginning July 1, 2006, the MEP stated that it received grants officer approval to carry undisbursed program income forward into the award period beginning July 2008. Based on this approval, the MEP believes OIG's finding of excess program income should be removed.

The MEP also stated its belief that only one-third of any excess amount must be reported to NIST and potentially used to reduce allowable program costs. According to the MEP, the remaining two-thirds of any excess "is unencumbered by the grant requirements." As basis for its opinion, the MEP cited a 1984 decision by the Department of Health and Human Services Departmental Appeals Board. The MEP's response states that "one must look to other federal agency regulations for guidance" on handling program income because neither NIST nor the Department of Commerce have issued regulations relative to program income under the MEP program.

B. OIG Comments

Massachusetts MEP did not provide documentation supporting its claim that undisbursed program income on June 30, 2006, was \$[REDACTED], rather than \$1,093,495, as originally reported to NIST. Therefore, we did not adjust our calculation for dealing with excess program income from the amount in the draft audit report.

We verified that NIST approved carry-forward of \$[REDACTED] in undisbursed program income from the award period ended June 30, 2008, into the period beginning July 1, 2008. However, the award amendment giving this approval does not specifically reference the undisbursed program income as of June 30, 2006. As a result, there still is no evidence that NIST approved carry-forward of the excess cited in this report. Furthermore, as discussed in the following paragraph, Massachusetts MEP's methodology for determining the amount of undisbursed program income that must be tracked and reported to NIST is flawed. If this methodology was used to calculate the June 30, 2008, carry-forward amount, the amount NIST approved may reflect only a portion of Massachusetts MEP's undisbursed program income as of June 30, 2008.

OIG does not agree with Massachusetts MEP's contention that only one-third of the undisbursed program income need be reported to NIST and potentially used to reduce federal funds earned. The MEP's contention that NIST has not issued specific regulations to deal with program income is misleading. There are specific directions for handling excess program income in 15 CFR Sec. 14.24, which codifies OMB Circular A-110 for the Department of Commerce. NIST augmented these directions with MEP-specific policy in the general terms and conditions for MEP awards. There is no provision in either the OMB or NIST policy that directs

recipients to report only a percentage of the excess program income to the government. Furthermore, the directions for handling excess program income included in 15 CFR Sec. 14.24(c) and applied in this report account for the federal and nonfederal portions of the excess by reducing total allowable project costs before computing federal funds earned. Once this calculation is completed, the excess has been resolved and the recipient is under no obligation to track and report any portion of the excess to NIST.

V. Recommendations

We recommend that the NIST grants officer

- disallow \$5,086,998 in questioned costs, and
- recover \$1,294,073 in excess federal funds after deducting excess program income in the amount of \$1,093,495 from total accepted project costs.

SUMMARY RESULTS OF FINANCIAL AUDIT

Below are summarized results of our interim cost audit for the period July 1, 2005, through June 30, 2006 (see appendix C):

Federal Funds Disbursed		\$2,364,771
Costs Incurred	\$9,392,908	
Less: Questioned Costs	<u>5,086,998</u>	
Costs Accepted	4,305,910	
Less: Excess Program Income	<u>1,093,495</u>	
Basis for Federal Share	3,212,415	
Federal Cost Sharing Ratio	<u>x 3.33%</u>	
Federal Funds Earned		<u>1,070,698</u>
Refund Due the Government		<u>\$1,294,073</u>

Dr. Brett M Baker March 31, 2009
Assistant Inspector General for Audit

APPENDIX A: OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of our audit was to determine whether Massachusetts MEP claimed costs to NIST, including costs incurred by subrecipients, that were reasonable, allocable, and allowable in accordance with applicable federal cost principles, cooperative agreement terms and conditions, and NIST policy, including MEP Operating Plan Guidelines. To meet our objective, we interviewed Massachusetts MEP and NIST Grants Office officials, reviewed NIST award documents, and examined financial records of Massachusetts MEP. We also interviewed officials and examined financial records of two Massachusetts MEP subrecipients.

Our audit objective did not include assessing Massachusetts MEP's performance under the award, so any subsequent performance audits could result in additional questioned costs. We did not rely solely on computer-processed data but instead augmented computer-processed data with substantive tests of transactions to develop our findings and recommendations.

This audit's scope included only costs claimed by Massachusetts MEP from July 1, 2005, through June 30, 2006.

Our audit included an assessment of the MEP's internal controls applicable to the award to evaluate the effectiveness of the control and accountability systems. We reviewed Massachusetts MEP's single audit report for the year ended June 30, 2004—the most recent report available at the time of our audit. An independent certified public accounting firm conducted the audit in accordance with Office of Management and Budget Circular A-133. The report found no material internal control weaknesses. We did not rely on the accounting firm's internal control reviews but instead determined that we could better meet our audit objectives by testing transactions.

We reviewed compliance with laws and regulations as they applied to costs incurred, using as criteria OMB Circular A-122, *Cost Principles for Nonprofit Organizations*, and 15 CFR, Part 14, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, Other Non-Profit, and Commercial Organizations*. We also assessed compliance with the Department of Commerce *Financial Assistance Standard Terms and Conditions*, *MEP General Terms and Conditions*, and the cooperative agreement *Special Award Conditions*. We note instances of noncompliance with stated laws and regulations in this report.

We performed audit fieldwork during August and September 2006 at Massachusetts MEP's headquarters in Woburn, Massachusetts, and at subrecipient offices in Boston and Chicago.

This audit was conducted under the authority of the Inspector General Act of 1978, as amended, and Department Organization Order 10-13, dated August 31, 2006, and in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained does provide a reasonable basis for our findings and conclusions

APPENDIX B

MASSACHUSETTS MEP
NIST COOPERATIVE AGREEMENT NO. 70NANB5H1144
SUMMARY OF SOURCE AND APPLICATION OF FUNDS
JULY 1, 2005 THROUGH JUNE 30, 2006

	<u>Approved Budget</u>	<u>Receipts & Expenses</u>
<u>SOURCE OF FUNDS:</u>		
Federal	\$2,364,771	\$2,364,771
Non-Federal	<u>4,729,542</u>	<u>7,028,137</u>
Total	<u>\$7,094,313</u>	<u>\$9,392,908</u>

APPLICATION OF FUNDS:

Personnel	\$ 	\$ 
Fringe Benefits		
Contractual		
Other		
Supplies		
Travel		
Equipment		
Cash Match		
In-Kind		
Indirect Costs		
Total	<u>\$7,094,313</u>	<u>\$9,392,908</u>

APPENDIX C

MASSACHUSETTS MEP
NIST COOPERATIVE AGREEMENT NO. 70NANB5H1144
SUMMARY OF FINANCIAL/COMPLIANCE AUDIT
JULY 1, 2005 THROUGH JUNE 30, 2006

Description	Approved Budget	Costs Claimed	Results of Audit		
			Costs Questioned	Costs Unsupported	Costs Accepted
Personnel	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	(a) 0	\$ [REDACTED]
Fringe Benefits	[REDACTED]	[REDACTED]	[REDACTED]	(a) 0	[REDACTED]
Contractual	[REDACTED]	[REDACTED]	[REDACTED]	(a)(c) 0	[REDACTED]
Other	[REDACTED]	[REDACTED]	[REDACTED]	(a) 0	[REDACTED]
Supplies	[REDACTED]	[REDACTED]	[REDACTED]	(a) 0	[REDACTED]
Travel	[REDACTED]	[REDACTED]	[REDACTED]	(a) 0	[REDACTED]
Equipment	[REDACTED]	[REDACTED]	[REDACTED]	(a) 0	[REDACTED]
Cash Match	[REDACTED]	[REDACTED]	[REDACTED]	(b) 0	[REDACTED]
In-Kind	[REDACTED]	[REDACTED]	[REDACTED]	0	[REDACTED]
Indirect Costs	[REDACTED]	[REDACTED]	[REDACTED]	(a)(d) 0	[REDACTED]
Total	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ 0	\$ [REDACTED]

Federal Funds Disbursed		\$2,364,771
Costs Incurred	\$9,392,908	
Less: Questioned Costs	<u>5,086,998</u>	
Costs Accepted	4,305,910	
Less: Excess Program Income	<u>1,093,495 (e)</u>	
Basis for Federal Share	3,212,415	
Federal Cost Sharing Ratio	<u>x33.33 %</u>	
Federal Funds Earned		<u>1,070,698</u>
Refund Due the Government		<u>\$1,294,073</u>

Notes:

- (a) Questioned amounts for personnel, fringe benefits, contractual, other, supplies, travel, equipment, and indirect costs represent charges claimed for activities under two contracts awarded to Massachusetts MEP to perform services for the respective procuring entities. (See page 9.)
- (b) Questioned cash match involves claims for costs incurred by two Massachusetts MEP subrecipients that could not provide documentation that their claims were based on actual costs incurred under their subawards. (See page 2.)

