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Jack O'Connell
State Superintendent of Public Instruction
California Department of Education
1430 N Street
Sacramento, CA 95814

Dear Superintendent O'Connell:

This **Final Audit Report**, entitled *San Diego Unified School District's Use of Federal Funds for Costs of Its Supplemental Early Retirement Plan*, presents the results of our audit. The purpose of the audit was to determine whether the San Diego Unified School District's (SDUSD) charges to Federal programs for Supplemental Early Retirement Plan (SERP) payments met applicable requirements under Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*. Our review covered SERP costs charged to Federal programs during the fiscal year periods from July 1, 2003, through June 30, 2006.

BACKGROUND

On February 4, 2003, the SDUSD Board of Education passed a resolution to adopt the SERP, which offered a one-time early retirement incentive to District employees who were employed on that date at non-charter schools and eligible to retire under either the California State Teachers' Retirement System (CalSTRS) or California Public Employees' Retirement System (CalPERS) by August 31, 2003.¹ Participants were required to enroll in the SERP by April 25, 2003, and resign from District employment by July 31, 2003. The SERP provided participants with a monthly cash income that was in addition to the monthly income the employees received from CalSTRS/CalPERS.

¹ The District employee was not required to retire under the CalSTRS/CalPERS to be eligible for the SERP and may seek employment at another district or other employer.

SDUSD entered into an agreement with the Public Agency Retirement Services (PARS)-Phase II Systems to implement and manage the SERP. SDUSD has provided funds for the SERP through annuity premiums paid in six installments over a five-year period. The estimated total cost of the SERP is about \$84 million. A total of 1,456 District employees participated in the SERP.

AUDIT RESULTS

SDUSD's charges to Federal programs for the SERP did not meet the applicable requirements of OMB Circular A-87. SDUSD did not obtain the required prior U.S. Department of Education (ED) approval to charge SERP costs to Federal programs and mistakenly concluded that SERP costs could be charged to Federal programs as a fringe benefit that did not require ED approval. As a result, SDUSD improperly charged over \$3.1 million of SERP costs to Federal programs during the fiscal year periods from July 1, 2003, through June 30, 2006. Of that amount, about \$1.9 million was charged to ED programs.

Since the SDUSD had not obtained the required prior ED approval to charge SERP costs to Federal programs, we did not evaluate the District's method for calculating the amounts charged to individual Federal programs.

In its comments to the draft report, CDE did not concur with our finding and recommendations. We made no changes to our conclusions and the recommendation in response to CDE's comments. The comments are summarized at the end of the finding along with the OIG response. The full text of CDE's comments is included as Attachment 3 to the report.

FINDING – SDUSD Charged Unallowable Costs of the SERP to Federal Programs

The payments to SERP participants are considered "abnormal or mass severance pay" under the applicable provisions of OMB Circular A-87. The costs of such payments are only allowed if approved by the cognizant Federal agency prior to charging the costs to Federal programs. Thus, the SERP costs charged to Federal programs are unallowable costs since SDUSD did not obtain the required prior approval.

Prior ED Approval Required to Charge SERP Costs to Federal Programs

OMB Circular A-87 establishes the principles and standards for determining costs for Federal awards carried out through grants, cost reimbursement contracts, and other agreements with State and local governments. Attachment B of the Circular addresses selected items of cost. Attachment B, Paragraph 8 addressing compensation for personal services states—

(g) Severance pay.

(1) Payments in addition to regular salaries and wages made to workers whose employment is being terminated are allowable to the extent that, in each case, they are required by (a) law, (b) employer-employee agreement, or (c) established written policy.

(2) Severance payment (but not accruals) associated with normal turnover are allowable. Such payments shall be allocated to all activities of the governmental unit as an indirect cost.

(3) Abnormal or mass severance pay will be considered on a case by case basis and is allowable only if *approved* by the cognizant Federal agency.²

The SERP is “abnormal or mass severance pay” because it was a one-time offer to all qualified employees as an incentive to leave the District’s employment.³

Attachment A of the Circular contains the principles for determining allowable costs. Paragraph B.1 of Attachment A explains the meaning of the phrase “approved by the cognizant Federal agency.”

‘Approval or authorization of the awarding or cognizant Federal agency’ means documentation evidencing consent prior to incurring a specific cost. If such costs are specifically identified in the Federal Award document, approval of the document constitutes approval of the costs. If the costs are covered by a state/local wide cost allocation plan or an indirect cost proposal, approval of the plan constitutes the approval.⁴

Since ED is the cognizant Federal agency, SDUSD should have obtained ED’s approval prior to charging SERP costs to Federal programs.⁵ SDUSD initially charged SERP costs to Federal programs on June 30, 2004, and made subsequent charges to Federal programs on June 10, 2005, and September 30, 2005. The SERP costs were direct charges to individual Federal programs and other funding sources.

SDUSD provided documentation in support of its conclusion that the SERP costs could be charged to Federal programs as a fringe benefit that did not require ED approval. SDUSD also provided other documents that were available to the District prior and subsequent to its decision to charge Federal programs. Based on our review of the documentation, we concluded that

² OMB Circular A-87 was most recently revised on May 10, 2004. Attachment B of the prior Circular (revised May 4, 1995, as further amended August 29, 1997) contained identical language under Paragraph 11.g.

³ The OMB Circular A-87 Implementation Guide states “[m]ass severance or termination benefits would include all expenses associated with the event. This would include: lump sum payments that may be linked to years of service, increased pension benefits such as granting additional years or eliminating penalties for early retirement, payments of unused leave, and the cost of any other incentive offered to employees as an incentive to leave government service, such as buy-outs.”

⁴ Attachment A, Paragraph B.1 of the prior Circular contained identical language.

⁵ The regulation at 34 C.F.R. § 80.30 (f)(3) states that subgrantees are to submit requests for prior approval to the grantee and, when Federal prior approval is required, the grantee will obtain the Federal agency's approval before approving the subgrantee's request. SDUSD did not submit a request for approval to the California Department of Education (CDE) prior to charging SERP costs to Federal programs.

SDUSD did not appropriately and fully consider the available information when making its initial decision to charge Federal programs for SERP costs, and its subsequent decision to continue to charge the Federal programs after receiving information from additional sources advising that the SERP costs required ED approval.

SDUSD Did Not Appropriately and Fully Consider Available Information When Making Initial Decision to Charge Federal Programs for SERP Costs

When SDUSD made its decision in February 2003 to implement the SERP and charge initial SERP costs to Federal programs in June 2004, the paragraphs from OMB Circular A-87 previously cited in this report and the OMB Circular A-87 Implementation Guide clearly specified that prior approval was required to charge Federal programs for the SERP costs (i.e., all costs associated with mass severance or termination benefits).

