
**WestEd's Administration of the
Regional Educational Laboratory Contracts**

FINAL AUDIT REPORT



**Audit Control Number 09-60009
March 1998**

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U.S. Department of Education
Office of Inspector General
Sacramento, California

NOTICE

Statements that financial and/or managerial practices need improvement or recommendations that costs questioned be refunded or unsupported costs be adequately supported, and recommendations for the better use of funds, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations on these matters will be made by the appropriate Education Department officials.



U.S. DEPARTMENT OF EDUCATION

Office of Inspector General Office of Audit Services-Region IX



MEMORANDUM

DATE: March 31, 1998

TO: Ricky Takai
Acting Assistant Secretary
Office of Educational Research and Improvement

FROM: Area Manager
Western Area

SUBJECT: FINAL AUDIT REPORT
*WestEd's Administration of the Regional
Educational Laboratory Contracts*
Audit Control No. A0960009

Attached is our subject report presenting our findings and recommendations resulting from our audit of *WestEd's Administration of the Regional Educational Laboratory Contracts*.

In accordance with the Department's Audit Resolution Directive, you have been designated as the primary action official responsible for the resolution of the findings and recommendations in this report. The Chief Financial and Chief Information Officer of the Office of the Chief Financial & Chief Information Officer is a collateral action official. Please coordinate with this official on actions in connection with all of the recommendations.

If you have any questions or wish to discuss the contents of this report, please contact me at (916) 498-6609.

Please refer to the above audit control number in all correspondence relating to this report.

GLORIA PILOTTI

Attachment

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WestEd's Administration of the Regional Educational Laboratory Contracts

Executive Summary

WestEd, a new entity that combined the operations of Far West and Southwest Regional Educational Laboratories, did not comply with certain Federal laws and regulations in managing its Office of Educational Research and Improvement (OERI) contract. Also, WestEd's indirect cost rates negotiated by the U.S. Department of Education do not reflect all of its indirect costs. WestEd:

- # Leased space to a radio station and a computer facility in buildings purchased with Federal funds for educational research purposes and retained profits from the leases. WestEd's fund balance included about \$627,000 of lease profits earned over the two-year period from December 1994 to November 1996.
- # Used lease-purchase agreements that resulted in excessive charges for furniture, equipment and building improvements. The interest portion of the lease-purchase payments was excessive since WestEd had funds available in its reserve to make cash purchases. Also, it accelerated charges to the contract for the purchases and charged interest to the contract during periods when interest was an unallowable cost.
- # Improperly billed the contract for indirect costs on work performed by subcontractors.
- # Charged the contract for indirect costs that were not necessary for the performance of Federal contracts.
- # Gave the impression that indirect costs remained fairly constant when in fact the indirect cost rate increased 29 percent over the past three years. For fiscal year 1996, WestEd's actual indirect cost rate was 45 percent rather than its stated rate of 12.8 percent.

The report presents recommended actions for the Offices of OERI and the Chief Financial and Chief Information Officer (OCF & CIO). The actions are necessary to ensure that WestEd uses Federally-purchased property and Federal funds for their intended purposes and that Federal funds are used in an efficient manner.

The report also recommends that WestEd be required to return about \$131,000 in Federal funds that were used for unallowable interest, improperly computed indirect costs, and other unallowable direct costs in Recommendations No. 5, 7 and 8. OERI should coordinate resolution actions with OCF & CIO on all of the recommendations. We further conclude that as much as \$2.6 million of accumulated rental profits could be better used to reduce program expenditures or further program objectives. In the future years, about \$300,000 of rental profits would be available for these purposes annually.

Except for indirect expenses paid for airfare upgrades and DJ entertainment, WestEd did not concur with our conclusions and recommendations. The entire text of WestEd's response is included in Attachment 1 of this report.

Audit Results

We concluded that WestEd, in its administration of the OERI contract, did not comply with certain Federal laws, regulations, and contract terms as discussed in our findings. During the audit, nothing came to our attention that would lead us to believe that WestEd did not comply with other laws, regulations and contract terms.

Finding No. 1 - WestEd Leased Space to a Radio Station and a Computer Facility in Buildings Purchased with Federal Funds for Educational Research Purposes and Retained Profits from the Leases.

WestEd leased excess space to entities with no educational research functions and retained the profits in its reserve fund. These actions did not comply with the provisions of the original Federal grants given to the regional educational laboratories (RELs) for construction or purchase of their buildings. Also, WestEd did not comply with Federal regulations regarding the use of the buildings' lease income. As a result, Federally-funded assets and income generated from those assets have not been used for their intended purposes. Further, because WestEd does not separately identify lease profits in its fund balance, the retained profits are at risk of being used for inappropriate purposes.

WestEd Leased Excess Space in Its Facilities for Non-educational Research Purposes.

The Cooperative Research Act (Title 20, United States Code, Section 332a) authorized Federal grant funds to construct facilities for research and related purposes. In the 1970s, the Federal Government (Department of Health, Education and Welfare) gave grants to the two RELs now comprising WestEd for the purchase or construction of buildings to conduct educational research. In 1989, the Department specified that the REL could rent excess space only to compatible tenants, for example, tenants whose business is appropriate in light of WestEd's educational research. This restriction on the use of the building will expire in the year 2019. WestEd has no outstanding debt on the purchase or construction costs of its buildings.

WestEd violated the grant provision by leasing excess space to entities with no related educational research functions. In its San Francisco building, about 34 percent of the building is leased to tenants with no relationship to educational research. One of the tenants is a rock music radio station. In Los Alamitos, about 70 percent of its building is rented to

the California State University System, which operates a computer center for the University system and houses staff in other non-research functions. Thus, the Federally-funded buildings have not been fully used for their intended purposes.

WestEd Retained Building Rental Profits Rather Than Using Them to Further Program Objectives.

Besides leasing excess space in its facilities for non-educational research purposes, WestEd did not use its building rental income to offset program costs, further program objectives or finance building improvements. Instead, WestEd retained the rental income in its reserve fund.

Federal provisions require WestEd to use rental profits for program purposes. The Office of Management and Budget (OMB) Circular A-110 provides standards for Federal agencies in administering grants and agreements with nonprofit organizations. Section 2 (x) of the Circular defines program income to include the rental of real property acquired under Federally-funded projects. Section 24 of the Circular further requires that program income earned from Federal awards must be retained by the recipient and used to:

- (1) further eligible project or program objectives,
- (2) finance the non-Federal share of the project or program, or
- (3) deducted from the total project or program allowable cost in determining the net allowable costs.

The U.S. Department of Education (Department) reemphasized the requirements for the use of rental income from Federally-funded buildings. In a letter¹ to Southwest Regional Laboratory (Southwest), it authorized the use of the rental income to carry out the broad objectives of the Cooperative Research Act “. . . including, but not limited to, any purpose which furthers the support or maintenance of the building, equipping the facility or educational research.” Far West Laboratory (Far West) also received a letter² from the Department granting similar approval for the use of rental revenue.

WestEd contends it can retain rental profits. WestEd officials contend that the Departmental letters provided them approval to retain the rental profits. They stated that the reserve fund is needed for future major

¹The letter to Southwest, dated August 19, 1992, was from the Department's Federal Real Property Assistance Program. Southwest's building is located in Los Alamitos, California.

²The letter to Far West, dated November 30, 1989, was from the Department's Deputy Under Secretary for Management. Far West's building is located in San Francisco, California.

building improvements and repairs because such costs are not covered under the building grant agreements with the Federal government.

From a review of the letters, we found no provision allowing the retention of rental profits. Also, the minutes for WestEd's Board of Directors' meetings show the Board approved recovery of major building improvements³ by charging the costs to its contracts.

In the minutes of the meeting held on December 1, 1995, the Board approved plans to remodel the fourth floor of WestEd's San Francisco building. The minutes indicated that the project's estimated cost was \$400,000 and that funds were available to cover this cost. However, the minutes also stated that WestEd would recover the costs by billing the contracts that use these remodeled facilities. At another board meeting held on March 29, 1996, the Board decided to remodel the Los Alamitos building at a cost of about \$375,000. Similarly, the Board decided to recover the costs by charging contracts over a ten-year period. These actions contradicted the claims by WestEd officials that rental profits retained in its reserve fund will be used to finance building costs. Instead, WestEd financed building improvements with capital leases and charged depreciation and interest expenses to the contracts.

In addition, our review of WestEd's expenses confirmed that reserve funds were not used to pay for building related expenses. Financial reports for fiscal years (FY) 1995 and 1996 show that WestEd used about \$300,000 of its reserve funds. WestEd expended these funds for costs, such as travel, salaries, membership dues, and bank fees, which were ineligible for reimbursement under its various contracts. The financial reports and records showed no outflow of reserve funds for building related costs or program expenditures.

The funds accumulated in WestEd's reserve balance are substantial. For FYs 1995 and 1996, the rental income collected from WestEd's tenants and contracts exceeded the maintenance costs of the buildings resulting in a profit. WestEd allocated space costs based on the square footage occupied by the tenants and WestEd. The net rental profits earned in these two years totaled about \$627,000. Table 1 shows WestEd's rental income, expenses and profits for FYs 1995 and 1996.

Table 1. WestEd's 1995 & 1996 Rental Income, Expenses and Profits

Location	San Francisco	Los Alamitos	
Year	1995 & 1996	1995 & 1996	Total
Rental Income (Tenants and Contracts)	\$2,326,439	\$1,931,119	\$4,257,558
Building Expenses	1,963,189	1,667,585	3,630,774
Net Profit	\$363,250	\$263,534	\$626,784

³Improvements relate to existing building space.

As of FY 1996, WestEd's financial statements show a reserve fund balance of about \$6.4 million.⁴ We estimated that the fund balance included about \$2.6 million of accumulated rental profits, which is about 40 percent of the fund balance.⁵ This estimate does not include interest earned on the rental profits. Also, WestEd's financial records do not separately identify accumulated lease profits and related interest earnings or disclose the restricted use of those funds. This places lease profits at risk of being used for inappropriate purposes.

We estimated that based on current earnings of rental profits as shown in Table 1 above, WestEd could accumulate an additional \$6.9 million of rental profits in its reserve fund balance by the expiration of the grant restrictions in the year 2019. This amount does not include a provision for rental increases or interest that WestEd would earn on those funds.