- (c) Questioned contractual costs include \$[REDACTED] for services provided prior to the July 1, 2005, starting date of the award. (See page 13.)
- (d) Questioned indirect costs include \$[REDACTED] associated with the questioned other direct costs.
- (e) Massachusetts MEP reported a balance of \$1,093,495 in undisbursed program income as of June 30, 2006. NIST did not approve carrying forward undisbursed program income for use in the subsequent award period. According to award terms and conditions and federal regulation, the undisbursed program income must be used to reduce the federal share of Massachusetts MEP's expenditures. (See page 13.)

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September 20, 2008

Judith J. Gordon
Assistant Inspector General
for Audit and Evaluation
United States Department of Commerce
Office of Inspector General
1401 Constitution Avenue, NW, Room 7886B
Washington, DC 20230

DENVER REGIONAL OFFICE

SEP 23 2008

OIG/OFFICE OF AUDITS
DEPT OF COMMERCE

John S. Bunting
Regional Inspector General for Audits
United States Department of Commerce
Office of Inspector General
Denver Regional Office of Audits
999 18th Street, Suite 765
Denver, Colorado 80202-2499


Dear Ms. Gordon and Mr. Bunting:

As counsel to Massachusetts MEP, please find enclosed comments on the Draft Audit Report concerning Award No. 70NANB5H1144. Please note that the letter that transmitted the Draft Audit Report, dated August 21, 2008, was not actually received by Massachusetts MEP until August 26, 2008. Therefore, we understand that we have 30 days from date of actual receipt of the Draft Audit Report to finalize comments. We sought clarification of this point on September 19, 2008 but were unable to have anyone in your offices confirm this understanding and were unable to reach you. Out of an abundance of caution, we are filing these comments. If we are correct that we have the full 30 days, we will file final comments within that time period.

Should you have any questions, please contact me directly at 202 661-.

Very truly yours,

K&L GATES LLP

By 
William A. Shook

September 20, 2008
Page 2

cc: Mr. Jack Healy

Joyce Brigham, Grants Officer
Grants and Agreements Management Division
National Institute of Standards and Technology
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100 Bureau Drive, Stop 1650
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w/o attachments

Massachusetts MEP Response to Draft Audit Report No. DEN-18135-8-001

INTRODUCTION

This Draft Audit Response responds to the findings and questioned costs raised by the Draft Audit Report No. DEN-18135-8-001, of the Massachusetts Manufacturing Extension Partnership (“MEP”) Award No. 70NANB5H1144 for the period July 1, 2005 through June 30, 2006. The Draft Audit Report contained findings and questioned costs in four main areas: unallowable subrecipient costs, unallocable contract costs, questioned contractual and other direct costs, and excess program income. This response will address each issue raised in the Draft Audit Report.

The Massachusetts Draft Audit Report is dated August 21, 2008. Massachusetts MEP Draft Audit Report Response is postmarked on or before September 20, 2008 (the thirtieth day from the date of the letter).¹ Although Massachusetts MEP (also sometimes referred to herein as the “Center”) requested an extension of time to respond to the issues raised in the report, that request was denied. We understand that the auditors will consider the comments below and issue a Final Audit Report, at which time Massachusetts MEP will again have an opportunity to respond.² At the same time, NIST will have a maximum of sixty (60) days to prepare an audit report action plan which must be approved or disapproved by the Office of Inspector General (“OIG”) within fifteen (15) working days.³ If the OIG has any disagreements with the audit action plan, the Assistant Inspector General for Compliance and Audit Resolution and the NIST audit resolution officer shall work to resolve any disagreements within 45 days.⁴ If agreement cannot be reached, the OIG will convene a meeting of the Audit Resolution Council. If the Council does not reach a resolution, the matter will be referred to the Deputy Secretary of the Department of Commerce for final decision.⁵

OVERVIEW OF THE MEP PROGRAM

The overarching goal of the MEP program, as embodied in the authorizing statute, is to increase the global competitiveness of United States manufacturing by enhancing productivity and technological performance.⁶ Congress envisioned that MEP Centers would accomplish this goal by: (1) the transfer of manufacturing technology and techniques from NIST to Centers to manufacturing companies; (2) participation of individuals from industry, universities, State governments, other Federal agencies and NIST in cooperative technology transfer activities; (3) efforts to make new manufacturing technology and processes accessible and usable by small and medium-sized U.S. companies; (4) active dissemination of scientific, engineering, technical, and management information to industrial firms; and (5) utilization of expertise and capability that exists in Federal labs other than NIST.⁷ Specific activities conducted by the Centers would include: (1) establishment of automated manufacturing systems and other advanced production technologies, based on research by the Institute, for the purpose of demonstrations and

¹ Ex. 1 at 1.

² *Id.*

³ United States Department of Commerce, Departmental Administrative Order No. 213-5, § 6.

⁴ *Id.*

⁵ *Id.*

⁶ 15 U.S.C. § 278k(a).

⁷ 15 U.S.C. § 278k(b).

technology transfer; (2) the active transfer and dissemination of research findings and Center expertise to a wide range of companies and enterprises, particularly small- and medium-sized manufacturers; and (3) loans, on a selective, short-term basis, of items of advanced manufacturing equipment to small manufacturing firms with less than 100 employees.⁸

MEP Centers are instructed, by statute, to achieve these objectives by forming partnerships with organizations such as private industry, universities, and State governments. The goal of these partnerships is three-fold: to accomplish programmatic objectives, to further the impact of the Federal investment, and to assist recipients in meeting their cost-share requirements.⁹ The partnering organizations take the knowledge shared by the MEP Center and, through their own activities, assist manufacturing firms, expanding the impact of the Federal investment.

In 1998, Massachusetts MEP began delivering manufacturing extension services to small- and medium-sized manufacturers ("SMEs"). Over the past ten years, Massachusetts MEP has developed many strong partnerships with organizations, associations, universities, and other non profits that focus on improving the competitiveness of American manufacturers. Working with these organizations and with manufacturers directly has led Massachusetts MEP to the realization, consistent with statutory direction, that participating in the statewide and nationwide economic development networks is an efficient and effective way for Massachusetts MEP to accomplish its statutory mission.

Partnerships, consistent with statutory mandates, add value to Massachusetts MEP by reducing the duplication of activities and by leveraging the partner's activities to increase Massachusetts MEP's mission effectiveness, penetration, and output.¹⁰ Partners use their own reputation and marketing and referral activities to promote the MEP efforts and services, resulting in increased market penetration and efficiencies in project execution. Partners also increase the Massachusetts MEP's value and prevalence within the American manufacturing community by integrating MEP services into the partner's own services to enhance achievement and performance by small and medium sized manufacturers.

Activities performed by partners are mutually beneficial to the partner, its members, Massachusetts MEP's clients, and the Center itself. The goal of the MEP program, as embodied in its programmatic objectives, is not to bring other resources back into the Center (the typical paradigm of cost-share programs), but instead the goal is to push the technology, programs, and expertise as far out into the American manufacturing community as possible. The direct benefit the Center receives from its partnerships is the ability of another entity to provide the services and perform the education and outreach functions that would otherwise fall to the Center, allowing the Center to focus on offering additional services, education, and outreach to SMEs.

Recently, in August 2007, Congress enacted a legislative amendment to clarify how the MEP Centers' cost contributions are to be determined. Clarification became necessary after the findings of the OIG audits of 2003 that were inconsistent with the original intent of Congress

⁸ 15 U.S.C. § 278k(c); Ex. 3

⁹ *Id.*

¹⁰ *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

with regard to the mission, purpose and structure of the MEP program as established by Congress.

The provisions in the legislative clarification clarify the nature and classification of non-Federal costs contributed by partnering organizations. The legislative clarification clearly establishes that “all non-Federal costs, contributed by such entities and determined by a Center as programmatically reasonable and allocable . . . are includable as a portion of the Center’s contribution.” America Competes Act, Pub. L. 110-69, § 3003(a)(3)(C) (emphasis added). The legislative history is clear that contributions by industry, universities, and state governments, “may be included as a portion of the Center’s 50 percent or greater funding obligation if it is determined by the Center to be programmatically reasonable and allocable.” H. Rept. 110-289 at 16 (emphasis added).