OMB Circular A-87 Implementation Guide. The U.S. Department of Health and Human Services publication titled *A Guide for State, Local and Indian Tribal Governments* (ASMB C-10), issued April 8, 1997, provides assistance to government units in applying the principles and standards in OMB Circular A-87. The procedures in the Guide are applicable to grants and contracts awarded by all Federal agencies.

In support of its decision, SDUSD provided selected pages from the Guide section titled “Questions and Answers on Attachment B.” The questions on the provided pages covering severance payments were marked and “SERP” was written next to Question 3-13, which provides the following definition of “severance pay” and reiterates the need for prior approval:

- (1) Mass severance or termination benefits would include all expenses associated with the event. This would include: lump sum payments that may be linked to years of service, increased pension benefits such as granting additional years or eliminating penalties for early retirement, payments of unused leave, and the cost of any other incentive offered to employees as an incentive to leave government service, such as buy-outs.
- (2) The costs of these special termination benefits must be determined and prior approval of such costs must be obtained from the Federal cognizant office prior to claiming these costs directly or indirectly against Federal programs. The requests for prior approval, at a minimum, must demonstrate the reasonableness and allocability of such costs to Federal programs.

Question 3-13 also explains the criteria that cognizant agencies will generally use in making a determination as to whether the abnormal severance costs will be allowed.

The other guidance available to the District at that time—an ED policy letter and a PARS investigation—did not mention the need for prior approval.

ED Policy Letter. SDUSD provided a policy letter that ED issued on January 14, 2002, to the Illinois State Board of Education on methods for allocating an employer's early retirement contributions to the Elementary and Secondary Education Act (ESEA) Title I program.⁶ The letter cited OMB Circular A-87 and states—

[E]mployee fringe benefits, such as early retirement are an allowable cost to a Federal grant 'to the extent the benefits are reasonable and are required by law, government unit-employee agreement, or an established policy of the government unit.' In addition, such benefits must be allocable to Title I that is, the costs must be relative to the benefits received.

* * * * *

In general, as noted above, Title I funds may be used to pay an employer's share of early retirement, provided those costs are reasonable, required by the law, agency-employee agreement, or agency policy, and allocated equitably to all related activities.

The policy letter provided two methods for allocating such costs: (1) district may charge the employer's share of early retirement costs to the ESEA Title I program for a given employee in proportion to the number of years the employee benefited from the district's Title I program or (2) district may establish an early retirement pool to which it would make annual contributions, where the annual contribution is determined using a fixed rate that is applied uniformly to all salaries paid by the district. The letter listed the documentation that should be maintained under these methods. The policy letter also explained that "Title I funds generally become available to States on July 1 of a given year and may thus not be used to liquidate obligations that occurred prior to that date."

Since the policy letter used "early retirement" as an example of fringe benefits and cited language from OMB Circular A-87, Attachment B, Paragraph 8.d. Fringe Benefits, SDUSD and its Independent Public Accountant (IPA) mistakenly concluded that the policy letter supported its decision to charge SERP costs to Federal programs as a fringe benefit without prior ED approval. The full text of the cited section on fringe benefits does not include "early retirement" as an example and alerts the reader to be aware of additional requirements presented elsewhere in the Circular (e.g., Paragraph 8.g. Severance pay), and states:

(1) Fringe benefits are allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages. Fringe benefits include, but are not limited to, the costs of leave, employee insurance, pensions, and unemployment benefit plans. Except as provided elsewhere in these principles, the costs of fringe benefits are allowable to the extent that the benefits are reasonable and are required by law, governmental unit-employee agreement, or an established policy of the governmental unit. [Emphasis added.]

⁶ The policy letter was available on the ED's website under the caption "Use of Funds for Retirement." ED has since removed the letter from the website.

PARS Investigation. In May 2003 (after the SDUSD adopted the SERP and prior to the SDUSD's initial charge of SERP costs to Federal programs), PARS provided SDUSD with the results of its investigation into whether the District could charge SERP costs on an ongoing basis to specific categorical programs (e.g., ESEA Title I program, etc.). PARS advised SDUSD that one PARS client (school district) had charged its entire costs to categorical programs. PARS also provided an email that the School Services of California (a consulting firm) had sent to one of its clients stating:

Charging the cost of fringe benefits and retirement contributions for current categorical staff, as well as the normal costs for retired categorical employees is clearly acceptable. Charging the costs of a voluntary retirement incentive program is an area that is not unequivocally clear or free from doubt. Accordingly, we would advise caution in this area. However, if the provisions/terms of a specific incentive program generates net cost savings for the categorical programs (i.e., the cost of replacement staff plus the incentive are less than the cost of the employee(s) being replaced) then we would think that it could be acceptable to charge the cost of the incentive to the categorical programs from which employees retire.

The documents provided by SDUSD contained no evidence that PARS had advised the District that OMB Circular A-87 required prior approval to charge Federal programs for the SERP costs.

Even though the ED policy letter and PARS investigation did not mention the need for prior approval, they do not provide justification for SDUSD's non-compliance with OMB Circular A-87, Attachment B, Paragraph 8.g and Attachment A, Paragraph B.1. The regulations at 34 C.F.R. Part 80 provide the Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments. Section 80.22 requires that local government grantees determine allowable costs in accordance with OMB Circular A-87.

SDUSD Did Not Take Prompt Action to Request ED Approval When Advised That Prior Approval Was Required for Charging SERP Costs to Federal Programs

Later, SDUSD sought advice from its IPA regarding early retirement incentives and its charges to Federal programs for the SERP to assist the District in responding to concerns raised by the Chairman for District Advisory Council for Compensatory Education (DAC) regarding the use of ESEA Title I program funds for SERP costs.⁷ While SDUSD primarily sought advice regarding its method for allocating the SERP costs, the advice disclosed the need for prior approval. After receiving the advice, SDUSD did not cease charging SERP costs to Federal programs or promptly submit a request to ED for approval of the SERP.

⁷ The DAC Chairman originally had raised concerns to District officials in May 2004 regarding the inclusion of costs for the SERP annuity premium in the Central Services proposed budget for the Title I program for fiscal year 2004-05. The DAC Chairman later articulated his specific concerns at a meeting with District officials on January 6, 2005.