WestEd Should Lease Excess Space to Tenants with Educational Research Purposes and Limit the Amount of Lease Profits Retained in Its Reserve Fund.

We recommend that OERI and OCF & CIO require WestEd to seek tenants that are compatible with the mission or objectives for educational research purposes when lease agreements with its current tenants expire. We also recommend that OERI limit the rental profits and the related interest earnings accumulated in WestEd's reserve fund balance. The amount to be retained should be limited to a reasonable estimate to cover necessary building expenditures, including capital improvements, that are not recovered through WestEd's operations. The rental profits and related interest earnings exceeding the limit should then be used to reduce program expenditures and/or further program objectives as required by Federal regulations.

WestEd uses reserve funds for expenditures that are ineligible for reimbursement under its contracts. Thus, the accumulated rental profits may be at risk of being used for inappropriate purposes. We recommend that OERI, in coordination with OCF & CIO, require WestEd to separately identify the accumulated lease profits, including related interest earnings, in its financial records and disclose the restricted use of those funds.

⁴WestEd's reserve fund balance of \$6.4 million consists of \$4.6 million from Far West and \$1.8 million from Southwest Regional Laboratories.

⁵The estimated percentage of rental profits in WestEd's fund balance is the ratio of total rental profit shown in Table 1 to the increase in the fund balance accounts for FYs 1995 and 1996. The fund balance increase for WestEd was \$1.5 million.

Auditee's Response

WestEd officials did not concur with our finding and recommendations. They asserted that WestEd leases space in its facilities in a manner permitted by the Department and the grants under which the facilities were constructed. They further asserted that personnel in the Department have never objected to the types of tenants leasing space at the Far West and Southwest facilities.

WestEd officials contended that the explicit written agreements in the letters from the Department gave Far West and Southwest discretion over the use of funds derived from leasing space. They stated that the limitations in OMB Circular A-122 relate to program income under contracts. Whereas, WestEd's facility rental income is governed by the grants under which the facilities were constructed and were not subject to OMB Circular A-122.

WestEd officials asserted that WestEd is authorized to retain accumulated rental income because neither WestEd's grants nor any communication from the Department prohibits the practice. The most critical concern to WestEd is being able to accumulate the necessary capital funds for catastrophic events such as earthquakes. Officials stated that the reserve will continue to provide WestEd the financial security necessary to prevent insolvency or the need to repair and maintain the facilities. Recovery from earthquakes alone could require expenditures of up to \$5.5 million from the reserve.

WestEd officials stated that its financial records currently contain information regarding all details on lease revenues. Also, a separate accounting would be redundant.

Auditor's Comments

The grant terms and conditions specifically stated that the RELs will use the facilities for research or related purposes. Far West sold the original building acquired under the Federal grant and purchased a replacement facility. The Department set forth additional conditions for the replacement facility. One of the conditions specified that Far West apply all terms under the grant to the replacement facility. Therefore, according to the grant terms, Far West should seek tenants who will use the space for research or related purposes. Also, since WestEd contended that Southwest obtained a similar arrangement with the Department on the use of the REL building, the grant terms and additional conditions also apply to Southwest.

OMB Circular A-122 establishes cost principles not only for contracts, but also for grants and other agreements with nonprofit organizations. In addition, Paragraph A.5.c. of the Circular refers to Section 24 of OMB Circular A-110 for rules governing program income under grants. We have cited the Circular A-110 criteria in the finding.

Federal funds reserved for catastrophic events such as earthquakes are unallowable. Under OMB Circular A-122, Attachment B, Paragraph 7, contingent reserves are not allowable for events that cannot be foretold with certainty as to time, intensity, or with an assurance of their happening. An earthquake meets the definition of events provided in this criteria.

Further, WestEd's financial statements do not separately identify accumulated lease profits and related interest earnings or disclose the restricted use of those funds. Our recommendations remain unchanged.

Finding No. 2 - WestEd Used Lease-Purchase Agreements that Resulted in Excessive Charges for Furniture, Equipment and Building Improvements.

WestEd acquired assets through lease-purchase agreements rather than outright purchases. Under this purchasing method, contract costs for assets were excessive due to the additional interest expense. Also, WestEd accelerated the charges of asset costs to contracts by using the lease period rather than the useful economic lives of the assets. In addition, it charged contracts for interest costs during the period when interest was an unallowable cost.

WestEd's Asset Costs Were Greater Due to Use of Lease-Purchase Agreements.

WestEd charged the contracts excessive costs by acquiring assets using lease-purchase agreements. The monthly payments of the leases included interest expense. With this added interest component, the leasing costs exceeded the assets' outright purchase costs.

We compared WestEd's leasing costs with the property's outright purchase costs in three leases for furniture and computer equipment. Table 2 shows how WestEd's leased assets cost more than outright purchases.

Table 2. WestEd's Leased Assets Cost More Than Outright Purchases.

Type of Asset:	Furniture	Furniture	Computers	Total
Dates of Lease:	Aug. 27, 1992	June 22, 1993	Sept. 30, 1992	
Total Lease Costs	\$ 74,215	\$ 86,806	\$ 140,679	\$301,700
Outright Purchase Cost	\$ 57,777	\$ 67,783	\$ 115,319	\$240,879
Cost Difference	\$ 16,438	\$ 19,023	\$ 25,360	\$60,821
Percent Increase	28.45%	28.06%	22.00%	25.25%

For the three leases, the outright purchase costs of the leased assets amounted to \$240,879, while the total leasing costs that WestEd charged to contracts were \$301,700 or a 25 percent increase in contract costs. This 25 percent cost increase represented the interest component in the lease purchase agreements.

WestEd Expedited Charges to Contracts by Accelerating the Cost Recovery Periods of Asset Acquisitions.

For the three leases we reviewed, WestEd recovered leased asset costs using the lease payment periods rather than over the useful lives of the assets. The leasing terms for WestEd’s assets were often less than the estimated useful lives specified in its depreciation policy and the Internal Revenue Service (IRS) guidelines for asset recovery periods.⁶ WestEd charged the entire monthly lease payments to its contracts. These charges exceeded the assets’ depreciation allowances specified in WestEd’s policy.

For example, WestEd leased furniture over a four-year period, its depreciation policy specifies five years, and IRS guidelines provide for seven years. Table 3 compares WestEd’s leasing terms with its asset recovery policy for the three selected leases.

Table 3. Most of WestEd’s Leasing Terms Are Accelerated.

Type of Asset:	Furniture	Furniture	Computers
Dates of Lease:	Aug. 27, 1992	June 22, 1993	Sept. 30, 1992
Lease Period: <i>(Period WestEd Used to Recover Asset Costs)</i>	4 years	4 years	3.17 years
WestEd’s Asset Recovery Policy	5 years	5 years	3 years
IRS Guideline	7 years	7 years	5 years

Recently, WestEd entered into capital leasing agreements to finance building improvements. The lease terms are seven years, its depreciation policy is ten years, while IRS guidelines state 31.5 years.

⁶As WestEd is a nonprofit, tax exempt organization, it is not subject to Internal Revenue Service (IRS) guidelines for asset recovery periods. However, the IRS guidelines provide the reader of this report a basis for assessing the reasonableness of WestEd’s asset recovery periods. WestEd did not provide any data or studies to support its own asset recovery policy.

WestEd Charged the Contract Unallowable Interest Costs.

WestEd charged the contract for interest costs during the period when interest was an unallowable cost. Prior to September 29, 1995, interest was an unallowable cost under applicable contract regulations. After that date, interest costs were allowable provided that the interest was not incurred under agreements for financed or refinanced assets acquired before that date.⁷ WestEd charged the entire monthly lease payments, which included interest costs, to its contracts during the period when interest was an unallowable expense. Also, WestEd continues to charge its contracts for the entire monthly lease payments for assets acquired before September 29, 1995. We estimated that WestEd charged the OERI contract about \$20,000 of unallowable interest in FY 1996.⁸

WestEd Should Be More Cost Effective in Its Asset Acquisitions.

We recommend that OERI, in coordination with OCF & CIO, require WestEd to select methods for acquiring assets that are most cost effective for the REL and other Federal contracts. WestEd should even consider using its reserve funds for furniture, computer equipment and building improvements. We also recommend that OCF & CIO review WestEd's practices for recovering asset costs.

Furthermore, WestEd should discontinue charging the REL and other Federal contracts any interest costs associated with assets refinanced after September 29, 1995. Also, WestEd should compute the amount of unallowable interest expense charged to the REL contracts prior to FY 1996 and return those funds to the Department.

Auditee's Response

WestEd did not concur with our finding and recommendations. Officials stated that WestEd has in the past selected, and continues to select, methods for acquiring assets that are cost effective under the circumstances. Also, Far West's decision to lease assets was prudent in matching cash outlays with projected cash inflows.

WestEd officials stated that the purchase amount, including the associated

⁷Attachment B, Paragraph 19.a. of OMB Circular A-122, Cost Principles for Non-Profit Organizations, states that interest on debt incurred to finance or refinance assets acquired before or reacquired after September 29, 1995, is not allowable.

⁸Computation of the estimated \$20,000 of unallowable interest costs:

Lease payments paid by WestEd in FY 1996	\$343,462
OERI contract's share of lease payments (23.35% of \$342,462)	\$80,186
Unallowable interest costs (interest component is 25% of \$80,186)	\$20,000

time value of that amount, exceeded the lease cost for the base period. The leases had a base period and an option for a 12-month extension. At the time of entering into the leases, Far West anticipated that it would need the items only for the base period. The total costs would equal the lease costs of the base period only. Officials stated that Far West ultimately extending the leases for another year is irrelevant to whether the decision to lease was reasonable at the time that decision was made.

WestEd officials stated that Far West did not charge the contract for interest costs during the period when interest was an unallowable cost. They reasoned that the lease costs represented allowable rental cost from operating leases, not interest costs under a capital lease. As for assets refinanced after September 29, 1995, officials stated that Far West never charged interest expenses, only rental costs, to any of its contracts.

Officials construed that the auditor has assumed the monthly rental payment represented depreciation expense and interest. They also stated that the auditor apparently assumed the lease period was the same as the depreciation period. Further, officials stated that WestEd's methods for recovering asset costs are consistent with all Federal regulations and sound accounting practices.