The language clearly defines “costs incurred” as “costs incurred in connection with the activities undertaken to improve the management, productivity, and technological performance of small- and medium-sized manufacturing companies.” America Competes Act, Pub. L. 110-69, § 3003(a)(3)(C). The legislation further states that:

“In meeting the 50 percent requirement, it is anticipated that a Center will enter into agreements with other entities such as private industry, universities, and State governments to accomplish programmatic objectives and access new and existing resources that will further the impact on the Federal investment. . . . All non-federal costs, contributed by such entities and determined by a Center as programmatically reasonable and allocable are includable as a portion of the Center’s contribution.”

Id. The Draft Audit Report dismisses the value of the partnership by arguing that these partners would exist whether there is an MEP Center or not. However, in doing so the auditors dismiss the statutory requirement that Massachusetts MEP enter into partnership agreements so as to obtain existing resources to finance their programmatic activities. Contrary to the auditors’ interpretation, the Center is not directed to create new organizations, but rather to utilize the resources of existing organizations in order to efficiently and economically promote the transfer of technology.

Please note that in determining whether an amendment clarifies or substantively changes a prior law, a court may consider several factors.¹¹ One such factor is whether the enacting body has stated its intent to clarify the prior enactment.¹² Here we have such a declaration by Congress, not just in the text of the act itself, but also in the legislative history. Congress titled the section “Clarification of Eligible Contributions in Connection with Regional Centers Responsible for Implementing the Objectives of the Program.” Clarification should be given its ordinary meaning and should be treated as a declaration by Congress of its intent for the amendment to serve as a clarification of existing practice.

¹¹ *Piamba Cortes v American Airlines*, 177 F.3d 1272, 1283 (1999).

¹² *Id.* at 1284 ([C]ourts may rely upon a declaration by the enacting body that its intent is to clarify the prior enactment.).

Another factor courts may consider is whether a conflict or ambiguity existed with respect to the interpretation of the relevant provision when the amendment was enacted.¹³ The prior provision on a Center's federal share stated only that "applicant shall provide adequate assurances that it will contribute 50 percent or more of the proposed Center's capital and annual operating and maintenance costs for the first three years and an increasing share for each of the last three years."¹⁴ The existing regulations enacted by the Department of Commerce inconsistently elaborated on this provision, so an amendment was necessary in light of conflicting interpretations as to sources of the Center's contributions. The opposing interpretations arose after a series of audits of MEP Centers where the OIG disputed the sources of cost share, claiming that contributions from partnering organizations were not allocable to the MEP Centers because these organizations would have carried out these activities without the MEP partnership. Despite statements by the Centers and their partners regarding the value and mutual benefit of these partnerships, the OIG auditors still failed recognize their expenditures as valid sources of matching funds. As explained above in Section I.B, the legislation clarifies Congress' intent for Massachusetts MEP to include a partner's expenditures as part of its cost share when Massachusetts MEP (and not NIST or the OIG) determines it to be reasonable and allocable to meet the cost share requirement.¹⁵

Where there is no explicit instruction from Congress as to whether a statute is applied retroactively, courts are generally reluctant to allow such an effect. *See Bowen v. Georgetown University Hospital*, 488 U.S. 204, 208 (1988). In its retroactivity analysis, the Supreme Court quotes Professor Llewellyn for his recognition of the tension between retroactive application and remedial statutes.¹⁶ The amendment in this case has none of the characteristics that would bar retroactive application and is a remedial statute which is to be applied retroactively to "promote the ends of justice." In *Landgraf v. USI Film Products*, 511 U.S. 244, 270 (1994) the Supreme Court announced that "the court must ask whether the new provision attaches new legal consequences to events completed before its enactment."¹⁷ The amendment does not impose a new penalty, a new liability, or create a new right of action. Concerns about the retroactive effect are absent in cases where an amendment is deemed to clarify the relevant law.¹⁸ Therefore the harms in applying the amendment retroactively are inapplicable in this case and the Draft Audit Report must take into consideration the Congressional mandate.

¹³ See *Liquilux Gas Corporation v. Martin Gas Sales*, 979 F.2d 887, 890 (1992).

¹⁴ 15 U.S.C. § 278k(c)(3).

¹⁵ America Competes Act, Pub.L. 110-69, § 3003, 121 Stat. 587 (2007) (non-Federal assets obtained from the applicant and the applicant's partnering organizations will be used as a funding source to meet not less than 50 percent...").

¹⁶ *Landgraf v. USI Film Products*, 511 U.S. 244, 264 n. 16 (1994), quoting Llewellyn, Remarks on the Theory of Appellate Decisions and the Rules or Canons about How Statutes are to be Construed, 3 Vand.L.Rev. 395 (1950) ([a] statute imposing a new penalty or forfeiture, or a new liability or disability, or creating a new right of action will not be construed as having a retroactive effect; [r]emedial statutes are to be liberally construed and if a retroactive interpretation will promote the ends of justice, they should receive such construction.).

¹⁷ See also *Piamba Cortes*, 177 F.3d at 1283 ("We first look to see whether the amendment effects a substantive change in the legal standard or merely clarifies the prior law.").

¹⁸ See *Id.*

SUBRECIPIENT COSTS

The Draft Audit Report questions \$4,167,430 in claimed project costs for two partners, the Association for Manufacturing Excellence (“AME”) and the Associated Industries of Massachusetts (“AIM”). The auditors propose disallowance of these costs because they determined that the partners were subrecipients, and therefore required to meet the Financial Management Standards applicable to recipients, set forth in 15 C.F.R. § 14.21, and that neither AME nor AIM had met these requirements. It is on this ground alone that the auditors questioned ALL costs claimed by Massachusetts MEP for the expenditures of AME and AIM that further the statutory mission of the MEP program.

The auditors’ proposed disallowance of these costs is incorrect on the grounds that the costs are verifiable in the recipient’s records, are allowable, and were determined to be reasonable and allocable to the MEP project by the Center in accordance with the authorizing statute. Furthermore, the auditors’ determination that AIM is a subrecipient is incorrect; AIM is a third party in-kind contributor and should therefore be treated as such. We have set out below the reasons we disagree with questioning of the \$4,167,430 in claimed project costs for expenditures of AME and AIM.

As noted in the Overview section, the authorizing statute requires MEP Centers to form a network of partnering organizations to assist them in reaching small- and medium-sized manufacturers, thereby furthering the impact of the Federal dollars. The statutory emphasis of the MEP Program is on forming strategic partnerships to use existing resources and avoid duplication of services.¹⁹ Partnering organizations of a MEP Center can be entities in private industry, universities, and State governments.²⁰ The Centers’ partnerships are integrated with existing state economic development, community college, and trade or industry association programs. This statutory partnering model is unique in the Federal Government to the MEP Program; it couples the partners’ work with that of the MEP Centers so that the provider of services to manufacturers is indistinguishable between the partner and the Center. The Centers’ partners have the same overall mission objectives and share common values, approaches, and targeted market segments.

The work of the partners is integrated with the MEP Centers to increase the efficiency and success of the MEP program. MEP partners work with the Center in reaching additional manufacturers, providing additional services, and transferring technology to SMEs to fulfill the core mission of the MEP Centers stated in 15 U.S.C. § 278k. The partners’ work has been added to achieve the desired synergies, and the partners’ output is beyond the partners’ “normal” or “regular” operations, demonstrating a direct benefit from the partnership. Together the MEP Center and the partner are able to coordinate and collaborate on activities that each would conduct entirely on its own if it were not for the partnership. In this way the Center uses the existing resources of the partner to further the impact of the Federal dollars by reaching manufacturers it would not, on its own, have the ability to reach and to provide additional

¹⁹ *America Competes Act*, P.L. 110-69, Sec. 3003(a)(3)(C).

²⁰ *Id.*

services the Center could not otherwise offer.²¹ Using a network of partners, the MEP Center can concentrate its resources on serving clients and on technology transfer. Without such a network, Federal resources would be diverted from providing direct services to SMEs and instead expended on marketing and outreach to recruit clients as well as duplicating other services need by SMEs that are available from partners. In this manner the activities of the partners are essential to the efficiency and effectiveness of the MEP Center and its ability to accomplish the programmatic objectives set forth in the statute and regulation. *See* 15 U.S.C. § 278k and 15 C.F.R. § 290.3. Massachusetts MEP selected its partners consistent with these requirements and goals and determined that the costs were “programmatically reasonable and allocable” and therefore properly includable as part of the Center’s cost share.