School Services of California Publication. In an email, dated January 4, 2005, the District's Director of Accounting Operations advised the IPA that SDUSD was charging SERP costs for any employee who charged time to Title I during the individual's last year of employment. He stated that the decision was based on several favorable opinions shared with the District's legal counsel. The Director also acknowledged in the email that there were less favorable opinions, including the opinion that charges should be based on the lifetime average of an employee's time charged to the Title I program. The Director stated that another "gray area" is the factors in OMB Circular A-87 that need to be considered when determining if the SERP is considered a severance payment. The Director incorporated in his email the following excerpt from the School Services of California (SSC) publication, "The Fiscal Report," dated February 27, 2004:

We [SSC] believe that a Memorandum of Understanding (MOU) with a bargaining unit and action of the Board of Education to offer an early retirement incentive (to nonrepresented and/or represented employees) constitutes the requirement referred to in item #1 above. However, an early retirement incentive, by its very nature, should be infrequent and not a continuous policy or agreement. Therefore, we [SSC] believe that item # 3 above, which refers to "abnormal" severance pay, could be the controlling factor and would require approval by the cognizant agency.⁸

While not quoted in the Director's email, the SSC recommends in the subsequent paragraph of the publication that "districts that are considering charging a categorical program for the cost of an early retirement incentive obtain approval by the cognizant federal agency before using those funds."

IPA's Response to SDUSD's Request for Advice. Initially, in a letter dated March 23, 2005, the IPA provided SDUSD with the following conclusion that did not mention the need for prior approval:

Under [OMB Circular A-87], applicable to Title I under 34 C.F.R. 80.22, employee fringe benefits such as the District's SERP are an allowable cost to a Federal award *to the extent those costs are reasonable, relative to the benefits received, required by law, agency-employee agreement, or agency policy, and allocated equitably to all related activities.*

We reviewed and believe that the SERP program characteristics, eligibility requirements, and basis of allocation as communicated to us by District administration, meet the above cited federal law. Title I's share, under the District's described allocation method provides a cost that is equitable and not in excess of its proportionate benefit received.

The letter notes that the allocation method differed from the two methods mentioned in the ED policy letter and that an opinion from the ED is critical to the final resolution of this matter.

⁸ The item numbers refer to segments of Paragraph 8.g of OMB Circular A-87, Attachment B which is cited in full earlier in the finding.

However, in a subsequent email dated June 24, 2005, the IPA relayed the results of its communication with the ED Director for Indirect Cost Group.⁹ The IPA stated in its email to SDUSD that—

[The ED Director for Indirect Cost Group] stated that the cost as presented is not allowable as a direct cost to federal award programs. Special provisions, however, exist in law for ‘abnormal or mass severance’, but only if these were approved in advance from a cognizant agency. [ED] is under the assumption that we submitted a proposal and has asked for additional information to determine if authorization can be granted under this special provision. [Emphasis added.]

The ED Director for Indirect Cost Group had advised the IPA in an email sent on June 24, 2005, that “abnormal or mass severance” would include the costs of any incentive offered to employees as an incentive to leave government service and that such costs are not allowable unless approved in advance by the cognizant Federal agency. The ED official listed information that would be needed to evaluate a proposed retirement incentive plan if the plan costs were submitted for ED approval. Attachment 1 provides a summary of the communications that occurred between the IPA and ED over the period from February 2005 through March 2007 that were identified from the documents provided by SDUSD and the ED Director for Indirect Cost Group. The communications generally focused on methods of allocating early retirement incentive costs for an unnamed school district rather than obtaining specific ED approval for SDUSD to charge its SERP plan costs to Federal programs. Also, except for the March 30, 2007 letter, the IPA did not disclose in its written communications with the ED Director that the retirement incentive plan in question had already been implemented and costs had already been charged to Federal programs.

After receiving this advice from ED, it appears that SDUSD initiated steps to obtain ED approval. An internal District memo, dated August 26, 2005, from the District’s Resource Development Director to the District’s Chief Financial Officer shows that SDUSD had compiled responses to the criteria listed in Question 3-13 of the OMB Circular A-87 Implementation Guide. The District’s IPA submitted additional information to ED on October 10, 2005, for consideration in responding to an earlier request for advice. The IPA letter appears to have been based substantially on information contained in the internal SDUSD memorandum. However, the IPA did not disclose the name of the district in its letter; disclose that the retirement incentive plan, in question, had already been implemented; or disclose that costs had already been charged to Federal programs.

Later, in a letter dated April 27, 2006, the IPA provided SDUSD with a summary of its efforts to resolve issues regarding the SERP. While the IPA provided incorrect information on when changes were made to the Circular, the IPA acknowledged the need for approval and recommended that SDUSD obtain approval from ED for the SERP costs. In the letter, the IPA states:

⁹ SDUSD officials advised us that the District had asked its IPA to address SERP matters with ED rather than the District contacting ED directly.

The former Circular A-87 [OMB Circular A-87 (revised May 4, 1995, as further amended August 29, 1997)] did not note a specific requirement for advance approval for such costs. It did require such cost to be reasonable, relative to the benefits received, required by law, agency-employee agreement, or agency policy, and allocated equitably to all related activities. We reviewed and believe that the SERP program characteristics and eligibility requirements as communicated to us by District administration, meet the requirements of this federal law. Additionally, we believe the cost allocated prior to July 1, 2004, met the former Circular requirements.

Since ED is the cognizant Federal agency and the policy for such costs changed, we believe ED approval should be obtained for SERP payments made after June 30, 2004.

The IPA statement that the former Circular did not contain a requirement for advance approval is incorrect.¹⁰ As noted in footnote 4 of this report, the former Circular contained identical language on the requirement for advance approval as the current Circular issued on May 10, 2004.

SDUSD did not take prompt steps to obtain ED approval even though the School Services of California publication, dated February 27, 2004, advised districts of the need for ED approval. In addition, the IPA advised SDUSD on June 24, 2005, that prior approval was needed and that the ED Director of Indirect Costs Group was under the assumption that SDUSD had submitted a proposal for ED approval. A letter requesting approval was not submitted to ED until March 30, 2007, after the SDUSD had been notified of the Office of Inspector General (OIG) audit.

SDUSD Improperly Charged Over \$3.1 Million to Federal Programs for SERP Costs

Because the SDUSD did not obtain the required prior ED approval to charge SERP costs to Federal programs, it improperly charged over \$3.1 million of SERP costs to Federal programs during the fiscal year periods from July 1, 2003 through June 30, 2006. The amount included about \$1.9 million of SERP costs charged to ED programs.

Fiscal Year	Date of Accounting Entry	SERP Costs	Amount Charged to Federal Programs	Amount Charged to ED Programs	Amount Charged to Other Federal Programs
2003-04	June 30, 2004	\$15,817,189	\$ 934,674	\$665,018	\$269,656
2004-05	June 10, 2005	15,817,189	1,012,924	619,950	\$392,974
2005-06	September 30, 2005	15,973,981	1,202,044	619,950	582,094
Totals		\$47,608,359	\$3,149,642	\$1,904,918	\$1,244,724

¹⁰ The IPA stated that information regarding the former Circular was based on a voice mail on June 24, 2005 from the ED Director for Indirect Cost Group. However, an email from the Director on that same date advised the IPA that "OMB Circular A-87 experienced a major transformation when revisions were issued in 5-17-95."

