

**Memorandum****JUN 23 1993**

Date

From

Bryan B. Mitchell *Bryan Mitchell*  
Principal Deputy Inspector General

Subject

Reimbursement to Educational Institutions and Nonprofit  
Organizations: Guidelines Needed for the Implementation of  
Financial Accounting Standards Board Statement Number 106  
(A-01-93-04000)

To

Kenneth S. Apfel  
Assistant Secretary  
for Management and Budget

Attached are two copies of an Office of Inspector General report entitled "Reimbursement to Educational Institutions and Nonprofit Organizations: Guidelines Needed for the Implementation of Financial Accounting Standards Board Statement Number 106 (FASB 106)." Our objective was to determine the effect of FASB 106 on Office of Management and Budget (OMB) Circulars A-21 and A-122, Cost Principles for Educational Institutions and Cost Principles for Nonprofit Organizations.

The FASB 106 changed the treatment of Postretirement Benefits (PRB) from the cash basis to the accrual basis of accounting. This could materially increase PRB costs claimed for reimbursement by schools and nonprofit organizations conducting federally sponsored research. Currently, OMB Circulars A-21 and A-122 do not state whether the accrued portion of PRB expenses should be recognized as a reimbursable cost. Without guidance as to whether accrued expenses should be charged, scarce Federal research funds may be used to reimburse unfunded PRB costs.

We recommend that the Assistant Secretary for Management and Budget (ASMB): (1) work with OMB to revise applicable cost principles to include specific provisions for Federal reimbursement of accrued PRB costs; and (2) advise negotiators for the Division of Cost Allocation to pay special attention to PRB costs when reviewing fringe benefit rates for schools and nonprofits. The ASMB concurs with our recommendations.

We would appreciate your views and the status of any further actions taken or contemplated on our recommendations within the next 60 days.

To facilitate identification, please refer to Common Identification Number A-01-93-04000 in all correspondence

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relating to this report. If you have any questions, please call me or have your staff contact Daniel W. Blades, Assistant Inspector General for Public Health Service Audits, at (301)443-3582.

Attachments

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**REIMBURSEMENT TO EDUCATIONAL  
INSTITUTIONS AND NONPROFIT  
ORGANIZATIONS: GUIDELINES NEEDED  
FOR THE IMPLEMENTATION OF  
FINANCIAL ACCOUNTING STANDARDS  
BOARD STATEMENT NUMBER 106**



**JUNE 1993    A-01-93-04000**

**Memorandum**

Date JUN 23 1993  
From Bryan B. Mitchell *Bryan Mitchell*  
Principal Deputy Inspector General  
Subject Reimbursement to Educational Institutions and Nonprofit  
Organizations: Guidelines Needed for the Implementation of  
Financial Accounting Standards Board Statement Number 106  
(A-01-93-04000)  
To

Kenneth S. Apfel  
Assistant Secretary  
for Management and Budget

This management advisory report summarizes the results of our review of the implementation, by educational institutions (schools) and other nonprofit institutions (nonprofits), of Financial Accounting Standards Board Statement Number 106 (FASB 106) relating to Postretirement Benefit (PRB) costs. The objective of our review was to determine the effect of FASB 106 on the Office of Management and Budget (OMB) Circular A-21 (A-21), Cost Principles for Educational Institutions and OMB Circular A-122 (A-122), Cost Principles for Nonprofit Organizations.

Our review disclosed that the effect of FASB 106 on PRB costs could materially increase the amount claimed for reimbursement by schools and nonprofits conducting federally sponsored research. Prior to FASB 106, financial reporting under generally accepted accounting principles (GAAP) recognized PRB costs when they were paid. Under FASB 106, the expected cost of providing PRBs to current employees and their beneficiaries and covered dependents are accrued. As such, institutions are now required under GAAP to report accrued PRB costs for current and retired employees as a liability on their financial statements.

The OMB A-21 and A-122 cost principles do not specifically state whether the accrued portion of PRB expenses should be recognized as a reimbursable cost. Without proper guidance as to whether accrued expenses should be charged, scarce Federal research funds may be used to reimburse unfunded PRB costs. For example, one major northeastern university has determined that its unfunded and unrecognized accumulated PRB obligation was approximately \$275 million. Under FASB 106, this amount will be accrued, whether funded or not, and included as an expense, increasing the university's fringe benefit rates by several percentage points. Each increase of 1 point in the fringe benefit rate would result in about \$578,000 in additional direct costs charged to Federal research at this university.