The MEP Center and the partner share the same mission – to provide services to SMEs throughout the country, or in this case particularly to SMEs in Massachusetts, that allow SMEs to maintain or to improve their competitiveness in an increasingly global market. Such services include education, outreach, technology, and other support. The activities that the partners perform on behalf of the MEP Center are allowable – they are operating expenditures that would be expended by the Center itself if it weren’t for the partnership. The services provided by the partners on behalf of the MEP Center, and the costs incurred in provided those services represent a direct financial benefit to the MEP Center. The costs incurred by the partners are costs that do not have to be incurred by the MEP Center, allowing the Center to then use the funds it retains on providing services to SMEs.

The costs incurred by the partner and claimed by the Center were always related to activities identified in the Scope of Work of the agreement executed between the partner and the Center. The activities identified in the Scope of Work are then used to create a budget that is also incorporated into the agreement between the partner and the Center. On a quarterly basis the partner submits its financial support for the relevant activities to Massachusetts MEP, which then reviews the documentation and removes any items of cost that are unallowable under the cost principles. Massachusetts MEP then creates a report matching the line items in the budget, and compares the expenditures to the budget and the scope of work to verify that costs are reasonable, allocable, and allowable.²²

The MEP partnerships encompass a variety of activities that may embody all, some, or none of the characteristics of traditional subrecipients, third-party contributors, or vendor/contractors. Some partnerships take the form of a joint venture. Indeed, one partnership agreement may involve the partner’s receipt of a limited amount of federal funds supporting certain specified activities, payment by the Center for expert services to the Center, the provision of services to a manufacturer referred by the Center to the partner, and services to manufacturers who learned of the availability of the services via the joint activities and outreach.

²¹ The program regulation, 15 C.F.R. Part 290, directs Centers to leverage their resources by concentrating on approaches that are broadly applicable to a range of organizations and regions. 15 C.F.R. § 290.3(e). The regulation defines leverage as “the principle of developing less resource-intensive methods of delivering technologies (as when a Center staff person has the same impact on ten firms as was formerly obtained with the resources used for one, or when a project once done by the Center can be carried out for dozens of companies by the private sector or a state or local organization).” *Id.*

²² The Center has the authority to determine which costs are reasonable and allocable under the cost principles. *America Competes Act*, P.L. 110-69. Sec. 3003.

Throughout the Draft Audit Report, two Massachusetts MEP partners, the Association for Manufacturing Excellence and the Associated Industries of Massachusetts, are characterized as subrecipients as defined by the regulation.²³ The Draft Audit Report questions \$4,167,430 of costs claimed by Massachusetts MEP for the two partners on the grounds that they “could not provide documentation supporting that its claims were based on actual costs incurred under the Massachusetts MEP subawards.” The Draft Audit Report asserts that these partner expenditures are unallowable because they were not documented in accordance with 15 C.F.R. § 14.21, made applicable to subrecipients through the flow-down provision of 15 C.F.R. § 14.5 and applicable to MEP Centers through incorporation by reference in the Center’s cooperative agreements. The Draft Audit Report further asserts that the MEP Operating Plan Guidelines issued March 2005 “require all MEP subawards to include the applicable administrative requirements and all general and special award conditions imposed on the recipient.” /both partners have ample documentation to show that actual non-federal costs were incurred in furtherance of the statutory objectives of the MEP program, as demonstrated below.

Association for Manufacturing Excellence

The Association for Manufacturing Excellence (“AME”) is a not-for-profit organization dedicated to assisting manufacturers with continuous improvement and the pursuit of excellence. As outlined in the Massachusetts MEP Operating Plan and the agreements reviewed and approved by the NIST Program Officer, the Grants Officer, and legal counsel, Massachusetts MEP and AME partnered together on planning, promoting and sponsoring the 2005 Annual AME Conference held in Boston and co-sponsored AME’s Best Plants/Industry Week Conference. At the Conference, Massachusetts MEP organized and conducted break out sessions on process improvement techniques, using Center staff as facilitators and providing the necessary training materials. Process improvement techniques are the exact kind of technology transfer and broadly applicable practices that the Center is expected to transfer to SMEs. Attendees of the Conference included representatives of SMEs served by both AME and Massachusetts MEP.

Massachusetts MEP also coordinated and conducted numerous tours showcasing manufacturing process improvement techniques currently in use in manufacturing plants in the greater Boston area. Over 800 conference attendees and 23 manufacturing companies participated, making the tours the most successful in recent history.²⁴ In addition to the AME Annual Conference and the Best Plants/Industry Week Conference, Mr. Joe Rizzo, a Massachusetts MEP Project Manager, served as President for the AME Northeast Regional Board, providing coordination and guidance to other regional boards and participating in AME National Board meetings. Also participating on the Northeast Regional Board were the Massachusetts MEP Director of Operations, Mr. Jack Healy and a Massachusetts MEP Project Manager, Mr. Dave Hess. Both Joe Rizzo and Jack Healy wrote articles for AME’s *Target Magazine*, a leading trade association publication the purpose of which is to share manufacturing and organizational progress throughout all types of manufacturing operations. *Target Magazine* covers an array of topics such as “Lean Methods for

²³ 15 C.F.R. § 14.2(jj).

²⁴ Ex. 9.

Creative Development” and “Training Within Industry.” Excerpts from *Target Magazine* are posted on the NIST MEP website.²⁵

Massachusetts MEP’s Director of Operations was a member of the AME Champions Club, which is comprised of senior executives from large and small companies and seeks to provide senior management within the manufacturing sector with informative insights and events in critical areas to American SMEs, including: staff training and skills development, accessibility to state-of-the-art manufacturing facilities, processes, and people, failure of manufacturing process and technology, business growth with profitability and developing and sustaining competitive edge. Jack Healy also served as the 2005 Annual Conference Marketing Director.

The Draft Audit Report questions *all* costs claimed related to AME because “the claimed costs simply reflect a major portion of the costs AME incurred while performing its regular operations – operations it appears would have been performed regardless of any subaward relationship between AME and Massachusetts MEP.”²⁶ This comment is inconsistent with the MEP Program’s governing statute, which directs MEP Centers to form partnerships with associations, like AME, and to take advantage of their existing resources.²⁷ Furthermore, this position simply ignores the benefits received from the collaboration of Massachusetts MEP and AME as determined by Massachusetts MEP pursuant to statutory authority granted to it. The impacts achieved through collaboration are far greater than the impacts either organization could achieve alone. The partnership allows AME members to access MEP services and vice versa, allowing a transfer of knowledge and skills through the sharing of resources that benefits both AME’s members and Massachusetts MEP’s client American manufacturers without unnecessary and wasteful duplication of services. As a result, the SME’s receive the maximum possible unduplicated benefit from both organizations.

The NIST-approved Massachusetts MEP Operating Plan for the audited period clearly outlines the collaborative activities of Massachusetts MEP and AME and describes the specific costs that AME was to incur (and did, in fact, incur) in furtherance of the Center’s mission.²⁸ This Operating Plan, including the description of the partnership with AME, was reviewed and approved by the NIST Grants Officer, the Program Officer, and legal counsel prior to issuing the award for the 2005-2006 year. Approval from the Grants Officer is additional support for the proper inclusion of the costs incurred as part of the Center’s cost share. OMB Circular A-122, codified at 2 CFR Part 230, defines “prior approval” as:

[S]ecuring the awarding agency’s permission in advance to incur cost for those items that are designated as requiring prior approval by this part and its Appendices. Generally this permission will be in writing. Where an item of cost requiring approval is specified in the budget of an award, approval of the budget constitutes approval of that cost.

²⁵ See, e.g. Tonkin, Lea A.P., NORTHROP GRUMMAN NEWPORT NEWS: REACHING OUT TO SUPPLIERS, Vol. 22:1 (2006), available at: www.mep.nist.gov/documents/pdf/supply-chain-management/NGNN_story.pdf.

²⁶ Draft Audit Report at 4.

²⁷ *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007). See also 15 U.S.C. § 278k.

²⁸ Ex. 4.

2 CFR § 230.25. The very cost items included in AME's budget, reviewed and specifically approved by the authorized NIST officials are therefore incorrectly questioned in the Draft Audit Report.

The Draft Audit Report questioned AME's expenditures claimed as cost share on the grounds that "AME's practice does not comply with 15 CFR, Sec. 14.21 because it does not (1) accurately disclose actual costs incurred under the subaward, (2) compare actual outlays with budgeted amounts, and (3) rely on written procedures for determining allowability of costs."

Accurate Disclosure of Actual Costs Incurred

The Agreement between Massachusetts MEP and AME, which was approved by authorized NIST officials includes a detailed Scope of Work (Schedule A) and a detailed description of Financial and Programmatic Monitoring (Schedule B).²⁹ Schedule B requires AME to submit to Massachusetts MEP the following documentation:

- (1) Financial documentation including validation of payroll costs associated with the activities and other in-kind services not otherwise recorded;
- (2) Selected portions of the general ledger as related to the activities described herein;
- and
- (3) Invoices, purchase orders, or related documentation verifying incurred costs.