Attachment 2 of this report provides the SERP costs charged to individual Federal programs. SDUSD advised us that it will not charge any additional SERP costs to Federal programs.

Recommendation

- 1.1 We recommend that the ED Chief Financial Officer (in collaboration with the Office of English Language Acquisition, Office of Elementary and Secondary Education, Office of Innovation and Improvement, and Office of Safe and Drug-Free Schools) require the California State Superintendent for Public Instruction to ensure that SDUSD returns to its Federal education program accounts or ED, as appropriate, the \$1,904,918 of SERP costs and related indirect costs charged to Federal education programs.

As we noted in the above table and in Attachment 2 of the report, SDUSD charged \$1,244,724 to programs administered by other Federal agencies: the U.S. Department of Agriculture and the U.S. Department of Health and Human Services. We provided the final report to the agencies' respective Offices of Inspector General for their decision on the action, if any, to be taken regarding their agencies' programs.

CDE Comments and OIG Response

CDE did not concur with the finding and recommendation. CDE provided five assertions as the basis for its nonconurrence. We made no changes to our conclusions and the recommendation in response to CDE's comments.

Assertion 1: OMB Circular A-87 may be reasonably interpreted to characterize early retirement incentives as fringe benefits that do not require prior approval.

CDE stated that the language of the Circular would suggest that an employee who receives payment for voluntarily retiring is a different scenario than an employee whose "employment is being terminated." CDE concluded that, because SDUSD's early retirement program provided compensation in addition to regular salaries for employees voluntarily retiring, the program was more characteristic of normal fringe benefits than severance pay.

OIG Response. The SERP was not a normal fringe benefit that the District provided to its employees. The SERP was a one-time offer to all qualified employees as an incentive to leave the District's employment. According to the District's documents, the employees that accepted the offer would be replaced with less experienced employees receiving a lower salary or wage. The offer was also contingent on the number of employees accepting the incentive. The District's documents stated that a minimum of 467 certificated non-management employees had to enroll in the SERP by April 25, 2003, in order for the SERP to be a cost benefit to the District. After the enrollment deadline, the resignations were locked in and could not be rescinded by the employee. The employees had to resign by the end of the 2002-2003 school year, effective no later than July 31, 2003.

Also, as noted in footnote 3 of this report the Implementation Guide states, mass severance termination benefits would include among other things the "cost of any other incentives offered to employees as an incentive to leave government service, such as buy-outs." A total of

1,456 employees accepted the SERP payments and left the District's employment. Thus, the SERP costs are identifiable as both abnormal and mass severance pay, not a fringe benefit.

Assertion 2: ED guidance characterized early retirement as a fringe benefit and did not indicate that prior approval would be required.

CDE stated that it was reasonable for SDUSD to rely on the 2002 policy letter from ED to the State of Illinois, which characterized early retirement payments as fringe benefits. CDE stated that the guidance provided in the 2002 policy letter was consistent with guidance that ED provided to CDE in a letter dated January 25, 1996, responding to a request for an opinion on early retirement incentive bonuses paid by another California school district under the Public Agency Retirement System (PARS), the same system used by SDUSD. CDE noted that, in the January 25, 1996 letter, ED stated that “[OMB] Circular A-87 (Attachment B, item 11(e)), allows grantees to use Title I funds to cover the cost of employee pension plans, including early retirement benefits, provided such benefits are granted under established written policies and the costs are distributed equitably to the Title I grant and to other activities.” CDE also stated that, in the 1998 comments to the final revisions to OMB Circular A-122, *Cost Principles for Non-Profit Organizations*, that OMB took the position that early retirement costs are not severance pay. Lastly, CDE pointed out that a document on ED's website entitled “Prior Approval Requirements in the Cost Principles,” which identifies costs requiring prior approval from the cognizant Federal agency, does not list either fringe benefits or severance pay.

OIG Response. We acknowledged in the finding that the wording in the 2002 policy letter contributed to SDUSD's improper conclusion that early retirement incentives were fringe benefits. We also acknowledge that the January 25, 1996, letter cited in CDE comments, failed to make a distinction between early retirement benefits and early retirement incentive payments. However, OMB Circular A-87 takes legal precedence over ED policy letters. The Circular and related Implementation Guide, taken together, clearly state the requirement for prior approval for abnormal or mass severance pay, such as those incurred under the SERP.

OMB Circular A-122, *Cost Principles for Non-Profit Organizations* establishes principles for determining costs of grants, contracts and other agreements with non-profit organizations. Although OMB Circular A-122 does not apply to school districts, it contains similar provisions for prior approval for “abnormal or mass severance pay” and considers “a golden parachute” payment as severance pay.¹¹ The omission in the “Prior Approval Requirements in the Cost Principles” document does not relieve the District of adhering to the requirements of OMB Circular A-87.

Assertion 3: OIG's reliance on the OMB Circular A-87 Implementation Guide in lieu of ED's own guidance is misplaced.

CDE claims that ED has not held the OMB Circular A-87 Implementation Guide out to the public as an important source for policy interpretation. The Implementation Guide has not been identified in ED's Grant Award Notifications or referenced in the relevant ED policy letters. CDE also noted that the Implementation Guide is not on either the ED or OMB websites.

¹¹ OMB Circular A-122, Attachment B, Paragraph k. Severance pay (2) (c).

OIG Response. When ED's Director for the Indirect Cost Group responded to the District's IPA request for guidance, he referred the IPA to the Implementation Guide, thus recognizing the Implementation Guide as an appropriate source for policy interpretation. The District also recognized the applicability of the Implementation Guide. In an August 26, 2005, memorandum to the District Chief Financial Officer, the District Resource Development Officer used the Implementation Guide to address issues to consider when determining whether the District's SERP qualifies under Federal guidelines. We agree that including a link to the Implementation Guide on ED's website would make the guide more readily available for ED grantees and subgrantees. We encourage CDE to also make the Implementation Guide available on its website.

Assertion 4: SDUSD sought expert opinion and vigorously researched the allowability of early retirement costs.

CDE stated that, in addition to reviewing the ED policy statement, SDUSD consulted with subject matter experts and accounting experts before making charges to Federal programs. CDE stated that SDUSD had compared its proposed charges to other local plans and determined that its method of allocating costs was either consistent with other plans or more cost efficient for the Federal government.

OIG Response. As we noted in the finding, SDUSD did obtain the opinions of others, but did not heed their advice. In the May 2003 document, PARS cautioned SDUSD about charging costs of a voluntary retirement incentive program to Federal programs. The School Services of California publication, dated February 27, 2004, advised districts to obtain prior cognizant agency approval. The District's IPA advised the District in a letter, dated June 24, 2005, that approval was required. In an April 27, 2006, letter to the District, the IPA again recommended that the District obtain ED approval for SERP payments made after June 30, 2004.