Auditor's Comments

When entering leases, Far West should have carefully considered the need to extend the leases. At the end of the base period, Far West extended all three leases cited in the report. Consequently, Far West incurred an additional \$40,789⁹ in lease payments over the purchase costs even when factoring in the time value of money. When we compared the lease costs of the base period with the total lease costs, Far West incurred an additional \$74,493¹⁰ (or about 33 percent) in lease costs by extending the leases for another year. Further, WestEd retained the assets at the end of the lease terms. Accordingly, we do not consider WestEd's action to lease the assets a prudent decision.

We recognize that lease payments under operating leases are recorded as rental costs for accounting purposes. However, whether WestEd called its lease agreements an operating or a capital lease, it is irrelevant when applying the interest provisions of OMB Circular A-122. The lease payments were based on an interest rate factor at the inception of the leases. Therefore,

⁹ Total lease costs for base period plus 12-month extension	\$301,700
— Purchase costs plus time value of money	= - \$260,911
Lease costs over purchase costs	\$ 40,789

¹⁰ Total lease costs for base period plus 12-month extension	\$301,700
— Total base period lease payments	= - \$227,207
Additional lease payments by extending the leases for a year, an increase of 33 percent (\$74,493 divided by \$227,207)	\$ 74,493

interest costs were part of the lease payments. WestEd's practice was to charge the entire monthly lease payment to its contracts. Thus, WestEd ultimately charged interest costs to contracts.

Further, the Education Department General Administrative Regulations under Section 74.44 requires organizations to do a lease and purchase analysis to ensure that assets are procured effectively and economically. WestEd had sufficient cash reserves accumulated during the periods when it executed the leases. Therefore, WestEd's decision to match its cash outflows with inflows was irrelevant and did not result in the economical use of Federal funds.

WestEd officials misinterpreted the essence of the finding regarding the assets' accelerated cost recovery periods. We did not assume that the monthly lease payment represented the depreciation expense and interest cost. For the three leases in our review, WestEd accelerated the charges of asset costs to contracts using the lease period. Whereas, if WestEd had acquired the assets with outright purchases, it would have allocated asset costs using the useful economic lives of the assets.

We also did not assume that the capital lease period was the same as the depreciation period. We presented WestEd's depreciation policy and IRS guidelines on the capital lease for building improvements for comparison purposes.

Finding No. 3 - WestEd Over Recovered Indirect Costs by Improperly Applying Its Indirect Cost Rate to Subcontracts.

WestEd properly excluded subcontract costs from the denominator of the formula for calculating indirect cost rates for periods prior to FY 1996 and its provisional rate for FY 1996. However, when WestEd used the rates to determine the amount of indirect costs to be charged to contracts, WestEd applied the rate to direct costs that included subcontract costs. By applying the rate to direct costs not included in the formula's denominator, WestEd overcharged contracts for indirect costs. In FY 1996, WestEd overcharged indirect costs to the OERI contract by \$108,061.

In its response to the draft report, WestEd provided us its computations for the final FY 1996 indirect cost rate that it submitted to the Department. WestEd submitted the computations to the Department after our fieldwork. We confirmed that the computations for this rate included total subcontract costs in the formula's denominator. Including total subcontract costs in the denominator is not appropriate. OMB Circular A-122, Attachment A, Paragraph D.2.c., instructs organizations to exclude major subcontract costs from the denominator when computing the indirect cost rate. WestEd has not obtained approval from the Department to include

total subcontract costs in the denominator.

While the Circular instructs organizations to exclude subcontract costs, it is common practice to include a limited amount of subcontract costs in the denominator, for example, up to \$25,000. Then the entity can apply the indirect cost rate to this limited amount to recover indirect costs allocable to subcontracts, such as processing payments to the subcontractors.

We recommend that OCF & CIO determine the appropriate amount of subcontract costs that WestEd may include in the denominator of the indirect cost rate formula. This will enable WestEd to recover indirect costs related to processing subcontracts. Also, WestEd should apply the indirect cost rates to only those direct costs included in the formula denominator. Further, WestEd should return \$108,061 of indirect costs overcharged to the OERI contract in FY 1996.

Auditee's Response

WestEd did not concur with our finding and recommendations. WestEd officials stated that Far West included all subcontractor costs in the FY 1996 direct cost base (formula's denominator) and properly applied its indirect cost rate to subcontract costs. Officials stated that Far West's indirect cost agreement, which both Far West and the Department approved, specified the method for calculating indirect costs. WestEd contended that if Far West had done as recommended in the report, the agency would have violated its explicit agreement with the Department.

Auditor's Comments

Prior to WestEd's submission of the FY 1996 final indirect cost rate, WestEd did not include subcontract costs in the denominator. Therefore, WestEd should not apply those rates to subcontract costs. We confirmed WestEd's change in the denominator with the Department's Indirect Cost Group. Further, the Department has not approved WestEd's FY 1995 and 1996 indirect cost rates. Thus, WestEd did violate its agreement with the Department by applying the rate to subcontract costs.

Finding No. 4 - WestEd Charged Contracts Unallowable Indirect Expenses.

WestEd charged its contracts indirect expenses in FY 1996 that were unallowable and unnecessary in the performance of Federal contracts. Our review of selected transactions identified the following questionable costs:

<u>Description</u>	<u>Amount</u>
• Lease of a Jeep Grand Cherokee for the Lab's Director	\$5,179
• DJ for dinner entertainment at two-day board and one-day staff/board meetings at a resort	\$450
• Airfare for foreign travel	\$532
• Airfare upgrades (<i>includes \$124 direct charged to the OERI contract</i>)	\$560
• Reorganization costs without prior approval (<i>Includes \$2,804 direct charged to the OERI contract</i>)	\$12,608

OMB Circular A-122, Attachment A, Paragraph A states that for a cost to be allowable, it must be reasonable for the performance of the award. In determining reasonableness, the cost should be ordinary and necessary for the performance of the award.

WestEd officials agreed that the DJ expenses for dinner entertainment and airfare upgrades are unallowable. They plan to exclude those expenses in the calculation of the final indirect cost rate. Also, WestEd should return \$124 of unallowable costs charged directly to the OERI contract for airfare upgrades.

WestEd incurred legal costs related to its merger of Far West and Southwest to form WestEd. According to the OMB cost principles for nonprofit organizations, such costs are disallowed, except with prior approval from the awarding agency. WestEd did not obtain prior approval from the Department nor did the Department request the merger. WestEd should return \$2,804 of these costs that were charged directly to the OERI contract.

OMB Circular A-122 does not specifically list foreign travel and executive automobiles as unallowable indirect costs. However, WestEd did not demonstrate that these costs were necessary for the performance of Federal contracts. Therefore, such costs should be excluded in the calculation of the final indirect cost rate. We recommend that OCF & CIO ensure that WestEd make the proper adjustments for the unallowable indirect costs in the final indirect cost rate.

Auditee's Response

WestEd officials stated that except for \$560 for airfare upgrade and \$450 for DJ expense, all other costs are allowable under OMB Circular A-122. WestEd disagreed that the legal costs associated with the merger of Far West and Southwest are unallowable. Officials asserted that only \$4,569 of legal costs were related to the finding and such expenditures were not considered organization costs.

Officials stated that WestEd leased the Jeep Cherokee for the Chief Executive Officer (CEO). The cost is in the CEO's compensation package and reported as income to the Internal Revenue Service. As for the foreign travel airfare that

WestEd charged to the indirect cost pool, officials asserted that OMB Circular A-122 requires only direct charges for foreign travel need prior approval to be allowable.

Auditor's Comments

Our position has not changed for the unallowable indirect expenses for the reorganization costs, auto lease and foreign travel. The legal costs associated with the merger of Far West and Southwest is an expenditure meeting the criteria for organization costs in Paragraph 26 of OMB Circular A-122, Attachment B. Under this criteria, fees to attorneys in connection with the reorganization of an entity are unallowable, except with prior approval of the awarding agency. The legal fees were incurred in connection with the reorganization of Far West and Southwest to form WestEd. Also, WestEd did not submit sufficient documentation to justify that only \$4,569 of legal costs were related to the merger.

For the auto lease, WestEd has not submitted documentation to demonstrate that the costs were included in the CEO's compensation package and reported as income to the Internal Revenue Service. As for the foreign travel, WestEd did not provide justification for the necessity of the trip and the allocability of the travel costs.

Finding No. 5 - WestEd's Indirect Cost Rate Does Not Reflect All Indirect Costs Charged to Its Contracts.

WestEd's stated indirect cost rate¹¹ gave the impression that indirect costs remained fairly constant when in fact the rate increased 29 percent over the past three years. For FY 1996, the indirect cost rate was 34.8 percent rather than the stated 12.8 percent. It should be noted that WestEd has other indirect costs, for example, buildings and facilities costs that WestEd excludes from its indirect cost rates and would not be applicable for the discussion in this finding. If we took into account these additional costs, the actual indirect cost rate would be about 45 percent for FY 1996.

WestEd shifted most of its indirect costs to its contracts as direct costs. Beginning in FY 1994, WestEd charged most of its indirect costs as direct costs by establishing cost centers for data processing, program support, contract management, and general services. WestEd directly charged cost

¹¹Indirect costs are expenses incurred for common or joint objectives and cannot be readily identified with a particular program. An indirect cost rate is a device for allocating the proportion of indirect costs to each program. It is the ratio (a percentage) of the indirect costs to a direct cost base.

center expenses to its contracts using direct labor hours as a basis for allocating costs. Under the new methodology, the indirect cost rate included only expenses for the accounting department, the office of the executive director, bid and proposal effort, and the Board members. Appendix A provides a graphic comparison of the former and new methodology.

As part of our analysis, we recalculated the indirect cost rates using WestEd’s former methodology. Table 4 shows the indirect cost rates under the former and new methodology for FYs 1994 to 1996.

Table 4. WestEd’s Indirect Cost Rate Does Not Reflect All Indirect Costs.

Indirect Cost Rates		
Fiscal Year	Former Methodology	New Methodology
1993	27.0%	
1994	26.4%	12.4%
1995	29.0%	12.8%
1996	34.8%	12.8%

Indirect costs have increased over the years. In FY 1993, WestEd’s final indirect cost rate was 27 percent. Since FY 1994, it directly charged most of its indirect costs that resulted in reduced indirect cost rates of 12.4 percent in FY 1994 and 12.8 percent in FYs 1995 and 1996. These stated low rates could give the appearance that WestEd is more efficient than other organizations. To gain marketing advantage in its contract bids, WestEd has an incentive to keep the stated indirect cost rate low. However, former indirect costs, such as contract services, actually increased from \$1 million to \$1.3 million between FYs 1994 and 1996 and would not be reflected in its stated low rate.