The documentation submitted by AME to Massachusetts MEP follows detailed procedures to allow Massachusetts MEP to determine that the costs are reasonable, allocable, and allowable. Massachusetts MEP also conducts periodic site visits to ensure that records are being kept pursuant to the Agreement. Massachusetts MEP verifies the costs claimed by AME by reviewing their accounting records and compares these reported expenditures against the original proposed budget. Massachusetts MEP is the recipient and is ultimately financially responsible for ensuring the allowability of costs.³⁰ This procedure, to which the parties agreed to in writing, and the results of which were made available to the auditors, is sufficient to show that the non-federal dollars expended by AME were expended to further the MEP statutory mission. It is the parties to the Agreement who are in the best position to know what they intended by the Agreement. See *National Urban League, Inc.*, United States Department of Health and Human Services Departmental Appeals Board, No. 294 (April 30, 1982) (DAB adopted Grantee's interpretation as reasonable, and gave it more weight than the Agency's interpretation since the Grantee was a party to the agreement.). As noted above, Massachusetts MEP is responsible for determining whether the costs are reasonable and allocable.³¹ During site visits, Massachusetts MEP verified that the claimed costs were actually incurred, that the activities benefit AME and the Massachusetts MEP Center, and are in furtherance of the MEP mission. *Id.*

²⁹ A copy of the Agreement is attached at Ex. 8.

³⁰ 15 C.F.R. § 14.2(ff) "Recipient means an organization receiving financial assistance directly from the DoC to carry out a project or program." 15 C.F.R. § 14.2(jj) "Subrecipient means the legal entity to which a subaward is made and which is accountable to the recipient for the use of the funds provided."

³¹ *America Competes Act*, P.L. 110-69, Sec. 3003, 131 Stat. 587 (2007).

AME provided Massachusetts MEP with: (1) summary financial reports that disclosed the MEP supported activities; (2) detailed financial reports and general ledgers that disclosed each expenditure by name, date, amount and description; and (3) vendor invoices and other source documentation to support the costs contributed to Massachusetts MEP. This documentation was provided to the auditors during their field visits to the Massachusetts MEP office. Additional reports and supporting documentation were provided during and following the AME and AIM field visits conducted by the auditors. From the documentation provided the auditors selected 140 invoices for a more in depth verification of costs.³² However, at the Audit Exit Conference, the auditors stated that they never reviewed the invoices or used them in making any findings. We request that the auditors review their records to determine whether they actually reviewed the invoices. These invoices are critical evidence as to the cost share of AME.

Comparison of Actual Outlays with Budgeted Amounts

AME and Massachusetts MEP met and reviewed together the annual operating budget, identifying the specific cost categories allocable to the activities under the agreement and incorporated in the Massachusetts MEP Operating Plan.³³ The monthly and quarterly financial reports provided by AME clearly show the actual expenditures against the budget by line item for those costs identified in the Center's Operating Plan and the Agreement.³⁴

Written Procedures for Determining Allowability

Massachusetts MEP makes its determination of allocability using its written procedures that apply applicable federal cost principles. Massachusetts MEP worked closely with AME, through the steps described above, to ensure that the costs claimed by Massachusetts MEP were reasonable, allocable, and allowable, and derived from non-federal sources. The Agreement, in Schedule B, clearly required AME, under 15 C.F.R. Part 14, to provide documentation sufficient for Massachusetts MEP to determine the allowability of costs pursuant to its own written procedures and the applicable cost principles. This procedure complies with the authorizing statute, which prevails over the general administrative provisions in the event of a conflict. See *United States v. Coates*, 526 F. Supp. 248 (E.D.Cal Nov. 19, 1981), *aff'd in part, reversed in part*, 692 F.2d 629 (9th Cir. Nov. 19, 1982). The authorizing statute states the following:

In meeting the 50 percent requirement, it is anticipated that a Center will enter into agreements with other entities such as private industry, universities, and State governments to accomplish programmatic objectives and access new and existing resources that will further the impact on the Federal investment. . . . All non-federal costs, contributed by such entities and determined by a Center as programmaticaly reasonable and allocable are includable as a portion of the Center's contribution.

Emphasis added; P.L. 110-69, Sec. 3003(a)(3)(C). The statute does not require that partners be subrecipients, nor does it require that partners abide by the Financial Management Standards in

³² A list of the invoices selected, as well as copies of the actual invoices will be provided upon request.

³³ Ex. 4

³⁴ Ex. 10

15 CFR Part 14. To the contrary, the statute explicitly and unambiguously places the responsibility of determining reasonableness and allocability on the Centers themselves.³⁵

Massachusetts MEP conducted periodic site visits with AME to review financial records, supporting documentation, and provide guidance for complying with applicable federal guidelines. AME followed generally accepted accounting principles ("GAAP") and undergoes an independent audit process annually. Consistent with this process, Massachusetts MEP determined that the expenditures of AME on behalf of SMEs were "programmatically reasonable and allocable" and were therefore "includable as a portion of the Center's contribution."³⁶

Subrecipient Program Income

The Draft Audit Report also states a concern over program income earned by AME but not reported to NIST by Massachusetts MEP. Massachusetts MEP did not report program income earned by AME because it was used by AME to fund Massachusetts MEP activities. AME generated program income consisting of conference fees, subscriptions, and other non-federal revenue generated by AME from its Center-supported activities. Any program income earned by AME from its Center-supported activities was likewise spent on Center activities. AME tracked this income in its accounting system and reported it to Massachusetts MEP throughout the year in its financial reports to Massachusetts MEP, delineating AME's revenue and expenses by activity.³⁷

The auditors reported that AME earned \$ [REDACTED] in total revenue from the subaward cost categories. Subtracting revenues that were not generated by Center activities and were therefore not program income (\$ [REDACTED]), results in total program income for AME \$ [REDACTED]. Program income (\$ [REDACTED]) minus allowable expenses (\$ [REDACTED]) equals \$ [REDACTED] in program income which the IG auditors state should have been reported. However, these funds were expended by AME in the following award period, to put on the AME annual conference in the second half of the calendar year of 2006. Planning for the annual conference was underway and Massachusetts MEP was aware that the program income funds in the 2006 program year would be spent in the following period on the conference, that the conference furthered the Center's mission and that conference costs were reasonable, allocable, and allowable.

Associated Industries of Massachusetts

Associated Industries of Massachusetts (AIM) is a nonprofit, membership driven organization the mission of which is to promote the well-being of its members, including SMEs, and their employees and the prosperity of the Commonwealth of Massachusetts by: (1) improving the economic climate of Massachusetts; (2) proactively advocating fair and equitable public policy; and (3) providing relevant, reliable information and excellent services. AIM provides human-resource management, employment law, employee training and education, and process improvement seminars and training to Massachusetts manufacturers. AIM contributes to the strategic objectives of the Massachusetts MEP by working on behalf of businesses in

³⁵ *Id.*

³⁶ *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

³⁷ Samples of these reports are included at Ex. 6.

Massachusetts and by offering services specifically designed to help improve processes while increasing the competitiveness of small and medium sized manufacturers in Massachusetts.

As outlined in the NIST-approved Massachusetts MEP Operating Plan, “[t]he cost share contributed by AIM to Mass MEP is a result of the cost of collaborative efforts to provide Lean training and Lean certification to manufacturers and the co-hosting of a series of informational roundtables and workshops that address issues that are pertinent to Massachusetts manufacturers.”³⁸

The Draft Audit Report questions “whether Massachusetts MEP’s relationship with AIM was a valid subaward.”³⁹ The relationship between Massachusetts MEP and AIM is not that of recipient and subrecipient, but is instead that of grantee and a third-party, in-kind contributor. The AIM CFO is correct in that AIM is not a subrecipient and the agreement between the two entities is properly characterized as a Memorandum of Understanding. There is no subaward of financial assistance made by Massachusetts MEP to AIM and AIM receives no other federal funds by which AIM could become a subrecipient. As the auditors correctly noted, no cooperative agreement funds are transferred to AIM. The only funds that AIM received from Massachusetts MEP were Commonwealth funds. Therefore, there is no subaward made.⁴⁰ Without federal funds or property, there is no nexus to require AIM to meet the financial management standards of 15 C.F.R. § 14.21. Instead, AIM is a third party, in-kind contributor and meets the requirements of 15 C.F.R. § 14.23. Under 15 C.F.R. § 14.23, cost sharing contributions must meet the following criteria:

1. verifiable from the recipient’s records
2. not included as contributions for any other federally assisted project or program
3. necessary and reasonable for proper and efficient accomplishment of project or program objectives
4. allowable under the applicable cost principles⁴¹
5. not paid by the Federal government under another award
6. provided for in the approved budget
7. conform to other provisions of [Part 14], as applicable.