Without ED approval, SERP costs are not an allowable charge to Federal programs. Comparisons and evaluations of the allocation methodology that were performed by SDUSD or its IPA are not relevant to the finding since SDUSD has not yet obtained the required ED approval.

Assertion 5: SDUSD pursued ED for approval once it was aware of controversy over the proper characterization of the early retirement costs.

CDE stated that the District's February 14, 2005, letter to ED requesting information about charges for early retirement payments was written within a month of the District becoming aware of serious questions about the characterization of the early retirement payments. CDE stated that the OIG criticized the letter for presenting a hypothetical payment system, but it was not clear at the time that ED approval for the payment system was required. CDE stated that it was not until June 24, 2005, nearly four months after the letter was sent to ED, that an ED official raised concerns that the early retirement costs should be characterized as severance pay. CDE stated that, from that point forward, SDUSD worked closely with ED officials to determine a proper methodology for charging the SERP costs.

OIG Response. SDUSD officials told us that it never directly contacted ED regarding the SERP. Instead, the District had asked its IPA to resolve the issue. Attachment 1 of the report details the communications that occurred between the District's IPA and ED. As we noted in the finding, the communications generally focused on methods for allocating early retirement incentive costs for an unnamed school district rather than seeking ED approval for SDUSD to charge SERP costs to Federal programs. ED advised the IPA in the email on June 24, 2005 of the need for prior approval, thus, lack of clarity on the requirement was not the reason for the IPA to use a hypothetical payment system in its later letter to ED, dated October 10, 2005. It was not until the IPA sent the March 30, 2007, letter on behalf of the District, that a request was made for ED approval for SDUSD to charge SERP costs to Federal programs. The March 30, 2007, letter was sent nearly two years after ED advised the IPA that approval was needed and after the OIG had notified the District of its plans to initiate an audit of the SERP charges.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our audit objective was to determine whether the SDUSD's charges to Federal programs for SERP payments met applicable requirements under OMB Circular A-87. The review covered SERP costs charged to Federal programs during the fiscal year periods from July 1, 2003, through June 30, 2006. Since the SDUSD had not obtained the required prior ED approval to charge SERP costs, we did not evaluate the District's calculation of the amounts charged to individual Federal programs.

To achieve our objectives, we gained an understanding of the applicable OMB requirements, Federal regulations, ED guidance, and CDE guidelines and instructions provided to districts. We reviewed the District's single audit reports for fiscal years ended June 30, 2004, through June 30, 2006. We reviewed the communications among SDUSD, the District's IPA, ED, and CDE regarding the SERP, and documentation of the calculation used to determine the SERP costs. In addition, we obtained reports from the District's accounting records showing the SERP costs charged to various Federal programs and other funding sources, and interviewed the District's Resource Development Director and the Budget Systems Analyst to obtain an understanding of amounts allocated to Federal education programs. We did not evaluate the methods used to allocate the SERP.

We interviewed officials and staff at CDE's Categorical Programs Complaints Management Unit and School Fiscal Services Division to gather information for determining whether SDUSD or CDE requested and/or obtained prior approval for charging SERP payments to Federal programs. We also interviewed CDE's Data Management Division staff to gain an understanding of the Consolidated Application approval process. In addition, we reviewed the Consolidated Applications (for funding categorical aid programs) prepared by the SDUSD for fiscal years 2004-2007. We held phone conversations with the ED Director for Indirect Cost Group.

We relied on data extracted by SDUSD from its accounting system to identify District employees who participated in the SERP, the amount of annual premiums paid to fund the SERP, and the amount of the premiums allocated to the District's various funds. To assess the completeness of the extracted data, we compared the amounts of the annual premiums to amounts reported in the District's financial statements. We concluded that the extracted data was sufficiently reliable in determining the charges to Federal programs for SERP payments.

We performed our fieldwork at SDUSD's administrative offices in San Diego, California and CDE's offices in Sacramento. An exit conference was held with CDE on July 26, 2007 and with SDUSD on July 27, 2007. We performed our audit in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

ADMINISTRATIVE MATTERS

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken, including the recovery of funds, will be made by the appropriate Department of Education officials in accordance with the General Education Provisions Act.

If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Education Department official, who will consider them before taking final Departmental action on this audit:

Lawrence A. Warder
Chief Financial Officer
Office of the Chief Financial Officer
U.S. Department of Education
400 Maryland Avenue, SW
Washington, 20202

It is the policy of the U. S. Department of Education to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be appreciated.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

/s/

Gloria Pilotti
Regional Inspector General for Audit

Attachments

Attachment 1: Communications Between District's IPA and ED Officials

The following table provides a chronological list of the communications between the IPA and ED officials regarding charging early retirement incentive costs to the ESEA Title I program. Relevant activities related to the SERP are also included in the table (shown in *italics*).

Table 2: Communications Between IPA and ED and Relevant Significant Activities Related to the SERP	
<i>February 4, 2003</i>	<i>District's Board of Education resolves to adopt the SERP.</i>
<i>September 3, 2003</i>	<i>District made initial SERP annuity premium payment.</i>
<i>June 30, 2004</i>	<i>District allocated first SERP annuity premium to Federal programs.</i>
<i>July 19, 2004</i>	<i>District made second SERP annuity premium payment.</i>
<i>January 6, 2005</i>	<i>DAC Chairman met with District officials to discuss his concerns with charging SERP costs to ESEA Title I program. (DAC Chairman had previously expressed the concern to the District in May 2004.)</i>
February 14, 2005	<p>Letter from the IPA to ED Director for Compensatory Education Programs, Office of Elementary and Secondary Education.</p> <p>The IPA asked for ED's position on the method proposed by a client (school district) to distribute the employer's share of early retirement premiums. The IPA stated that it had determined that the client's costs meet the Federal laws outlined in the ED policy letter addressed to the General Counsel for the Illinois State Board of Education. The IPA requested that ED provide assurance that the client's proposed method, which differs from the two methods mentioned in the cited policy letter, is acceptable to ED before implementation.</p> <p>In the letter, the IPA provided the proposed program characteristics and eligibility requirements, including the following:</p> <ul style="list-style-type: none"> • Plan effective date: August 1, 2005 • Participants required to be employed by the District as of February 1, 2005 • Premium paid to Investment Fiduciary in six installments over five years beginning July 20, 2005 and ending August 1, 2010. <p><i>[OIG Note: The IPA did not identify the district in its letter and described an early retirement program that had not yet been implemented. The SDUSD Board of Education adopted the SERP in February 2003 and employees were required to resign from District employment by July 31, 2003. The District paid the first SERP annuity premium on September 3, 2003.]</i></p>
February 17, 2005	Email from the IPA to ED official from Compensatory Education Programs requesting ED advice on the method proposed by a school district to distribute the employer's share of early retirement premiums. The text of the email contained the same language as the IPA letter dated February 14, 2005.
February 17, 2005	Email from ED official from Compensatory Education Programs to IPA advising the IPA that the February 17, 2005, email was referred to ED Office of the General Counsel.