Under the new methodology, WestEd’s stated indirect cost rate also gave the impression that the rate remained fairly constant. However, using the former approach, the indirect cost rate actually increased by 29 percent from FY 1993 to 1996. Further, the indirect costs increased by 20 percent between FY 1995 and 1996. During this period, WestEd’s business base grew from \$16.9 million to \$24.6 million, or a 45 percent increase in its operating revenues. In a period of substantial expansion, we would expect the indirect cost rate to decrease as more contracts are available to absorb the increased indirect costs.

We recommend that OCF & CIO, in coordination with OERI, assess the reasonableness of WestEd’s indirect costs in relation to other nonprofit entities. To ensure that all indirect cost rates are fully disclosed, the Department should include WestEd’s rates for each cost center, including buildings and facilities, in WestEd’s indirect cost rate agreement.

Auditee's Response

WestEd did not concur with our finding and recommendations. WestEd officials interpreted our finding to mean that WestEd must have a single indirect cost pool that includes all costs incurred. They stated that the relevant question is whether WestEd is allocating costs in a manner that ensures the Federal share of costs is not disproportionate. They contended that the indirect cost rate, under the old methodology, was 32.5% in FY 1996.

Auditor's Comments

WestEd misinterpreted the essence of the finding. Our intent was to show that WestEd's new methodology for computing the indirect cost rate did not reflect the increase of indirect costs during a period of substantial expansion. We did not express that WestEd must have a single indirect cost pool. Also, WestEd has not provided documentation to support the 32.5 percent rate that it computed for FY 1996 using the former methodology.

Recommendations

We recommend that OERI, in coordination with OCF & CIO:

1. Require WestEd to seek future tenants that are compatible with the mission or objectives for educational research purposes. *[Finding No. 1]*
2. Limit the rental profits and related interest earnings accumulated in WestEd's reserve fund. The amount to be retained should be limited to a reasonable estimate to cover necessary building expenditures, including capital improvements that are not recovered through WestEd's operations. The amount exceeding the limit should be used to reduce program expenditures and/or further program objectives. *[Finding No. 1]*
3. Require WestEd to separately identify the accumulated lease profits and related interest earnings in its financial records and disclose the restricted use of those funds. *[Finding No. 1]*
4. Require WestEd to select methods for acquiring assets that are most cost effective for the REL and other Federal contracts. WestEd should even consider using its reserve funds for furniture, computer equipment and building improvements. *[Finding No.2]*

We also recommend that OCF & CIO:

5. Recover \$20,000 of FY 1996 costs that represent the interest component in WestEd's payments for asset leases. WestEd should also be required to compute the amount of unallowable interest expense charged to the REL contracts prior to FY 1996 and return those funds to the Department. Further, WestEd should discontinue charging the REL and other Federal contracts any interest costs associated with assets refinanced after September 29, 1995. *[Finding No.2]*
6. Review WestEd's practices for recovering asset costs. *[Finding No.2]*
7. Recover excess indirect costs amounting to \$108,061 associated with subcontracts. Also, OCF & CIO should determine the appropriate amount of subcontract costs that WestEd may include in the denominator of the indirect cost rate formula. Then, OCF & CIO should require that WestEd apply the indirect cost rates to only those direct costs included in the formula denominator. *[Finding No.3]*
8. Ensure that WestEd makes the proper adjustments for unallowable costs in the FY 1996 final indirect cost rate. Also, OCF & CIO should recover \$2,928 of other direct costs (\$2,804 for reorganization costs and \$124 for airfare upgrades). *[Finding No.4].*
9. Assess the reasonableness of WestEd's indirect costs in relation to other nonprofit entities. *[Finding No.5]*
10. Ensure that WestEd's rates for each cost center, including buildings and facilities, are fully disclosed in WestEd's indirect cost rate agreement. *[Finding No.5]*

Other Matters

WestEd Purchased Furnishings Exceeding the Quality Necessary for Federal Contracts.

WestEd remodeled the Los Alamitos building at a cost of about \$240,000 and financed this project through a building improvement capital lease with seven-year payout terms. From our observation, the furnishings purchased exceeded the quality that is necessary for the performance of Federal contracts. WestEd purchased about \$31,000 of furniture for the executive offices of this building between January and April 1997. These costs were originally allocated among WestEd's contracts. After we inquired as to how these costs are recovered, WestEd reclassified these costs to a general fund account. In its response to the draft report, WestEd officials stated that they furnished the offices in a manner comparable to the office suites provided for senior staff in the nonprofit and government sectors.

WestEd Included CEDaR Dues in Its Contract Charges.

In FY 1996, WestEd paid \$60,000 in dues to the Council for Educational Development and Research (CEDaR), a trade organization for the regional educational laboratories. The dues were based on WestEd's full-time staff count. Of the \$60,000, a total of \$4,200 was charged to the general fund, and \$55,800 was placed in the general services cost pool and allocated to WestEd's programs based on direct labor hours. OMB Circular A-122, Attachment A, Paragraph A provides that for costs to be allowable, such costs must be reasonable, allocable and necessary for the performance of the contract.

OCF & CIO developed a guideline on the amount of CEDaR dues that could be charged as indirect costs. The Department limits allowable CEDaR dues to 0.2 percent of WestEd's revenue.¹² Under this guideline, \$51,500 in CEDaR dues could be included as indirect costs. Thus, OCF & CIO may consider \$4,300 (\$55,800 minus \$51,500) of CEDaR dues as unallowable.

In its response to the draft report, WestEd officials stated that the CEDaR dues are allowable costs in their entirety. They asserted the guideline referred to in the report limiting the recovery of the costs on government contracts has no standing in either law or regulation. The officials also stated that the guideline was never published in the Federal register, disseminated in any official Federal publication, or transmitted by letter prior to, or during the period relevant in this instance. Further, they contended that the guideline is completely arbitrary because any standard of reasonableness requires an assessment of benefits received in relation to their costs.

¹²WestEd's revenue sources and amounts are listed in the Background Section of this report.

Background

Congress originally authorized the regional educational laboratories (REL) to improve education through research and development under Title IV of the Elementary and Secondary Education Act of 1965. The Educational Research, Development, Dissemination and Improvement Act of 1994, Public Law 103-227, provides funding for the ten current RELs.

The RELs, in partnership with state and local educators, carry out educational research and development projects. In fiscal year 1996, the ten RELs received a combined total of about \$51 million in Federal funds. The RELs also received funds from other Federal, state and private sources.

On December 1, 1995, WestEd was created to unite the operations of Far West Laboratory for Educational Research and Development (Far West) and Southwest Regional Laboratory (Southwest). WestEd's main facilities are in San Francisco and Los Alamitos, California. Under the REL contract, WestEd serves the states of Arizona, California, Nevada and Utah.

On December 1, 1990, Far West was awarded a five-year OERI contract for \$17.7 million. During that time, Southwest was a subcontractor for Far West. On December 11, 1995, Far West was awarded a new five-year OERI contract for \$22.0 million. During 1995 to 1996, Southwest continued as a subcontractor for Far West. As of December 1, 1996, through an agreement submitted to the Department, WestEd became the prime contractor on the current OERI contract. Since Southwest is now part of WestEd, the prime and subcontractor relationship between Far West and Southwest does not exist. Currently, WestEd is a nonprofit research, development, and service agency organized under the Joint Powers Act of the State of California. With a staff of 250, its business base and related revenues for FY 1996 consisted of:

<u>Contracts Revenue:</u>	OERI	\$ 4.1 million	
	Other Federal	11.4 million	
	State	3.4 million	
	Other ¹³	<u>5.7 million</u>	\$ 24.6 million
<u>Other Revenue:</u>	Building	0.9 million	
	Other Income	<u>0.3 million</u>	<u>1.2 million</u>
	Total Revenue		\$ 25.8 million

¹³This amount includes fiscal agent contracts for which WestEd's responsibilities are limited to providing accounting services, including preparing the billings and paying contract expenditures. No programmatic functions are performed on these contracts.

Purpose, Scope and Audit Methodology

The purpose of the audit was to determine whether costs incurred by WestEd and its subcontractors under the REL contract with OERI complied with applicable Federal laws and regulations and the terms of the contract. The audit covered the period from December 1, 1995 to November 30, 1996. We conducted our fieldwork from January 6, 1997 to May 5, 1997, at WestEd's business office in Los Alamitos, California. We also performed data analyses as appropriate to our audit at our field audit office in Long Beach, California.

To accomplish the audit purpose, we reviewed and analyzed Federal Regulations, contract terms, procedures manuals, accounting records and financial reports. We interviewed Department staff and WestEd personnel. We also reviewed records, reports and transactions from other award years that we considered relevant to our review.

We conducted our audit in accordance with generally accepted government auditing standards appropriate to the scope of the audit described above.