Massachusetts MEP’s documentation of AIM’s cost contributions meet these criteria. The cost contributions from AIM are verifiable in Massachusetts MEP’s records, are not counted toward any other federal grant, and are necessary and reasonable for proper and efficient accomplishment of Massachusetts MEP objectives given the nature of AIM’s activities and the partnership between Massachusetts MEP and AIM. Additionally, Massachusetts MEP reviewed the reports of expenditures from AIM and eliminated from the cost contribution any expenditures that are unallowable under the cost principles. AIM’s expends no Federal dollars and its claimed

³⁸ Ex. 4

³⁹ Draft Audit Report at 5.

⁴⁰ Subaward is defined in 15 C.F.R. § 14.2(ii) as “an award of financial assistance in the form of money, or property in lieu of money, made under an award by a recipient to an eligible subrecipient or by a subrecipient to a lower tier subrecipient.” An award is cash that originates from the federal government. *See* 15 C.F.R. § 14.2(f).

⁴¹ “Allowable under the cost principles” means that the cost item must be permissible as a charge to the federal award, not that the third party providing the cost contribution has to comply with the cost principles.

expenditures were provided for in the budgets submitted by Massachusetts MEP in its Operating Plan for 2005-2006.

Massachusetts MEP identifies the AIM operating costs that support activities that benefit all of the AIM clients, not just the manufacturers. AIM does not specifically track its costs related directly and only to its activities on behalf of manufacturers. Massachusetts MEP and AIM therefore agreed to an allocation method of costs based upon the percentage of manufacturing members.⁴² The Operating Plan, approved by authorized NIST officials, described this allocation of costs contributed by AIM: "AIM contributes █% of its operating expenses, which corresponds to the percentage of manufacturing companies in its membership, to Massachusetts MEP as cost share."⁴³ The method of allocation received approval from the authorized NIST Program Officer, Grants Officer, and legal counsel.

Quarterly, AIM provides Massachusetts MEP with its Consolidated Statement of Financial Position showing its actual expenditures to budget expenditures. Annually, AIM provided Massachusetts MEP with a copy of its annual operating budget and independent audit report.⁴⁴ In addition, Massachusetts MEP conducted a yearly site visit with the chief financial officer of AIM to review documentation to support the expenditures reported by AIM. Massachusetts MEP officials discussed AIM's federal funding requirements and the use of AIM contributed costs as cost share, discussed percentage of manufacturing vs. non-manufacturing members, eliminated any lobbying costs and other unallowable expenses, reviewed and verified payroll registers and reports, discussed accounting policies and procedures, and reviewed audit requirements and audit reports. As a result, the AIM contribution clearly meets the statutory requirement for allowable cost share.

CONTRACT COSTS

The OIG questions project costs of \$908,823 claimed by Massachusetts MEP as unallocable on the grounds that the costs claimed were expended for contracts which were awarded to Massachusetts MEP as procurement contracts and not for MEP activities. The auditors stated: "[a]s procurement contracts, not awards of financial assistance, the services provided by Massachusetts MEP under these agreements were for the direct use and benefit of the procuring entities, and not for the benefit of accomplishing the objectives of the NIST cooperative agreement."⁴⁵ In support of this conclusion the auditors assert that costs incurred under the contracts must be allocated to the contracts, not the MEP cooperative agreement.⁴⁶ The auditors' proposed disallowance of \$908,823 is incorrect because the costs incurred for these projects were determined by the Center, pursuant to its statutory authority, to be reasonable and allocable to the MEP program as activities that improve the competitiveness of SMEs in the global market through the adaptation and transfer of technology to SMEs.

⁴² The Center has the authority to determine reasonableness and allocability under the statute. *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

⁴³ Ex. 4 at 19.

⁴⁴ Ex. 17

⁴⁵ See Draft Audit Report at 6.

⁴⁶ *Id.*

The Department of Labor, Employment and Training Administration has partnered with NIST MEP on at least one other initiative (the WIRED program) and recognizes the critical need for skills training for American manufacturers so that American manufacturing can remain competitive in the global market. Furthermore, NIST MEP remains the main point of contact for the Interagency Network of Enterprise Assistance Providers ("INEAP"), in which the Department of Defense and the Defense Logistics Agency are directly involved. According to the NIST MEP website, current discussions of the INEAP have focused on joint service delivery programs, similar to the Supply Chain and MOST initiatives. Other MEP Centers also work closely with Department of Defense contractors on supply chain initiatives.⁴⁷ NIST's support and encouragement of these partnerships and programs is evidence that such activities and initiatives are well within the MEP mission and are therefore Massachusetts MEP's determination that the cost were allocable to the MEP Center is reasonable.

Please note that the contracts were awarded to the Massachusetts MEP Center because of its unique qualifications to provide the services required under the award. The Center has the authority to determine which costs are reasonable and allocable to the MEP award.⁴⁸ NIST supports these types of activities and encourages Centers and their clients to compete for Federal contracts. In fact, to preserve their eligibility for such dollars the MEP statute contains the following provision:

In addition to such sums as may be authorized and appropriated to the Secretary and Director to operate the Centers program, the Secretary and Director also may accept funds from other Federal departments and agencies for the purpose of providing Federal funds to support Centers. Any Center which is supported with funds which originally came from other Federal departments and agencies shall be selected and operated according to the provisions of this section.

A cost is allocable to an award if it: (1) is incurred specifically for the award; (2) benefits the award and other work and can be distributed in reasonable proportion to the benefits received; or (3) is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown. 2 C.F.R. Part 230, App. A(4). The costs of the contracts are allocable to the Massachusetts MEP award because the contracts and the work performed thereunder are in furtherance of the Massachusetts MEP's mission. MEP incurred the costs associated with the contracts not because of the contracts themselves but because the contractors were like many other clients who contract with Massachusetts MEP for services. These fees for services performed allow the Center to fulfill its mission by assisting small and medium sized manufacturers to improve their competitiveness.

New England Manufacturing Supply Chain Initiative

_____ received a contract under a limited competitive bid process from the Department of Defense's Defense Logistics Agency, an agency within the United States Department of Defense to ultimately improve defense acquisition of resources and

⁴⁷ See Client Success Stories, Trek Connect, Inc., New Jersey MEP, available at: <http://blue.nist.gov/ss/2481488B690F30B685256F95005BEA72> (September 15, 2008).

⁴⁸ America Competes Act, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

materials with the goal of obtaining parts and materials domestically in the New England area, utilizing an existing Supply Chain of SMEs. The multi-phase program was known as the Rapid Mobilization of Manufacturing Sources. [REDACTED] then awarded a subcontract to MEP MSI to assist in on-the-ground operations and investigations of the capability of small and medium sized manufacturers. In order to reach more small and medium sized manufacturers in the six-state area, MEP MSI in turn contracted with individual MEP Centers, including Massachusetts MEP, to provide outreach, education, and other services under the contract.

Under the Vendor Agreement between MEP MSI and Massachusetts MEP, Massachusetts MEP was responsible for conducting outreach and education on the Supply Chain and SupplyPoint initiatives with their small and medium-sized manufacturing clients and to assess the capabilities of their clients to participate in Defense contracting and subcontracting processes. The ultimate goal was to inform small and medium sized manufacturers throughout Massachusetts about opportunities in defense manufacturing and to get them involved in defense procurements. In order to do so, Massachusetts MEP staff conducted face-to-face meetings and on-site assessments with their clients to ascertain capacities and capabilities of those manufacturers. Assisting small and medium size manufacturers in Massachusetts to be more competitive for DoD and DLA contracts is clearly within the Massachusetts MEP's statutory mission. Furthermore, this program involves the direct transfer of technology and process improvements described in the Programmatic Objectives at 15 C.F.R. § 290.3(b). The goals and activities of the Supply Chain Initiative were described in the Massachusetts MEP 2005 Operating Plan, subsequently approved by the authorized NIST Program Officer, Grants Officer, and legal counsel prior to the release of funds for the 2005-2006 operating year.