We are recommending that the Department of Health and Human Services, Assistant Secretary for Management and Budget (ASMB): (1) work with OMB to revise applicable cost principles to include specific provisions for Federal reimbursement of accrued PRB costs; and (2) advise negotiators for the Division of Cost Allocation (DCA) to pay special attention to PRB costs when reviewing fringe benefit rates for schools and nonprofits. The ASMB, in response to our draft report, concurred with these recommendations.

#### BACKGROUND

During Fiscal Year (FY) 1991, the Federal Government allocated direct and indirect costs of over \$10 billion to research at schools and over \$2 billion to research at nonprofits through grants and contracts. Direct costs can be identified with a specific federally sponsored project, instructional activity, or other institutional activity. Conversely, indirect costs are incurred for common and joint objectives which cannot be readily identified with a specific research project, instructional activity, or other institutional activity.

The OMB A-21 and A-122 cost principles provide schools and nonprofits, respectively, guidelines for determining allowed costs for research and other work performed under federally sponsored agreements. These cost principles are intended to ensure that the Federal Government pays only its fair share of total costs for research and development. Allowed costs include reimbursement for employee benefits, including PRBs, as long as such benefits are provided in accordance with established institutional policies and are distributed to all institutional activities on an equitable basis.

The FASB 106 established accounting standards for employers' accounting of PRBs other than pensions. Although FASB 106 applies to all types of PRBs, it focuses principally on retirees' health care benefits since these are likely to be most significant in terms of cost and prevalence. Nevertheless, it applies equally to all PRBs. The effective date for FASB 106 is FYs beginning after December 15, 1992. The FASB, however, encouraged early adoption.

The FASB 106 changed the treatment of PRB costs from the cash basis to the accrual basis of accounting. Under FASB 106, the expected cost of providing PRBs to current employees and their beneficiaries and covered dependents, also known as net periodic service costs, are accrued. As such, institutions are now required under GAAP to report accrued PRB costs for current and retired employees as a liability on their financial statements. The FASB 106 also requires the annual

disclosure of transition obligations (i.e., the cumulative effect of an accounting change) which may be recognized either immediately or amortized over a period of up to 20 years.

#### METHODOLOGY

The objective of our review was to determine the effect of FASB 106 on OMB A-21 and A-122. To accomplish our objective, we:

- (1) reviewed FASB 106 and the guidelines for implementation;
- (2) reviewed current OMB A-21 and A-122 cost principles;
- (3) reviewed Health Care Financing Administration (HCFA) proposed guidelines relative to Medicare reimbursement for PRB costs, and applicable sections of the Federal Acquisition Regulation (FAR) pertaining to all Government contracts;
- (4) met with DCA officials to discuss the impact of FASB 106 on fringe benefit and indirect cost rates at schools and nonprofits;
- (5) reviewed the most recent financial statements for 36 northeastern schools under DCA cognizance to determine if any schools opted for early adoption of FASB 106;
- (6) discussed the implementation of FASB 106 with HCFA and independent actuaries; and
- (7) discussed the differences in the accounting treatment of PRB costs and pension costs with the FASB.

Our review was conducted during November and December 1992, at the northeastern DCA office in New York, New York, and the Office of Inspector General (OIG) Regional Office in Boston, Massachusetts. We provided the ASMB a draft report for comment on April 14, 1993. The ASMB's comments are summarized below and appended in their entirety to this report (see APPENDIX).

#### RESULTS OF REVIEW

Our review disclosed that the effect of FASB 106 on PRB costs could materially increase the amount claimed for reimbursement by federally sponsored schools and nonprofits. Prior to FASB 106, financial reporting under GAAP recognized PRB costs when they were paid. Under FASB 106, PRB costs for current

and retired employees are accrued. The OMB A-21 and A-122 cost principles, however, do not specifically state whether the accrued portion of PRB expenses should be recognized as a reimbursable cost. As a result of implementing FASB 106, the amounts claimed in PRB costs by schools and nonprofits could result in the reimbursement of substantial unfunded costs. Accordingly, it is essential that related cost principles not only meet the requirements of FASB 106, but also ensure that scarce Federal research dollars will not be used to reimburse unfunded PRB costs.