Statement on Management Controls

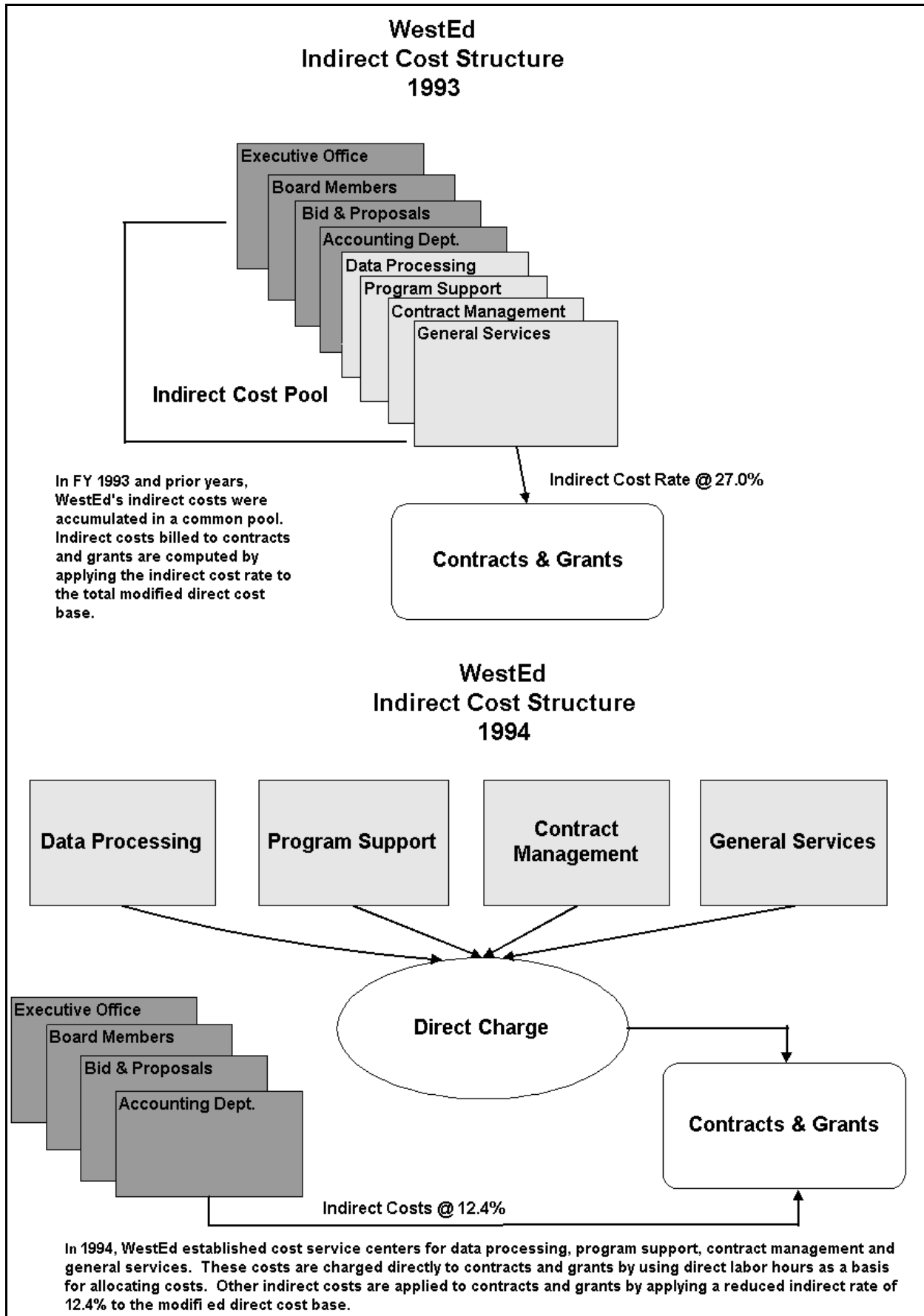
As part of our review, we assessed the system of management controls, policies, procedures, and practices applicable to WestEd's administration of material aspects of the OERI contracts in accordance with Federal requirements. Our assessment was performed to determine the level of control risk for determining the nature, extent and timing of our substantive tests to accomplish our audit objective.

For the purpose of this report, we assessed and classified the significant controls into the following categories:

- # Management of Federally-funded buildings
- # Asset acquisitions
- # Contract billings
- # Cash management for drawdowns
- # Contract expenditures
- # Subcontract costs
- # Indirect costs
- # Financial and administrative reporting

Because of inherent limitations, a study and evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed control weaknesses which affected WestEd's ability to administer the OERI contracts. These weaknesses included WestEd not complying with all Federal laws and regulations and the terms of the contract. Also, WestEd's indirect cost rates negotiated by the Department do not reflect all of its indirect costs.

The control weaknesses and their effects are fully discussed in the Audit Results section of this report. The findings of this report that relate to the control categories listed above are WestEd's: improper use and retention of rental profits from its Federally-funded buildings, excessive and unallowable costs for asset acquisitions, improper application of indirect cost rate to subcontracts, and unnecessary indirect and other direct costs for the performance of Federal contracts.



Attachment 1

WestEd Response to the Report

**U.S. Department of Education
Office of Inspector General Note**

The exhibits of WestEd's response are available in our office and will be provided upon request

January 15, 1998

Ms. Gloria Pilotti
Area Manager
U.S. Department of Education
Office of Inspector General
Office of Audit Services — Region IX
8011 I Street, Suite 219
Sacramento, CA 95814

California
Public Services
Unit
For West
Education and
Development
and Southern
California
California

Dear Ms. Pilotti:

We are in receipt of your November 21, 1997 letter and enclosed "Draft Audit Report," Audit Control No. A0960009, regarding "WestEd's Administration of the Regional Educational Laboratory Contracts."

California
San Francisco

Enclosed please find WestEd's detailed and itemized comments of response to your office's Draft Report. Note that we are submitting our comments prior to January 20, 1998, per your request.

WestEd reserves the right to later append this letter and/or our Response so as to further comment on the I.G. Audit, the November 1997 Draft Report, and other related matters.

Sincerely,



Glen H. Harvey, Ph.D.
Chief Executive Officer

JAN 16 REC'D

Enclosures

GHH:jag

WestEd Response

to

Draft Audit Report WestEd's Administration of the Regional Educational Laboratory Contracts

**U.S. Department of Education
Officer of Inspector General
Office of Audit Services**

**Audit Control No. A0960009
November 1997**

20 January 1998

Finding No. 1

I.G. Report:

WestEd Leased Space to a Radio Station and a Computer Facility in Buildings Purchased with Federal Funds for Educational Research Purposes and Retained Profits from the Leases.

Summary:

WestEd leased excess space to entities with no educational research functions and retained the profits in its reserve fund. These actions did not comply with the provisions of the original Federal grants given to the regional educational laboratories (REL) for construction or purchase of their buildings. Also, WestEd did not comply with Federal regulations regarding the use of the buildings' lease income. As a result, Federally-funded assets and income generated from those assets have not been used for their intended purposes. Further, because WestEd does not separately identify lease profits in its fund balance, the retained profits are at risk of being used for inappropriate purposes.

WestEd's response:

Introduction:

Before addressing the particulars of this finding, it is important to consider the context of the federally-designated Regional Educational Laboratories (RELs) leasing "excess space."

There have been dramatic changes in the relationship between the Department of Education (formally the Office of Education within the Department of Health Education and Welfare) and the RELs since the initial awards of facilities grants in 1972 and the present, over 25 years later. At the time of the facility awards — and for a few years thereafter, the federal government provided for the full cost of the facilities through REL "master contracts". Such contracts supported staff who fully occupied the facilities. All facility costs were included in the contract awards. The RELs received full government support as "institutions".

Laboratories no longer receive such full, institutional support from the U.S. government. Rather, RELs must now largely support themselves by securing individual programs and projects through processes involving competing for grants and contracts.

The same personnel in the Department of Education were aware of the tenant arrangements at both the Los Alamitos and San Francisco facilities. These personnel have never raised any objection to the types of tenants leasing space at either facility. This conduct indicates that the parties share a common interpretation of the limitations contained in each of the grants which permit the type of tenants now leasing space at the respective facilities.

The Report's interpretation of the limitations in the grants is inconsistent with the reasonable interpretation adopted by the parties and, therefore, is both incorrect and irrelevant to WestEd's responsibilities under the grants.

WestEd Retained Building Rental Profits Rather Than Using Them To Further Program Project Objectives.

The I.G.'s Draft Report makes two contentions regarding rental income in this part of the finding. First, it contends that WestEd must use rental income "to offset program costs, further program objectives or finance building improvements." In support of this assertion, the Report cites the requirements pertaining to program income under Paragraph A.5 of OMB Circular A-122, and the requirements for use of rental income identified in letters to SWRL and FWL in 1992 and 1989, respectively.

Whether or not the Report is correct, the purported "finding" regarding the proper purposes for which rental income may be spent has absolutely no relevance to any expenditure WestEd has made because WestEd has spent none of the \$2.6-million accumulated rental profits which are contained in WestEd's reserve balance, as acknowledged by the Report (p.4).

Nevertheless, when such time comes for WestEd to spend from its accumulated rental income reserve, WestEd disagrees that this reserve may be used only for the purposes cited in the Report. The limitations relating to "program income" under contracts subject to OMB Circular A-122 do not apply to WestEd's facility rental income because the use of that income is governed by the grants under which the facilities were constructed, which were not subject to A-122.

In addition, the limitations set forth in letters from the Department of Education to SWRL and FWL are far broader than the description provided in the Report. The Report erroneously implies that the Department of Education permitted SWRL to spend rental income only for "any purpose which furthers the support or maintenance of the building, equipping the facility, or educational research." The letter actually states:

"Given the broad reach of [the grant and relevant Education Department General Administrative Regulation] provisions, whether the period of the grant support is regarded as completed or continuing, we conclude that SWRL is authorized under the terms of the grant and the applicable regulations to use the rental income from the above-described facility to carry out the broad objectives of the [Cooperative Research] Act, *including, but not limited to*, any purpose which furthers the support or maintenance of the building, equipping the facility, or educational research." [Emphasis added.]

As discussed more fully below, WestEd accumulated rental income to pay for anticipated facility-related costs requiring capital funds to which WestEd otherwise would not have access. These purposes are well within the limitations described in the letters from the Department of Education.

The second contention in the Report regarding rental income is that WestEd is not authorized to retain for any period of time accumulated "rental profits" that exceed a "reasonable estimate to cover necessary building expenditures, including capital improvements that are not recovered through WestEd's operations." The purported basis for this position is that the letters from the Department of Education contain no provision that expressly permits retaining accumulated rental income.

WestEd is authorized to retain accumulated rental income because doing so furthers the broad purposes of the Cooperate Research Act and neither WestEd's grants nor any communication from the Department of Education prohibits the practice. A reserve is necessary because WestEd does not have sufficient access to capital funds for uses that are critical to the continued viability of its research programs, such as:

1. Offsetting the costs associated with vacant building space that cannot be leased due to poor market conditions. Such a situation nearly bankrupted SWRL in the mid-1980s.
2. Underwriting the self-insurance portion — "deductible" — required by the earthquake policies carried on the FWL and SWRL buildings — mandatory given their respective locations in two high earthquake-prone areas of California. In 1997, this amount alone was over \$2.5 million — a total that does not even include funds needed to make repairs that might be required but which are in excess of the policy limits. This additional cost would be in the range of \$2,000,000 to \$3,000,000.