Finding these costs unallocable to the Massachusetts MEP program is inconsistent with statutory authority and requirements with regard to assisting small and medium sized manufacturers in Massachusetts by increasing their competitiveness. Such a finding also is inconsistent with the terms of the MEP statute which give the Center the authority to determine which costs are reasonable and allocable.⁴⁹ Furthermore, pursuit of supply chain initiatives is not unique to Massachusetts MEP and is supported by NIST, as evident from their "Supply Chain" Community of Practice on the website maintained by NIST for the MEP network. This forum allows MEP Centers to share their experiences and opportunities for involvement and improvement of the supply chain on behalf of their small and medium sized manufacturer client. Such activities are clearly allocable to the Massachusetts MEP program.

Machine Operators Skills Training ("MOST") Grant

In July of 2005, the Maine Department of Economic and Community Development ("DECD") received a financial assistance award from the Department of Labor, Employment and Training Administration to provide job opportunities for small and medium-sized manufacturers by increasing their competitiveness (thereby increasing their ability to win contracts and bring in revenue) and to provide training for machinists to allow them to become Computer-Numerically Controlled ("CNC") Operators, Programmers, and Machinists, of which there is a significant shortage of qualified and trained workers in the United States.

⁴⁹ *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

To carry out this project, Maine DECD awarded a grant to Maine MEP to pilot the “innovating CNC training program with advanced machine shops [with] six New England states”.⁵⁰ It was agreed that Massachusetts MEP would assist Maine MEP in accomplishing the objectives of the grant by providing the following services:

- Designate staff member to liaison with the project manager.
- Assist in identifying small and medium sized manufacturers to participate in the program
- Assist in working with local Career Centers to recruit potential machine operator trainees.
- Assist in identifying community colleges or other institutions that can provide training facilities.
- Assist the project manager in other activities that are deemed necessary for the success of the program.⁵¹

The activities required of Massachusetts MEP in order to perform the services under the Scope of Work are well within the scope of and complementary to the objectives of the MEP program, stated in 15 C.F.R. § 290.3(b), *Program Objective*, and the enabling statute, 15 U.S.C. § 278k. As stated in the regulation, the objective of the MEP program is “to enhance productivity and technological performance in United States manufacturing.” This is the same objective as the MOST program. The MOST program aims to enhance productivity through training machine operators to be CNC operators, critical to enable SMEs to utilize recent improvements in technology, as more and more machines are run by computers, knowledge in computer technology becomes more important. NIST MEP demonstrated approval of the MEP partnership with the MOST program by awarding Mr. Jack Healy, Director of Operations for Massachusetts MEP, the Innovator of the Year Award at the 2008 National MEP Conference held in Orlando, Florida, specifically for Massachusetts MEP’s participation in the MOST Program.

Guidance on determining whether the relationship is that of recipient-subrecipient or recipient-vendor can be found in OMB Circular A-133, § __.210:

- (b) Federal award. Characteristics indicative of a Federal award received by a subrecipient are when the organization:
- (1) Determines who is eligible to receive what Federal financial assistance;
 - (2) Has its performance measured against whether the objectives of the Federal program are met;
 - (3) Has responsibility for programmatic decision making;
 - (4) Has responsibility for adherence to applicable Federal program compliance requirements; and

⁵⁰ The grant was given to Maine MEP from the Maine Department of Economic and Community Development “to pilot a new CNC training paradigm with advanced machine shops”. Maine DECD was awarded the grant after the Department of Labor reported “a national shortage of skilled Computer Numerical Controlled (CNC) operators who are critical to the survival of advanced machine shops especially in the six-state New England region.” A copy of the Grant Agreement between Maine DECD and Maine MEP is attached at Ex. 23.

⁵¹ A copy of the Vendor Agreement between Maine MEP and Massachusetts MEP, including Schedule A, Scope of Work, is attached to this report at Ex. 22.

(5) Uses the federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) Payment for goods and services. Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

Clearly under this guidance Massachusetts MEP is a vendor to Maine MEP. The vendor agreement with Maine MEP does not require Massachusetts MEP to conduct any activities that are outside of its statutory mission or the current scope of work under the Massachusetts MEP cooperative agreement, nor does it require Massachusetts MEP to conduct any additional activities. It is providing services that it provides on a regular basis under its MEP cooperative agreement and they are within its “normal business operations” and such services are “ancillary to the operation of the Federal program.” The Federal program, for which the Maine Department of Economic and Community Development is responsible, is the pilot training program. Massachusetts MEP’s responsibility under the vendor agreement is to assist in the identification of participants and facilities for the program. Furthermore, nothing in the Scope of Work gives Massachusetts MEP any decision making responsibilities, or performance of the actual Federal program, nor is its performance evaluated against the objectives of the Federal program. Consequently, payments to Massachusetts MEP from Maine MEP for the goods and services received are not Federal awards.⁵²

The work performed under the vendor agreement is not outside the normal operations of Massachusetts MEP, but consists of information sharing with Maine MEP. Furthermore, questioning costs on the grounds that 15 C.F.R. §14.23(a)(5) prohibits costs “paid by the federal government under another award, except where authorized by federal statute to be used for cost sharing or matching.”⁵³ The Draft Audit Report continues, “[t]he funds used to compensate Massachusetts MEP for the services under both subcontracts originated with the federal government.”⁵⁴ This is an inaccurate characterization of the funds received by Massachusetts MEP under the vendor agreement. OMB Circular A-133 clearly states that vendor payments should not be considered Federal awards, yet this is exactly the incorrect conclusion reached by

⁵² OMB Circular A-133, § __.210(a) (An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. *The payments received for goods or services provided as a vendor would not be considered Federal awards.*)(emphasis added).

⁵³ IG Draft Audit Report at 8.

⁵⁴ *Id.*

the auditors. For this and the reasons stated above, the \$ [REDACTED] claimed under the Vendor Agreement with Maine MEP is allowable.

QUESTIONED CONTRACTUAL AND OTHER DIRECT COSTS

Pre-Award Costs

Massachusetts MEP does not challenge the auditor's questioning of \$ [REDACTED] in contractual costs for consultant services invoiced prior to the July 1, 2005 start date of the cooperative agreement.

Registration Fees

The auditors questioned \$ [REDACTED] in registration fees paid for eight participants (four from New Hampshire and four from Maine) to attend the Association of Manufacturing Excellence annual conference. However, the costs that the auditors questioned were not actually charged to Massachusetts MEP but rather to the various centers where the employees worked. This can be determined by looking at the cost codes next to the amounts which are highlighted. The documents showing the charges relied upon by the auditors are a balance sheet entry, and do not reflect actual costs incurred. The costs for the New Hampshire participants were properly charged to New Hampshire and the costs for the Maine participants were properly charged to Maine and were never charged as costs incurred to the Massachusetts MEP Program.⁵⁵

PROGRAM INCOME

NIST MEP officials have caused considerable confusion over the years regarding the treatment of program income and excess program income in its regulation,⁵⁶ terms and conditions, presentations to the recipients, and in discussions over the years. At one time there was a special task group formed by NIST with the participation of several MEP Centers to address the treatment of program income and excess program income, but it was disbanded before the work was completed. Program income is defined as "gross income earned by the recipient that is directly generated by a supported activity or earned as a result of the award,"⁵⁷ including fees for services performed, use of rental or real property acquired under federally-funded projects, and sale of commodities fabricated under an award.⁵⁸ As the auditors noted, most program income generated under the Massachusetts MEP award results from the fees paid by private manufacturing firms and individuals for services or for fees paid by conference participants or sponsors. These fees are not paid with federal dollars. The federal government has a partial interest in the program income because the federal dollars supported the costs incurred in conducting the activities under the cooperative agreement that generated the program income. The "recipient organization must account for all program income related to projects financed in whole or in part with federal funds."⁵⁹ The recipient is directed to retain the program income and to use it in one of three ways, add it to the project funds, use it to finance the non-federal share,

⁵⁵ Ex. 25.

⁵⁶ The program regulation defined two types of program income as "cost share." 15 C.F.R. § 290.4(c)(2) and (3).

⁵⁷ 15 C.F.R. § 14.2(aa).

⁵⁸ *Id.*

⁵⁹ 15 C.F.R. § 14.24(a).

or deduct it from the total project costs. The grantor agency chooses the treatment of program income under its awards and NIST chose the alternative under 15 C.F.R. § 14.24(b)(2), which provides that program income may be applied to the non-federal cost share.