The FASB 106 relies on a basic premise of GAAP that accrual accounting provides more relevant and useful information than cash basis accounting. The FASB 106 does not, however, require employers to actually fund the accrued liability since FASB concluded that the decision of how and when to fund PRB obligations is a financing rather than an accounting issue. Although the effective date for FASB 106 is FYs beginning after December 15, 1992, early adoption is encouraged.

The current versions of OMB A-21 and A-122 stipulate that pension plan costs are allowable provided the cost assigned to a given FY has been funded. However, they do not specifically state whether the accrued portion of PRB expenses should be recognized as a reimbursable cost for Federal research. Without proper guidance as to whether accrued expenses should be charged, scarce Federal research funds may be used to reimburse PRB expenses not yet incurred by schools and nonprofits.

Our review of DCA's files and schools' financial statements disclosed that the majority of schools had not determined the effect of FASB 106 on their research and development programs. Those schools that did implement FASB 106 experienced the following effects:

- o a major northeastern university determined that its unfunded and unrecognized accumulated PRB obligation was approximately \$275 million (transition obligation due to an accounting change). University officials need to determine: (1) whether the transition obligation will be recognized immediately or amortized as a component of net periodic PRB costs; and (2) the amount of accrued PRB costs that will be funded. Assuming the university elects to amortize the transition obligation over a 20-year period, university officials expect fringe benefit rates to increase by several points. An increase of 1 point in the fringe benefit rate would result in about \$578,000 in additional direct costs charged to Federal research;

- o the Research Foundation for the State University of New York (SUNY) opted for early adoption of FASB 106 for FY 1987. The adopted method used to recognize expenses for health insurance costs increased annual expenditures by about \$2 million in FY 1987. The impact of this change on future years would depend on the amount accrued in health insurance costs determined annually by actuaries;
- o in FY 1991, SUNY established \$11.1 million in transition obligations, and elected to amortize the cost over 20 years. Amortization of the transition obligation increased the university's annual PRB costs by \$550,000 (\$11.1 million/20 years). A SUNY official provided information indicating that SUNY funded \$1.6 million of the \$2 million reported in FY 1991 PRB expenses; and
- o the Research Foundation for the City University of New York (RFCUNY) included a provision of \$1.5 million for postretirement health benefits in its calculation of its actual fringe benefit rate for FY 1989. The RFCUNY had not funded any portion of the \$1.5 million. Approximately \$410,000 of the \$1.5 million liability was charged to Federal agreements through the application of the FY 1989 fringe benefit rate.

Based on the above examples, it is evident that implementation of FASB 106 may result in significant increases in PRB costs claimed for reimbursement by schools and nonprofits due to the change from the cash to the accrual basis of accounting. We believe that it is unreasonable to expect schools and nonprofits to fund such significant increases. Currently, we cannot assure that schools and nonprofits will not claim the unfunded portion of their PRB costs for reimbursement under federally sponsored research grants.

Anticipating the implementation of FASB 106, some Federal policymakers have taken the initiative to revise and issue regulations that clarify the accounting treatment and Federal reimbursement procedures related to accrued PRB costs. For example:

- o in October 1991, HCFA issued a proposed rule clarifying Medicare's policy for accrued costs. The proposed rule specifies that PRB costs must be actually funded in order to qualify for Medicare reimbursement. The OIG issued on March 30, 1993, a final report entitled "Implementation of Financial Accounting Standards Board Statement No. 106, Entitled 'Employers' Accounting for Postretirement



Benefits Other Than Pensions'" (A-01-92-00520) recommending that HCFA expeditiously institute its proposed rule as Medicare regulations;

- o in July 1991, the General Services Administration, Department of Defense, and National Aeronautics and Space Administration jointly revised the FAR to clearly establish the requirement that the unfunded portion of accrued PRB costs assigned to the current year is unallowable for commercial contractors;
- o the OMB is soon expected to publish proposed changes to its Circular A-87, Cost Principles for State and Local Governments, which will include a revision that PRB costs must be calculated according to GAAP and funded by the recipient to be allowable; and
- o the OIG issued a draft report (A-01-92-01528) on the Principles for Determining Costs Applicable to Research and Development Under Grants and Contracts with Hospitals in which we included a recommendation to revise the hospital cost principles to stipulate that PRB costs will be reimbursed to the extent funded or paid.