As noted above, the Report itself recommends that some amount of reserve is necessary to finance necessary capital improvements (despite its inconsistent position that *no* reserves are authorized under the Department

of Education letters). The Report, therefore, apparently does not question WestEd's practice of creating a reserve, but only the amount of reserve that is appropriate. This determination requires business judgment that the auditor is in no-position to make or to second-guess.

As discussed above, recovery from earthquakes alone could require the expenditure of up to \$5.5 million from the reserve. A substantial shortage of funds due to unforeseen circumstances could bankrupt the organization and cut short the performance of many educational research projects required by various agencies of the U.S. Government. Indeed, SWRL and FWL both have been encouraged consistently by auditors — both independent and government — as well as their respective boards of directors, to seek such financial security from rental income specifically for protection against such liability.

If the recommendations suggested by the Report had been adopted 10 years ago, it is almost certain that SWRL would have either gone bankrupt or had to abandon its office facility. At that time a large portion of the building was vacant and the cost of maintaining the facility was far beyond the resources the Laboratory had to support it. The leasing of the excess space was the only way that SWRL could begin to cover its costs. Since the federal government has a substantial financial interest in these facilities, it is not only prudent but necessary that WestEd reserve funds to be used for the protection of its facilities.

WestEd's creation of a reserve rental income is entirely consistent with the purposes of the Cooperative Research Act and with direction provided by the Department of Education. The reserve provided FWL and SWRL, and will continue to provide WestEd, with the financial security necessary to prevent insolvency or the need for an unexpected infusion of federal money to repair and maintain the Los Alamos and San Francisco facilities.

Finding No. 2

I.G. Report:

WestEd Used Lease-Purchase Agreements that Resulted in Excessive Charges for Furniture, Equipment and Building Improvements.

Summary:

WestEd acquired assets through lease-purchase agreements rather than outright purchases. Under this purchasing method, contract costs for assets were excessive due to the additional interest expense. Also, WestEd accelerated the charges of asset costs to contracts by using the lease period

rather than the useful economic lives of the assets. In addition, it charged contracts for interest costs during the period when interest was an unallowable cost.

WestEd's response:

WestEd's Asset Costs Were Greater Due To Use Of Lease-Purchase Agreements.

The Report asserts that FWL's costs to lease furniture and computer equipment were "excessive" because they were greater than the costs would have been to purchase the items. This conclusion is wrong — legally and factually.

As a legal matter, a cost that is subject to OMB Circular A-122 is reasonable if "in nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs." A-122, Attachment A, ¶ 3. Lease costs, in particular, generally are allowable, subject to certain limitations, without regard to whether purchase of the item leased would have resulted in less cost. A-122, Attachment B, ¶ 42.

FWL's decision to lease rather than buy the furniture and computer equipment at issue was prudent under the circumstances in view of the time value of money associated with an up-front outlay of cash, and the potential that FWL would not have a continuing need for the items after the basic lease period. FWL entered into two leases for furniture and one lease for computer equipment. The base period for the furniture leases was 36 months and for the computer equipment lease it was 26 months.

All three leases contained a purchase option rider that permitted FWL, at the termination of the lease period, to (1) purchase the items at the greater of fair market value or 20% (for furniture; 35% for computer equipment) of the cost when new, (2) arrange to sell the items to a third party at the option purchase price and forward the proceeds to the lessor, or (3) if the items could not be sold, continue to lease the items for an additional 12 months and return the items to the lessor at the conclusion of the extended period.

At the time of entering into the leases, FWL anticipated that it would need the items only for the base period and would be able to dispose of them at the conclusion of the lease period. Thus, FWL anticipated that its total costs would equal the lease costs for the base period only.

Purchasing the items would have made these funds unavailable for other purposes, resulting in lost opportunities to make other needed payments or in the need to borrow to replenish operating funds. Cash is a very scarce commodity in most non-profit organizations, including FWL. The decision to lease the equipment was prudent in matching the out-lay of cash with projected in-flow.

It is not always beneficial or possible for not-for-profits like FWL (as well as SWRL and WestEd) to be advancing large sums of money to purchase assets. The match of outflows with inflows is usually the most significant factor in making a lease or buy decision.

It is imperative that an organization keep its cash reserves at a level that will ensure adequate levels of working capital so as to be able to survive any unforeseen business downturn or some other catastrophic event. Access to external capital by a non-profit agency for such purposes is a most difficult proposition.

Contrary to the assertion in the Report, the table below demonstrates that the purchase amount, *including the associated time value of that amount*, exceeds the lease costs for the base period.

	<u>Furniture</u>	<u>Furniture</u>	<u>Computers</u>
Purchase Price - New	\$57,777	\$67,783	\$135,319
Time Value of Money	<u>5,319</u>	<u>6,241</u>	<u>8,472</u>
Total Purchase Costs to FWL	\$63,096	\$74,024	\$123,791
Total Base Period Lease Payments	\$60,070	\$70,472	\$96,665
Purchase Cost Greater Than Base Lease Cost	\$3,026	\$3,552	\$27,126

Under this scenario, FWL reasonably determined that leasing was far more economical. At the end of the current lease period, management intended to reassess its need for the equipment based on its overall level of program support. The fact that FWL ultimately extended the leases for another year is irrelevant to whether the decision to lease was reasonable at the time that decision was made.

WestEd Expedited Charges To Contracts By Accelerating The Cost Recovery Periods Of Asset Acquisitions.

Response:

The leases entered into by FWL were operating leases, not capital leases. As such, the assets in question belong to the leasing company and not to the Laboratory. It would be improper for the assets to be recorded on FWL's balance sheet and then depreciated. The auditor has assumed that the monthly rental payment represented depreciation expense and interest. It does not. It represents rental cost, which is an allowable cost. (See response to next item).

FWL [WestEd] does not use accelerated depreciation practices which are inconsistent with its own policies. The Report's discussion of depreciation practices is only relevant in situations where assets are being purchased. It is not relevant under the circumstances of an operating lease.

The Auditor's assertion that WestEd recently entered into capital leasing arrangements for building improvements and used a depreciation policy inconsistent with its stated policy of 10 years is incorrect. The assets in question are currently on a 10 year depreciation schedule and have been always, from the date that they were acquired. (See Exhibit 2-1).

The Auditor apparently assumed that the capital lease period was the same as the depreciation period. This is simply not the case. The depreciation schedule is independent of the lease period.

WestEd Charged The Contract Unallowable Interest Costs.

Response:

FWL did not charge the contract for interest costs during the period when interest was an unallowable cost because the lease costs represented allowable rental costs from operating leases, not interest costs under a capital lease.

At the time of the three leases in question, the criteria of FASB Statement No. 13 were applied. The criteria that established them as operating leases is as follows:

1. Ownership was not to be transferred at the end of these leases.
2. The lease did not contain a bargain purchase. That is, at the end of the lease these assets could not be purchased for (significantly) less than their fair market value. These leases called for a purchase of

FMV or 20% to 35% of initial value whichever was higher. This would not be considered a bargain purchase.

3. The lease term was less than 75 percent of the property's estimated economic life.
4. The present value of the lease payments was less than 90 percent of the fair market value.

FWL's independent auditors, Grant Thornton, confirmed that the leases complied with the above criteria and were indeed operating leases. Attached is the worksheet showing the calculations using the above criteria (Exhibit 2-2).

The entire amount of the lease costs are allowable under Paragraph 42, Attachment B, of OMB Circular A-122. That cost principle contains a limitation regarding leases in which the lessee has a material equity in the equipment. However, the limitation does not apply in this case. The provision states, "the lessee may not have a material equity in the equipment in order for the lease payments to be completely allowable as rental costs." A material equity exists, under paragraph 42(d)(3), if the term of the lease cannot be canceled and has one or more of the following characteristics:

- (1) the lease has a "bargain purchase option," i.e., the purchase price is substantially less than the probable fair market value will be when the option can be exercised,
- (2) title to the property passes during or after the lease period,
- (3) the "term of the lease (initial term plus periods covered by bargain renewal options, if any)" is equal to 75 per cent or more of the economic life of the leased property.)

The FWL leases meet none of the criteria above that would indicate that FWL possessed a material equity in the equipment. As noted above, the leases did not have a "bargain purchase option" because the purchase price was to be *at least* the fair market value of the equipment. In addition, title would not necessarily pass during or after the lease if the lessee did not exercise the purchase option, which is what FWL contemplated when it entered into the leases. Finally, for none of the leases was the term equal to 75% or more of the economic life of the leased property.

The applicable lease term is the base period because the leases did not contain a bargain purchase option, as discussed above. The economically useful life is universally recognized as being 60 months for furniture and 36 months for computer equipment. The lease period for furniture was

36/60 = 60%; for computer equipment it was 72% — lower in both cases than the 75% criteria set forth in the cost principle.

The costs for such operating leases, with no material equity involved, involved no costs for interest. All payments were, and should be, classified as leasing expense or rental cost as provided for under Paragraph 42, Attachment B, of OMB Circular A-122.

WestEd Should Be More Cost Effective In Its Asset Acquisitions.

Response:

WestEd management is in agreement that it should always select methods for acquiring assets that are most economical under the circumstances that exist at the time of acquisition. The prudent use of its reserves will always be considered in making such decisions.

Furthermore, WestEd welcomes a review of its policies related to asset recovery and will implement gladly suggestions that improve its management practices.

The admonition that WestEd stop charging interest expense related to assets refinanced after 29 September 1993 to the REL and other federal contracts is unnecessary. Far West Laboratory never charged interest expenses, only rental costs, to any of its contracts, as state above.

Finding No. 3

I.G. Report:

Summary:

WestEd Over Recovered Indirect Costs by Improperly Applying Its Indirect Cost Rate to Subcontracts.

The indirect cost rate is expressed as the percentage of the total allowable indirect costs to total direct costs (excluding major subcontracts and capital expenditures). The formula for the indirect cost rate is the ratio of indirect costs to a direct cost base:

$$\frac{\text{Allowable Indirect Costs}}{\text{Direct Costs}} \\ (\text{excluding subcontracts and capital expenditures})$$

To fully recover the indirect costs, the rate is applied only to direct costs included in the denominator of the above formula. By applying the rate to direct costs not included in the base, WestEd overcharged indirect costs on the OERI contract.