May 25, 2005	Email from the IPA to ED Director for Indirect Cost Group, Office of the Chief Financial Officer asking for his assistance in obtaining response from ED. The email included the text from the February 17, 2005 letter.
June 1, 2005	Email from ED Director for Indirect Cost Group to IPA stating that costs should be allocated indirectly and then only if the district can demonstrate there is a "current" benefit to Federal programs equivalent to the amount allocated. The Director advised the IPA that "there are a lot of hoops you have to jump thru . . . including credits back to the federal government should the employee be re-hired" and referred the IPA to the OMB Circular A-87 Implementation Guide.
June 3, 2005	Emails between ED Director for Indirect Cost Group and IPA addressing a question on whether the proposed arrangement would create a contingency fund. The IPA advised that "[t]he calculation will be based on actual individuals retiring in one year with the incentive starting then. It is not to finance a future event."
<i>June 10, 2005</i>	<i>District allocated second SERP annuity payment to Federal programs.</i>
June 24, 2005	<p>Email from ED Director for Indirect Cost Group to IPA responding to IPA's letter dated February 14, 2005. The Director advised the IPA that severance costs are not covered by the fringe benefit provisions of Circular A-87 as implied by the ED policy letter addressed to the General Counsel for the Illinois State Board of Education. The Director noted that Attachment B, Paragraph 8.d. Fringe benefits contains the language "except as provided elsewhere in these principles, the costs of fringe benefits are allowable..." and provided the IPA with the language contained in Paragraph 8.g. Severance pay.</p> <p>The Director further stated that, if the proposal contemplates losing 1,000 employees over a short period of time, then the plan would qualify as mass severance. If the early retirement payments are in addition to the normal pension the employee would receive, then it would be a retirement incentive cost. Thus, Paragraph 8.g (3), which requires prior approval, would govern. The Director stated that if there was still an interest in the early retirement plan, he would need the information on the savings projections, rehiring policy, and actuarial projections of the costs.</p>
<i>July 19, 2005 and August 19, 2005</i>	<i>District made third SERP annuity premium payments.</i>
<i>September 30, 2005</i>	<i>District allocated third SERP annuity payments to Federal programs.</i>
October 10, 2005	<p>Letter from the IPA to ED Director for Indirect Cost Group providing additional background information in response to the Director's email of June 24, 2005.</p> <p><i>[OIG Note: The IPA letter did not identify the district and dates used throughout are non-specific (i.e., shown as 200X). Also, the IPA did not disclose that the district had already charged costs to Federal programs.]</i></p>

<p>November 28, 2005 and November 29, 2005</p>	<p>Emails between ED Director for Indirect Cost Group and IPA. The Director requested details on how the cost savings were computed and clarified that the purpose of reviewing the information was to determine whether the costs of the incentive program would be allowable at all, or what portion. If the incentive program costs, or portion thereof, were deemed allowable, then those costs could be allocated indirectly, but not directly.</p> <p>The IPA responded that it understood from the June 24, 2005, email and its review of OMB Circular A-87, Attachment B, Paragraph 8.g (3) that abnormal or mass severance can be allocated as direct costs, if the method and cost for such allocation is approved in advance by the cognizant Federal agency. The IPA stated that it is attempting at this time to assist its client in obtaining such approval for allocation as direct costs.</p> <p>The Director clarified that severance, whether normal or abnormal, is still severance and allocable only indirectly, except for rare circumstances where a Federal program has been abolished.</p>
<p>December 19, 2005 and December 21, 2005</p>	<p>Emails between the IPA and ED Director for Indirect Cost Group. The IPA provided documents to show the client's projected savings by employee group for five fiscal years. The IPA also expressed concerns with charging costs indirectly. The Director responded to the IPA concerns regarding use of indirect cost rates.</p>
<p>January 30, 2006, January 31, 2006, and February 2, 2006</p>	<p>Emails between the IPA and ED Director for Indirect Cost Group. The IPA provided a summary matrix to show the projected cost savings for Title I and non-Title I districtwide programs.</p> <p>The Director responded that additional information was needed to show how the incentive programs benefit Title I as a whole and explained that often reductions in federally paid salaries are accompanied by corresponding increases in professional services, outsourcing of activities, fringe benefit costs, and re-employment actions. He reiterated that the allocation of acceptable costs would be indirect, not a direct charge to the Title I program.</p> <p>The IPA stated that the client can provide the additional information and that the IPA understands that the allocation of acceptable costs would be indirect.</p>
<p>March 6, 2006</p>	<p>Email from the IPA to ED Director for Indirect Cost Group requesting information on where to obtain the state education agency "model" to "indirectly" allocate special termination benefits. IPA stated that it had advised its client that the practice of ED is not to approve any plan for distribution of these benefits as "direct" costs and that its client's goal is now to follow an ED acceptable plan with higher probability for ED approval, rather than develop something that may not be approved.</p>
<p>March 31, 2006</p>	<p>Email from ED Director for Indirect Cost Group to the IPA providing contacts at Texas Education Agency for a "model" of an ED approved plan for allocating costs.</p>
<p>July 20, 2006</p>	<p><i>District made fourth SERP annuity premium payment.</i></p>
<p>March 23, 2007</p>	<p><i>District official received call from ED-OIG auditor to schedule entrance conference.</i></p>

March 30, 2007	<p>Letter from the IPA to ED Director for Indirect Cost Group requesting ED approval of the SERP costs that SDUSD has applied against Title I funds. The letter provides a summary of the IPA's previous communications with ED and provides responses and District information for the criteria listed in Question 3-13 of the OMB Circular A-87 Implementation Guide that is generally used by cognizant Federal agencies in making a determination as to whether abnormal severance costs will be allowed.</p> <p><i>[OIG Note: The letter notes that OMB Circular A-87 was revised on May 10, 2004 and states that the new cost policy defines early retirement and special termination benefits as severance pay. The letter further states that the Director had previously stated that "the former Circular A-87 did not note a specific requirement for approval of such costs by the cognizant Federal agency." While the Circular was revised on May 10, 2004 which resulted in a change in the paragraph number for severance pay, the language in the paragraph on severance pay did not change from the prior Circular. In an email on June 24, 2005, the Director advised IPA that major changes to the Circular occurred in the May 4, 1995 revision (published on May 17, 1995).]</i></p>
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Attachment 2: SERP Costs Charged to Federal Programs

The below amounts were obtained from information contained in the District's accounting system. Since SDUSD had not obtained the required prior ED approval to charge SERP costs, we did not evaluate the District's calculation of the amounts charged to individual Federal programs.