With the full implementation of FASB 106 required for FYs beginning after December 15, 1992, it is essential that the Federal Government stay abreast of this emerging issue to provide assurance that scarce Federal research dollars are most efficiently and effectively utilized. Since most schools and nonprofits have yet to adopt FASB 106, and have not yet determined the monetary effect, we were unable to quantify the total amount of potentially unfunded charges for Federal research. We believe, however, that millions of dollars in charges to research projects can be avoided by swiftly revising OMB A-21 and A-122. Accordingly, we believe that applicable cost principles for schools and nonprofits need to be updated to: (1) consider the significant changes in accepted accounting practices related to the recognition and measurement of PRB costs; and (2) ensure compatibility with other Federal requirements regarding PRBs and pensions.

#### RECOMMENDATIONS

We are recommending that ASMB:

- (1) work with OMB to revise applicable cost principles to include specific provisions relating to the recognition and measurement of accrued PRB costs, and the Federal reimbursement of the funded portion of net periodic PRB costs. In this respect, the OMB A-21 and A-122 need to be updated to specify

that the amount of PRB costs assigned to each FY should be determined in accordance with FASB 106 and such costs must be paid or funded to qualify for Federal reimbursement; and

- (2) advise negotiators for DCA to pay special attention to PRB costs when reviewing fringe benefit rates for schools and nonprofits to ensure that only the funded portion of PRB costs are included in the development of the fringe benefit rates.

**ASMB COMMENTS AND ADDITIONAL OIG COMMENTS**

The ASMB concurs with these recommendations. In response to the draft report, the ASMB indicated that departmental guidelines are not necessary as all the OMB cost principles will include guidance. We are in agreement and have deleted the applicable recommendation.

To facilitate identification, please refer to Common Identification Number A-01-93-04000 in all correspondence relating to this report. If you have any questions, please call me or have your staff contact Daniel W. Blades, Assistant Inspector General for Public Health Service Audits, at (301)443-3582.

**APPENDIX**



MAY 13 1993

RECEIVED  
5/14/93

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RECEIVED  
OFFICE OF INSPECTOR  
GENERAL

TO: Bryan B. Mitchell  
Acting Inspector General

FROM: Elizabeth M. James  
Acting Assistant Secretary  
for Management and Budget

SUBJECT: Draft OIG Report -- Guidelines Needed for  
Implementation of Financial Accounting Standards Board  
Statement Number 106 by Educational Institutions and  
Nonprofit Organizations (A-01-93-04000)

We have reviewed the draft OIG report on the treatment of post-retirement employee benefits costs under Financial Accounting Standards Board Statement Number 106.

We agree with the recommendation in the report that the cost principles for educational institutions and nonprofit organizations (OMB Circulars A-21 and A-122, respectively) should be revised to provide specific guidance on Federal reimbursement for accrued post-retirement benefit costs. We also agree that this guidance should require that the accrued costs be funded to qualify for Federal reimbursement. As indicated on page 6 of the report, we've been working with OMB on a revision of Circular A-87 that will provide guidelines on the treatment of these costs by State and local governments, including a funding requirement. We had intended to incorporate similar provisions in A-21 and A-122 in the next revisions of the circulars. Your report will be very useful in this effort and will be forwarded to OMB as soon as it is finalized.

Since guidance on the treatment of these costs will be included in all the OMB cost principles, the suggestion in the report that HHS issue its own separate guidelines on this subject does not appear necessary. We do, however, agree that it would be useful to issue instructions to the Department's cost negotiators to alert them to the need to review this area in their reviews of indirect cost proposals and fringe benefits rates. We have discussed this with the negotiators and will issue written instructions in the near future.

We appreciate the opportunity to review the draft OIG report.

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