WestEd excluded all subcontractor costs from the denominator of the indirect cost rate. However, it applied the rate to its direct costs plus subcontract costs. Consequently, in FY 1996, WestEd overcharged indirect costs on the OERI contract by \$108,061. We recommend that OCFO recover this amount from WestEd.

Also, it is inappropriate to apply the indirect cost rate to the full amount of the subcontract. Paragraph A.4 of OMB Circular A-122 states that a cost is allocable if it can be distributed in reasonable proportion to the benefits received. It is common practice to include a limited amount of subcontract costs in the direct cost base, for example, up to \$25,000. Then the entity can apply the indirect cost rate to this limited amount to recover indirect costs allocable to subcontracts, such as processing payments to the subcontractors. We recommend that OCFO allow a limited amount of subcontract costs in WestEd's direct cost base to recover indirect costs allocable to subcontractors.

WestEd's response:

WestEd overrecovered indirect costs.

There are two problems with this I.G. Draft Report finding. First, it asserts that "WestEd excluded all subcontractor costs from the denominator of the indirect cost rate," when, in fact, all documentation provided to the auditors clearly shows that WestEd *included* subcontractor costs. Second, while the Report cites what it claims is "common practice" for calculating indirect cost rates, it ignores the fact that the FWL indirect cost agreement that was approved by both FWL and the U.S. Department of Education specified the method for calculating indirect costs. If FWL had done as the Report recommends, the agency would have been in violation of explicit agreements with the Department of Education.

Far West Laboratory's application of its indirect cost rate to subcontracts is entirely proper. A more careful examination of Far West's indirect cost structure would have clearly revealed that subcontracts are included in the denominator of its indirect cost base. Thus, the Report is in error in its claim that WestEd excluded all subcontract costs.

Far West captured indirect costs in two subpools. The first contained all indirect costs of the agency and the costs that make up the base except for

subcontracts. The second pool contains the subcontract portion of the base. The two pools are then combined for the purpose of computing an indirect cost rate.

Exhibit 3-1 is a printout of the two pools for FY 1996 and a computation of the rate. Exhibit 3-2 contains two pages from Far West's indirect cost proposal to the U.S. Department of Education that again show that subcontracts are indeed included in the base for determining the indirect cost rate.

As for the calculation of the indirect cost rate in the future, each year WestEd and the Department of Education conduct negotiations to determine the most appropriate method for calculating and allocating indirect costs. Each negotiation results in an agreement subsequently approved by both parties. We anticipate continuing to employ this process.

Finding No. 4

I.G. Report:

Summary:

WestEd Charged Contracts for Unallowable Indirect Expenses

WestEd charged its contracts indirect expenses in FY 1996 that were unallowable and unnecessary in the performance of Federal contracts. Our review of selected transactions identified the following questionable costs:

<u>Description</u>	<u>Amount</u>
• Lease of a Jeep Grand Cherokee for the Lab's director	\$5,179
• Two-day board and one-day staff/ board meetings at a resort (for hotel rooms, conference fees, meals, transportation expenses, DJ for dinner entertainment, etc. for Board members and Lab officials)	\$31,775
• Airfare for a Board member's foreign travel	\$532
• Airfare upgrades (includes direct charged to the OERI \$560 contract)	\$124

<u>Description</u>	<u>Amount</u>
<ul style="list-style-type: none"> Reorganization costs without prior approval (includes \$2,804 direct charged to the OERI contract) 	\$12,608

OMB Circular A-122, Attachment A, Paragraph A states that for a cost to be allowable, it must be reasonable for the performance of the award. In determining reasonableness, the cost must be ordinary and necessary for the performance of the award.

WestEd officials agreed that the DJ expenses for the dinner entertainment and airfare upgrades are unallowable. They plan to exclude those expenses in the calculation of the final indirect cost rate. Also, WestEd should return \$124 of unallowable costs charged directly to the OERI contract for airfare upgrades.

WestEd incurred legal costs related to its merger of Far West and SWRL to form WestEd. According to the OMB cost principles for nonprofit organizations, such costs are disallowed, except with prior approval from the awarding agency. WestEd did not obtain prior approval from the Department nor did the Department request the merger. WestEd should return \$2,804 of these costs that were charged directly to the OERI contract.

In our opinion, the other amounts shown in the schedule above are unreasonable and unnecessary and should also be excluded in the calculation of the final indirect cost rate. We recommend that OCFO ensure that WestEd make the proper adjustments for the unallowable indirect costs in the final indirect cost rate.

WestEd's response:

Jeep Cherokee

This automobile was not acquired for the general use of Laboratory staff. It was leased for the use of the Chief Executive Officer as a component of the CEO's compensation package and reported as income to the Internal Revenue Service. The automobile is in lieu of an equivalent amount of salary. Thus, the allowability of the cost is governed by the cost principle for compensation costs, OMB Circular A-122, Attachment B, ¶ 6.

In accordance with that provision, the WestEd Board has determined that its CEO's compensation package is comparable with that provided other

CEOs in organizations of similar type, size, and complexity. (See ¶ 6.c.2.)
The Report makes no assertion that the costs are unallowable under the
compensation cost principle, nor are they.

Two-Day Staff/Board meeting

**U.S. Department of Education
Office of Inspector General Note**

WestEd's response relating to indirect costs for a two-day staff/board meeting has been omitted since it pertained to a draft finding that was not included in the final report.

The cost of entertainment — in this case \$450 for a DJ — originally was inadvertently charged to the indirect cost pool, but subsequently (and well *before* the audit) was removed from that pool in FWL's 1996 Indirect Cost Rate Proposal, and was not claimed for reimbursement.

Airfare for a Board member's foreign travel

The item in question relates to a trip taken by a FWL employee — not a Board member, as the Report states — to London. The purpose of the trip was to explore future funding opportunities for FWL with the Millennium Foundation. Its cost was charged to the indirect cost pool.

Paragraph 50 (d), Attachment B, of OMB Circular A-122 provides:

Direct charges for foreign travel costs are allowable only when the travel has received prior approval of the awarding agency. . . . (Emphasis added.)

Somehow the Report has construed this provision to mean that prior approval is required for foreign travel regardless of whether the cost is direct or indirect. Such an interpretation is clearly incorrect. If indirect travel costs required prior approval, the above cost principle would so indicate. They do not. Instead, they apply specifically and exclusively to the use of "direct charges."

Airfare upgrades

Any such upgrades are unallowable costs and have always been treated as such by Far West Laboratory. The charges in question were inadvertently charged to the indirect cost pool due to a coding error. These costs were removed from FWL's FY 1996 claim for indirect expenses.

Reorganization costs

The Report asserts that \$12,607.58 in costs paid for outside legal services constitute unallowable organization costs. As noted on the auditor's workpapers, WestEd informed the auditor that these costs, which were designated on the law firm's invoices as "Administrative Matters," related to the novation of government contracts for FWL and SWRL to the new entity, WestEd.

Subsequently, WestEd has researched these costs more thoroughly and has determined that only \$4,569 of these costs related to novation agreements. The remaining costs related to several other types of administrative matters, including leasing agreements, trademark issues, conflict of interest and building issues. See Exhibit 4-2, attached hereto.

The Report takes the position that novation costs constitute unallowable "organization costs." Organizational costs are defined as "[e]xpenditures, such as incorporation fees, brokers' fees, fees to promoters, organizers

[etc.], . . . in connection with the establishment or reorganization of an organization." (OMB Circular A-122, Attachment B, § 26.) Contract novations play no part in the incorporation of an entity or in its capitalization, which are the kinds of activities contemplated by the organization cost principle. Novations are not necessary for incorporation or to establish or reorganize the capital structure of a business entity.

The fact that contract novations are typically necessary to conduct business after an organization or reorganization occurs does not make the costs of those activities an "organization" cost. If that were the case, the costs of necessary office rearrangements and printing costs for a company's new stationery also would constitute "organization costs." This result clearly was not contemplated by the cost principle.

Consequently, all of the \$12,608 of legal costs presented in this finding are allowable under OMB Circular A-122. To conclude otherwise requires a misreading of federal guidelines.

Finding No. 5

I.G. Report:

WestEd's Indirect Cost Rate Does Not Reflect All Indirect Costs Charged to Its Contracts.

Summary:

WestEd's stated indirect cost rate¹ gave the impression that indirect costs remained fairly constant when in fact the rate increased 47 percent over the past three years. For FY 1996, the indirect cost rate was 34.8 percent rather than the stated 12.8 percent. It should be noted that WestEd has other indirect costs, for example, building and facilities costs that WestEd excludes from its indirect cost rates and would not be applicable for the discussion in this finding. If we took into account these additional costs, the actual indirect cost rate would be about 45 percent for FY 1996.

¹ Indirect costs are expenses incurred for common or joint objectives and cannot be readily identified with a particular program. An indirect cost rate is a device for allocating the proportion of indirect costs to each program. It is the ratio (a percentage) of the indirect costs to a direct cost base.

WestEd's response:

WestEd Shifted Most Of Its Indirect Cost To Its Contracts As Direct Costs.

Four years ago Far West Laboratory, working cooperatively and with the approval of the U.S. Department of Education, rearranged its cost allocation structure in order to provide a more equitable assignment of costs on the basis of benefits received. Prior to 1994, FWL had included all functions/costs other than direct labor, travel, direct purchases, computer depreciation, and facilities in a single indirect cost pool. The agency then allocated indirect across all final contracts and grants on the basis of total direct costs.

In 1994, following extensive consultation with Mr. John Masaitis of the U.S. Department of Education, FWL determined that establishing service centers for multiple services on the basis of staff days was a much more accurate and equitable approach than allocating the cost of such services on the basis of total direct costs. For example, an analysis demonstrated that the benefits received by any of the organization's multiple projects from services — such as information systems support (IS) — were in direct proportion to each project's total number of staff days.

While the approach used previously was simple, it was not supportive of an organization growing rapidly and, at the same time, diversifying its business mix. A "one-size-fits-all" indirect pool works fine in an organization having a homogenous research work program, but not one in the process of changing its program mix across the spectrum from basic research to training services. Thus, a more reflective system was needed for grouping costs functions and allocating them on something other than a total direct cost base.