Table 3: SERP Costs Charged to Individual Federal Program By Fiscal Year						
CFDA Number	Federal Agency	SDUSD Resource Code	SDUSD Resource Name	Fiscal Year		
				2003-2004	2004-2005	2005-2006
ED Programs						
84.010	OESE	30100	Title I Basic Program	\$307,977	\$511,125	\$ 99,549
84.010	OESE	30103	Title I Parent Involvement	15,494		15,494
84.010	OESE	30104	Title I Blue Print Site Funded			208,428
84.010	OESE	30105	Title I Blue Print Central Program	187,654		187,654
84.165	OII	58220	Other Federal - Magnet School	24,702		
84.184	OSDFS	58122	Other Federal-Middle School	12,215		
84.186	OSDFS	37100	Improving America's Schools Act: Drug Free School	74,054	74,054	74,054
84.215	OII	58311	Fund for Improvement of Education	1,284	1,284	1,284
84.367	OESE	40351	Title II No Child Left Behind	15,212	15,212	15,212
84.367	OESE	40352	Blueprint/Title II	24,777	18,275	18,275
84.365	OELA	42150	Title VII Emergency Immigrant (Title III Language Instruction for Limited English Proficient)	1,649		
Total Charges to ED Programs				\$665,018	\$619,950	\$619,950
Other Federal Programs						
10.555	USDA	53100	Child Nutrition		379,241	379,241
93.938	HHS	58240	Other Federal- Aids Education	13,733	13,733	13,733
93.575	HHS	50610	Child Development Alternative	255,923		
93.596	HHS	50250	Child Development: Center Based			189,120
Total Charges to Other Federal Programs				269,656	392,974	582,094
Total Charges by Fiscal Year				\$934,674	\$1,012,924	\$1,202,044

Legend: CFDA Catalog of Federal Domestic Assistance
HHS U.S. Department of Health and Human Services
OELA Office of English Language Acquisition
OESE Office of Elementary and Secondary Education
OII Office of Innovation and Improvement
OSDFS Office of Safe and Drug-Free Schools
USDA U.S. Department of Agriculture

Attachment 3

California Department of Education

Comments to Draft Report



CALIFORNIA
DEPARTMENT OF
EDUCATION

1430 N STREET
SACRAMENTO, CA
95814-5901

JACK O'CONNELL

State Superintendent of
Public Instruction

PHONE: (916) 319-0800

October 15, 2007

Gloria L. Pilotti
Regional Inspector for Audit
U. S. Department of Education
Office of Inspector General
501 I Street, Suite 9-200
Sacramento, CA 95814

Dear Ms. Pilotti:

Subject: Response to Draft Audit Report: ED-OIG/A06H0014

The California Department of Education (CDE) and the San Diego Unified School District (SDUSD) appreciate the opportunity to respond to the Office of Inspector General's (OIG) findings outlined in its August 30, 2007, draft audit report entitled *San Diego Unified School District's Use of Federal Funds for Costs of Its Supplemental Early Retirement Plan*. This response was originally due thirty days after the date of the letter transmitting the draft report. On September 26, CDE requested an extension to respond to the findings. OIG granted the extension and required that this response be submitted no later than October 15, 2007.

In the draft audit report, OIG concluded SDUSD charged unallowable costs to federal programs because it failed to obtain the U.S. Department of Education's (ED) prior approval of certain early retirement costs charged to federal programs.

We respectfully disagree with this finding. First, OMB Circular A-87 may be reasonably interpreted to characterize early retirement incentives as fringe benefits that do not require prior approval. Second, ED's guidance on early retirement categorized the cost as a fringe benefit and did not state that prior approval was required. Third, OIG's reliance on *A Guide for State, Local and Indian Tribal Governments* (ASMB C-10) (also known as the OMB Circular A-87 Implementation Guide) in lieu of ED's own guidance is misplaced. Fourth, SDUSD sought expert opinions and vigorously researched the allowability of early retirement costs. Finally, SDUSD pursued ED approval once it became aware that there were questions about the proper characterization of the early retirement costs.

1) OMB Circular A-87 may be reasonably interpreted to characterize early retirement incentives as fringe benefits that do not require prior approval.

OIG concluded SDUSD was required to obtain ED's prior approval before charging early retirement payments to federal grants because such costs should be characterized as severance pay under Office of Management and Budget (OMB) Circular A-87.¹ Circular A-87 does not explicitly address the treatment of early retirement incentive costs. Rather, it is subject to interpretation as to whether such cost is treated as a normal fringe benefit or abnormal or mass severance pay.

Circular A-87 describes fringe benefits quite generally as allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages. Fringe benefits include, but are not limited to, the costs of leave, employee insurance, pensions, and unemployment benefit plans. The Circular indicates that the costs of fringe benefits are allowable and does not state that prior approval is required, "except as provided elsewhere in these principles."²

In a separate paragraph, the Circular describes "severance pay" as "payments in addition to regular salaries and wages made to workers *whose employment is being terminated*."³ In the event of "abnormal or mass severance pay," the cost will be considered on a case by case basis and is allowable only if approved by the cognizant Federal agency.

A straightforward reading of the language of the Circular would suggest that an employee who receives payment for voluntarily retiring is a different scenario than an employee whose employment is being terminated. Because SDUSD's early retirement program provided compensation in addition to regular salaries for employees voluntarily retiring, as opposed to those whose employment was being terminated, the program was more characteristic of normal fringe benefits than severance pay. And as a normal fringe benefit, the cost would not be dependent on prior approval.

2) ED guidance characterized early retirement as a fringe benefit and did not indicate that prior approval would be required.

To help interpret the ambiguity of Circular A-87, SDUSD relied on a 2002 policy letter from ED to Illinois which characterized early retirement payments as fringe benefits, not severance pay. OIG rejected SDUSD's reliance on this letter (and presumably the

¹ See OMB Circular A-87, Att. B, ¶ 8(h) (2004). OMB Circular A-87 was revised in 2004; however, the provisions on compensation for personnel services are substantially the same as the provisions that were in effect at the time SDUSD began charging the early retirement costs.

² OMB Circular A-87, Att. B, ¶ 8(d) (2004).

³ OMB Circular A-87, Att. B, ¶ 8(g) (2004) (emphasis added).

validity of the letter) because of a statement in the OMB Circular A-87 Implementation Guide. Notwithstanding the Implementation Guide, SDUSD's reliance on ED's policy letter was entirely reasonable.