It is well-established in law, that program income does not automatically acquire a federal character and is not required to be deposited in the Treasury as miscellaneous receipts.⁶⁰ Under a cost-share grant, the federal government's interest is limited to the extent of its participation. To the extent that federal dollars paid the costs of the activities that generated the program income, it may direct the recipient as to how it may expend that income. Many federal agencies that anticipate that a cost-share grant program will generate program income, address it specifically in their program regulations. In those regulations, federal agencies clearly acknowledge that the federal government may only direct the recipient on the use of the program income to the extent of the federal share, i.e., one-third of the income under an MEP cooperative agreement.⁶¹ Neither NIST nor the Department of Commerce have issued such a regulation regarding program income produced under cost share grants, despite the fact that MEP clearly anticipated fees for services to be charged by recipients (as do other programs at Commerce, such as the Minority Business Development Administration). For this reason, one must look to other federal agency regulations for guidance.⁶²

During 2006, NIST was implementing changes to its operating plan guidelines and general terms and conditions with respect to: the calculation of program income, undisbursed program income, the impact of state and other funding on the calculation of program income, the restrictions of all or a portion of program income, the amount that could or should be carried forward by a center, and the process and procedures for approval of program income. The MEP General Terms and Conditions were not actually incorporated into the 2006 cooperative agreements until February 2006.⁶³ Once the procedures were clearly established, Massachusetts MEP closely followed the approval process and the calculations and restrictions placed upon program income as evidenced by the clear and complete disclosure of 2006 results contained in the approved operating plan for the year beginning July 2008. Having disclosed the undisbursed program income in the operation plans approved by NIST, reporting it in the SF 269s, and ultimately getting Grants Officer written approval to carry over the excess program income, this finding should be removed.

Excess program income results if the recipient has generated more program income than is needed to match the federal dollars or if the federal agency has stipulated any limits upon what

⁶⁰ B-191420 (August 24, 1978), p.4 and 44 Comp. Gen. 87,88 (1964) which established that income generated from federal funds was not subject to section 3617 of the Revised Statutes, 31 U.S.C. § 484 (1970).

⁶¹ This interpretation has been adopted by the Department of Justice, *Financial Guide*, Office of Justice Programs, U.S. Department of Justice, Chapter 4, *available at* <http://www.ojp.usdoj.gov/finguide06/part3/part3chap4/part3chap4.htm> (Where a program is only partly funded by Federal funds, the Federal portion of program income must be accounted for up to the same ratio of Federal participation as funded in the project or program.), the Department of Housing and Urban Development, 24 C.F.R. § 570.489(e)(1) (When income is generated by an activity that is only partially assisted with CDBG funds, the income shall be prorated to reflect the percentage of CDBG funds used.), and the Department of the Interior, Office of Surface Mining, *Federal Assistance Manual*, Office of Surface Mining, Department of the Interior, *available at* <http://www.osmre.gov/fam/defin.htm>.

⁶² *Id.*

⁶³ Ex. 6.

the grantee may apply under one of the methods. NIST attempted at one point to establish a limit of 25%,⁶⁴ but then withdrew the requirements.⁶⁵ The regulation acknowledges this may happen under 15 C.F.R. § 14.24(c) where it provides that any excess program income be used to deduct the total project costs. The recipient then deducts the excess program income from the total costs upon "which the Federal share of costs is based" under 15 C.F.R. § 14.24(3). MEP Centers that generated more program income than was needed to meet the two-thirds cost share are only obligated to deduct one-third of the excess program income to reduce the total award costs, because the federal share of the program expenses and income is one-third under the terms of the MEP Cooperative Agreement. Only one-third excess program income at the end of each award year is required to be expended and may only be expended as directed by NIST under 15 CFR § 14.24(c). The remaining two-thirds of the excess program income is unencumbered by the grant requirements. This was clearly set forth in a decision by the Department of Health and Human Services Departmental Appeals Board which states that the recipient can expend excess program income even on expenses that are "not otherwise permissible as charges to federal funds." *Anchorage Neighborhood Health Center, U.S.*, HHS DAB No. 561 (August 6, 1984). If used to add activities to the award, the program income funded activity need only further the program purpose, and is not subject to the cost principles.

As stated in the Draft Audit Report, program income, consisting entirely of project fees, was \$[REDACTED], which was greater than the amount anticipated by Massachusetts MEP in its operating plan budget. The actual program income was significantly greater than budgeted program income due to the success of Massachusetts MEP's efforts. Accordingly, the Center generated undisbursed program income as reported on the financial status report for the period ending June 30, 2006.⁶⁶ The undisbursed program income is questioned because it was carried forward without prior approval from the Grants Officer as required by May 2006 amendment to the cooperative agreement. However, approval for the carry forward has since been granted. The Massachusetts MEP operating plan for the period beginning July 1, 2008 reported this undisbursed program income, requested and was granted approval for carry-forward. The 2008-2009 Operating Plan, on page 8, reports the total undisbursed program income for the years ending in 2006, 2007 and 2008 and identifies that [REDACTED] of that net income is "restricted". The "restricted" amount adds to \$[REDACTED] and ties to the number identified on page 32 in the budget and page 33 in the budget narrative. NIST MEP identified and approved \$[REDACTED] of carry-forward program income in amendment 11, special award condition 9 for the 2008-2009 program year. We have attached the revised SF 269 for 2006 and the approved Operating Plan for 2008 to demonstrate approval of the carry-forward program income.⁶⁷

CONCLUSION

Massachusetts MEP has a strong MEP program with several strong partners. Massachusetts MEP continues to provide important services to its clients throughout Massachusetts. The

⁶⁴ The 2006 MEP General Term and Condition No. ___ initially imposed a 25% limitation on program income, but was subsequently repealed by NIST in May 2006. Ex. 5, 7, 26.

⁶⁵ Ex. 5.

⁶⁶ It should be mentioned for accuracy that the undisbursed program income for the period in question was subsequently re-calculated to reflect final adjustments to the Center's financial reports, resulting in a reduction to \$[REDACTED].

⁶⁷ Ex. 27.

annual report of the client impact surveys performed by a contractor on behalf of NIST reported for Fiscal Year 2006 that

MEP focuses on results and outcomes. It maintains its accountability to its clients, investors, and stakeholders by asking the people with the best information - its clients - about the impacts of its work. MEP delivers measurable results to its clients and its investors. Each year, MEP makes it possible for thousands of companies to solve problems, to increase productivity, to achieve higher profits, to find new markets, to adopt technology, and to create and retain thousands of jobs. In FY 2006, MEP clients reported that these services led to:

- Boosting productivity among nearly eight in ten (78.8 percent) MEP clients
- Creating and retaining over 52,000 jobs
- Increasing and retaining sales of over \$6.8 billion
- Modernizing their companies by leveraging over \$1.7 billion in new private sector investments
- Saving more than \$1.1 billion in costs
- Improving the competitiveness for 82 percent of the respondents.⁶⁸

Massachusetts MEP has consistently followed the direction of NIST and the applicable statutes and regulations in carrying out its MEP program. The auditors' insistence that there are not valid subrecipient costs on the basis of the financial management standards is plainly inaccurate. The partners, AME and AIM opened up their books not just to Massachusetts MEP but also to the auditors. Massachusetts MEP uses both summary financial reports and underlying source documentation to verify that the partner costs it claims are reasonable, allocable and allowable to the MEP program. This documentation was made available to the auditors during their fieldwork at Massachusetts MEP and on location with the partners. In addition, the agreements executed with the partners include budgets and scopes of work, and flow-down provision that requires the partner to make its books and records available for inspection and allow Massachusetts MEP to conduct an annual site visit. Massachusetts MEP works very closely with its partners to ensure that financial recordkeeping requirements are understood and can be met.

The auditors' questioning of the validity of the relationship between Massachusetts MEP and its partners, AME and AIM, is likewise inaccurate. While some partnerships exhibit several characteristics of subrecipients, others are more akin to third-party in-kind contributors, vendors, and joint ventures. Often a partnership contains many of these characteristics. Furthermore, the plain language of the MEP statute demonstrates Congressional intent for the MEP Centers to create a network of MEP Centers, to form partnerships with associations, universities, and other non-profit organizations, and for the costs incurred by the partners to be counted in the cost contribution of the MEP Center, so long as the Center determines that those costs are reasonable and allocable.⁶⁹ We respectfully disagree with the auditors' findings and questioned costs for the

⁶⁸ U.S. Department of Commerce, National Institute of Standards and Technology, *THE MANUFACTURING EXTENSION PARTNERSHIP: DELIVERING MEASURABLE RESULTS TO ITS CLIENTS*, Fiscal Year 2006 (January 2008), available at <http://www.mep.nist.gov/impacts/delivering-measurable-results.htm> (September 15, 2008).

⁶⁹ *America Competes Act*, P.L. 110-69, Sec. 3003, 121 Stat. 587 (2007).

reasons stated herein. To support our arguments, we have enclosed with this Response the necessary supporting documentation relied upon.