At the time SDUSD made its decision to charge the early retirement costs, ED's interpretation of early retirement benefits reflected the straightforward language of A-87, which suggested early retirement incentives were more like fringe benefits than severance pay. On January 14, 2002, ED wrote a letter to the Illinois State Board of Education, expressing its opinion that early retirement costs are employee fringe benefits and are allowable under OMB Circular A-87. The letter made no reference to severance pay and no reference to prior approval.

ED's 2002 policy letter (upon which SDUSD explicitly relied) was not an isolated policy statement, but rather reflected ED's consistent interpretation that early retirement benefits were treated as normal fringe benefits. An earlier ED letter was directed specifically to the California Department of Education addressing a scenario almost identical to the situation in SDUSD. On January 25, 1996, ED wrote to CDE expressing its opinion that "[OMB] Circular A-87 (Attachment B, item 11(e)), as referenced by Part 80 of the Education Department General Administrative Regulations, allows grantees to use Title I funds to cover the cost of employee pension plans, including early retirement benefits, provided such benefits are granted under established written policies and the costs are distributed equitably to the Title I grant and to other activities." The letter made no reference to severance pay and no reference to prior approval. Even more importantly, this letter was in response to a request for an opinion on early retirement incentive bonuses paid by a California school district under the Public Agency Retirement System (PARS) – *exactly the system questioned by OIG in the draft audit against SDUSD.*

ED's interpretation, it is worth noting, also appears to be consistent with OMB's position. In 1998 OMB released the final revisions to OMB Circular A-122, Cost Principles for Non-Profit Organizations. Like Circular A-87, Circular A-122 distinguishes between fringe benefits and severance pay. In comments published with the final revisions, OMB took the position that early retirement costs are not severance pay:

Comment: Early retirement benefits should be allowable costs.

Response: Early retirement benefit costs are allowable costs, subject to limitations, and are discussed in subparagraph 6.f, Fringe Benefits, along with other forms of fringe benefits. Paragraph 49, Severance Pay, deals only with severance policy, i.e., dismissal, and the reimbursement of its costs.⁴

⁴ Cost Principles for Non-Profit Organizations, 63 Fed. Reg. 29,794 (June 1, 1998).

Finally, ED's website provides a list of items from OMB Circulars that require prior approval from the federal cognizant agency. The document is entitled: "Prior Approval Requirements in the Cost Principles," and it is found at: www.ed.gov/policy/fund/guid/gtrain/PriorApp.doc. Although the document is not dated, the legal citations seem to refer to the 1995 version of Circular A-87 that was in effect until the 2004 revisions. (As noted in the OIG draft report, the 1995 version of A-87 contained the same language on fringe benefits and severance pay as the 2004 revisions.) This ED document identifying prior approval requirements does not list either fringe benefits or severance pay as a cost that requires prior approval by the cognizant Federal agency.

3) OIG's reliance on the OMB Circular A-87 Implementation Guide in lieu of ED's own guidance is misplaced.

OIG concluded that SDUSD did not consider available guidance before charging the early retirement costs because it did not review the OMB Circular A-87 Implementation Guide. The Implementation Guide has not been held out to the public by ED as an important source of policy interpretation. The Implementation Guide has not been identified in Grant Award Notifications to states as an applicable authority, or discussed in major ED guidance documents. It was not referenced in the relevant policy letters on the topic (as described above). The Implementation Guide is not available on ED's website or even on OMB's website, presumably because the document is issued by the U.S. Department of Health and Human Services.

In contrast, ED's 2002 policy letter was published on ED's website and was easily accessible by the public. Moreover, ED's 1996 pronouncement on the issue was directed specifically to California to address a scenario nearly identical to the matter at hand.

It is difficult to understand how SDUSD or CDE were to anticipate that guidance that is not even referenced by the federal grantor agency can override the express policy interpretation of that agency.

4) SDUSD sought expert opinion and vigorously researched the allowability of early retirement costs

OIG's finding ignores the fact that SDUSD vigorously investigated the allowability of the retirement costs. SDUSD consulted with subject matter experts, accounting experts, and ED's own policy statements before making charges to the federal programs. SDUSD compared its proposed charges to other local plans and determined that its method of allocating costs was either consistent with other plans or more cost efficient for the federal government. In other words, SDUSD conducted diligent and thorough research to determine that its actions were proper and reasonable.

5) SDUSD pursued ED for approval once it was aware of controversy over the proper characterization of early retirement costs

OIG concluded SDUSD did not take prompt steps to obtain ED approval when it became aware such approval might be needed. As OIG acknowledges, the first serious questions about the characterization of the early retirement payments were raised in January 2005.⁵ SDUSD considered these questions and within a month, on February 14, 2005, it wrote a letter to ED requesting information about charges for early retirement payments. OIG criticizes the letter for presenting a hypothetical payment system, but as discussed in more detail above, it was not clear at the time that ED's approval for the payment system was required. SDUSD relied on ED's own policy statements to determine the costs were allowable and sent this letter to confirm ED's interpretation.

SDUSD diligently followed up on its February 14th letter. On February 17, 2005, SDUSD's independent public accountant emailed ED's Compensatory Education Programs office reiterating its request for advice regarding early retirement payments. An official from the Compensatory Education Programs office informed the independent public accountant that her question had been referred to ED's Office of General Counsel. SDUSD's independent public accountant tried repeatedly to follow-up on her letter and email to ED officials with no luck. Finally, SDUSD's independent public accountant contacted ED's Director of the Indirect Cost Group within the Office of the Chief Financial Officer. It was not until June 24, 2005, nearly four months after SDUSD first contacted ED, that an ED official raised concerns that the early retirement costs should be characterized as severance pay.⁶ From that point forward, SDUSD worked closely with ED officials to determine a proper methodology for charging the relevant costs.

Far from OIG's characterization of SDUSD's actions, the correspondence between SDUSD and ED show that SDUSD has and is continuing to work closely with ED to resolve this issue.

⁵ The draft audit report notes in a footnote that the Chairman of the District Advisory Counsel raised general concerns about the charges for early retirement incentives but OIG acknowledges the Chairman did not articulate any specific concerns until January 6, 2005.

⁶ To the best of our knowledge, the Office of General Counsel still has not responded to the February 14th letter.

Gloria Pilotti, Regional Inspector for Audit
October 15, 2007
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If you have any questions regarding CDE's response, please contact Kevin W. Chan, Director, Audits and Investigations Division, at (916) 323-1547, or by e-mail at kchan@cde.ca.gov.

/s/
MARSHA BEDWELL
General Counsel, Legal and Audits Branch

MB:kwc:dr