FWL implemented this concept by preparing a detailed formal proposal for the U.S. Department of Education that set forth the alternative cost groupings and the bases by which they would be allocated. This procedure established which functions would be included in the single indirect cost pool and which would be grouped as service centers. The service center costs would be allocated through a base reflecting benefits received.

Before issuing FWL's provisional indirect cost rate, John Masaitis of the Department of Education's Office of Cost Determination visited FWL on December 17 and 18, 1995 to discuss the proposal in detail and how it would affect federal awards. The proposed method was subsequently approved.

For the Department to now rescind its approval for this method would create enormous financial and administrative burdens for WestEd. Our agency currently has in excess of 150 contracts and grants, representing approximately \$30-million. Each of these agreements would have to be individually renegotiated. Many funding agencies have multi-layered approval procedures for making any such changes to budgets, processes that can take many months. More importantly, making such a modification would accomplish nothing. It would not result in any costs savings on federal awards or result in a more equitable distribution of WestEd's costs. Indeed, the effect would be just the reverse.

The Report's contention that WestEd's must have a single indirect cost pool that includes all costs incurred for joint objectives is simply not supportable. Many organizations group service/functions as service centers; a surrogate that best measures the relative benefits received by a final cost objective contract or grant is then used to allocate the costs. For example, a computer center which supports all segments of an agency's operation is commonly treated as a service center and is only allocated to those units which use the services. Printing and duplication centers, telephones, etc., can be handled in the same manner. This practice is entirely consistent with paragraph D(1)(b), Attachment A, OMB Circular A-122. Paragraph D(1)(b) states that:

"Where an organization has several major functions which benefit from its indirect costs in varying degrees, allocation of indirect costs may require the accumulation of such costs into separate cost groupings which then are allocated individually to benefiting functions by means of a base which best measures the relative degree of benefit."

Paragraph D(3)(b) also provides:

"The groupings shall be established so as to permit the allocation of each grouping on the basis of benefits provided to the major functions. Each grouping should constitute a pool of expenses that are of like character in terms of the functions they benefit and in terms of the allocation base which best measures the relative benefits provided to each function. The number of separate groupings should be held within practical limits, taking into consideration the materiality of the amounts involved and the degree of precision desired."

The relevant question is whether costs are being allocated in a manner that ensures that federal awards are not negatively impacted by a disproportionate share of the costs. By any objective measure, WestEd's grouping of cost and

allocating based on benefits received ensure an equitable, proportionate share of costs. Finally, even if WestEd or others followed the advice implied in the Report and shifted more direct costs to an indirect cost pool, not a single dollar in savings to the federal government or anyone else would be realized.

Indirect Costs Have Increased Over The Years.

In support of a contention that WestEd should change its cost allocation, the Report suggests that the organization's cost rate, under the old methodology, has soared from 23.7% in 1993 to 34.8% in 1996. These numbers are simply erroneous and entirely unsupported by fact. WestEd's final negotiated indirect rate in 1993 was 27.0%, as shown in Exhibit 5-1. ^{*(See Note Below)} Furthermore, the rate for FY96 was 32.5%, using the old methodology, not 34.8%, as shown by the Report's Table 4.

The cited increase in contract services (Program Support) from \$1 million to \$1.3 million between FY 1994 and FY 1996 was due largely to management decisions regarding the need for strengthened general internal communications, staff development, personnel training, preparation of employee workplans, and performance appraisal activities, among others.

The Report's contention that WestEd's current indirect cost rate leads potential clients to believe that the organization is extraordinarily efficient so as to provide a marketing advantage is preposterous. WestEd principally competes for procurements from the National Science Foundation, the U.S. Department of HES, the U.S. Department of Education, and the State of California. The personnel in these agency scrutinize every line item of a cost proposal and know exactly the nature of all costs. They recognize no "market advantages."

To ensure full disclosure, WestEd always provides detailed information, as requested, to the procurement offices in receipt of our proposals. An example of the type of information that we make available is shown in Exhibit 5-2. Funding agencies with whom we work are informed of our cost structure. We do not believe that any funding agency, competitor, colleague organization, or client is, has ever been, or will be deceived.

Recommendations *[Draft I.G. Audit Report, p. 11]*

I.G. Report: We recommend that OERI, in coordination with OCFO:

1. Require WestEd to seek future tenants that are compatible with the mission or objectives for educational research purposes.

^{*}U.S. Department of Education, Office of Inspector General Note: We agree that the final indirect cost rate for FY 1993 is 27 percent and have adjusted the rate in the finding. Using the revised data for FY 1993, our position on this finding has not changed, that is, WestEd's indirect costs still demonstrate an increasing trend.

WestEd's response:

1. Far West Laboratory and SWRL have leased out excess space in their facilities to organizations who are compatible with the Laboratories' mission and operations. Please see our response to Finding No. 1.

I.G. Report:

2. Limit the rental profits accumulated in WestEd's reserve fund. The amount to be retained should be limited to a reasonable estimate to cover necessary building expenditures, including capital improvements that are not recovered through WestEd's operations. The amount exceeding the limit should be used to offset program expenditures and/or further program objectives.

WestEd's response:

2. Implementation of the Report's recommendation would severely limit the ability of FWL and SWRL to maintain the ownership responsibilities they now have for the respective buildings. The accumulation of reserves is consistent with agreements with the U.S. Department of Education. As stated in our response to Finding No. 1, the most critical concern to agencies such as ours is being able to accumulate the necessary capital funds to see us through catastrophic events such as building damage from earthquakes or to make necessary, major building repairs.

I.G. Report:

3. Require WestEd to separately identify the accumulated lease profits in its financial records and disclose the restricted use of those funds.

WestEd's response:

3. Implementing this recommendation would create an unnecessary burden, and one that would contribute nothing to the understanding of the matter of use of lease revenues. WestEd's financial records currently contain detailed information regarding all details about all revenues received from leasing. In addition, these records contain information about all expenses for facility and non-facility costs. A separate accounting would be redundant.

WestEd maintains auditable records of its total accumulated reserve balance and its total accumulated rental income. The total reserve

amount exceeds the total accumulated rental income, which demonstrates that no rental income thus far has been spent.

WestEd assumes that the last funds it will spend out of the reserve are the funds that were generated by rental income. When it becomes necessary to draw the reserve below the accumulated balance of the rental income (i.e., to spend some of the rental income funds), WestEd's current accounting practices already provide that the amount and purpose of all costs that have been expended will be recorded.

Thus, it always will be possible to determine the amount of rental income that has been expended during a given accounting period and whether WestEd has incurred costs for permitted purposes of at least that amount during the same accounting period. Therefore, a separate line item for the lease proceeds is not necessary for inclusion on formal financial statements.

I.G. Report:

4. Require WestEd to select methods for acquiring assets that are most cost effective for the REL and other Federal contracts. WestEd should even consider using its reserve funds for furniture, computer equipment and building improvements.

WestEd Response:

4. WestEd has in the past selected, and continues to select, methods for requiring assets that are the cost effective under the circumstances.

WestEd operates in a very competitive environment, re: awarding of contracts and grants. Cost of services is a significant factor in the evaluation process in virtually all of these awards. Consequently, WestEd does conduct "business" in a manner that is as cost efficient as possible in light of any financial or other constraints the agency might be subject to.

It is in WestEd's best interest to acquire assets using methods that are most cost effective for the REL or any other federal contract, subject to the business conditions that exist at the time of purchase. Furthermore, all such asset acquisitions are accomplished in accordance with OMB A-122, EDGAR, and any other regulations related to this subject just as they have in the past, notwithstanding the findings of this Report.

I.G. Report:

5. Assess the reasonableness of WestEd's indirect costs in relation to other nonprofit entities.

WestEd Response:

5. WestEd continually assesses the reasonableness of its indirect costs relative to other non-profit entities of similar size and complexity. Furthermore, we work with the U.S. Department of Education annually to determine an indirect cost rate reasonable to all parties.

I.G. Report:

We also recommend that OCFO:

6. Recover \$20,000 of FY 1996 costs that represent the interest component in WestEd's payments for asset leases. WestEd should also be required to compute any unallowable interest costs in the contract's prior years and return those funds to the Department. Also, WestEd should discontinue charging the REL and other Federal contracts any interest costs associated with assets that were refinanced after September 29, 1995.

WestEd Response:

6. WestEd disputes the Report's finding that the lease agreements entered into by Far West Laboratory involved an equity interest, thus making the interest component of the leases an unallowable cost. See response to Finding No. 2.

I.G. Report:

7. Review WestEd's practices for recovering asset costs and establish appropriate guidelines for RELs

WestEd Response:

7. WestEd's methods for recovering asset costs are consistent with all federal regulations and sound accounting practices. The Report's implication that WestEd's accounting treatment for recovery of asset costs is inconsistent and in need of reform is, in our opinion, a result of the auditors' lack of diligence in ascertaining the facts in this case.

I.G. Report:

8. Recover excess indirect costs amounting to \$108,061 associated with subcontracts and allow a limited amount of subcontract costs in WestEd's direct cost base to recover indirect costs allocable to subcontracts.

WestEd Response:

8. WestEd disputes the Report's contention that Far West Laboratory improperly billed the government for indirect costs associated with subcontracts since subcontracts were not included in the Laboratory's direct cost base. FWL did include all subcontracts in its direct cost base for 1996 and properly applied its indirect cost rate to billed subcontract costs. We are perplexed by this finding since the facts substantiating the inclusion of subcontract costs in the base were contained in the records reviewed by the I.G. audit team members, who then subsequently discussed the matter with WestEd staff.

I.G. Report:

9. Ensure that WestEd makes the proper adjustments for unallowable costs in the FY 1996 final indirect cost rate. Also, OCFO should recover \$2,928 of other direct costs (\$2,804 for reorganization costs and \$124 for airfare upgrades).

WestEd Response:

9. Of the \$50,654 of questioned costs identified by the auditors, only \$450 for a DJ and \$560 for air fare upgrades are, in fact, unallowable costs under OMB Circular A-122. These two items were inadvertently charged within indirect cost pools due to coding errors and have been reclassified subsequently. See response to Finding No. 4.

Other Matters

I.G. Report:

- A. WestEd purchased furnishings exceeding the quality necessary for Federal contracts.

WestEd remodeled the Los Alamitos building at a cost of about \$240,000 and financed this project through a building improvement capital lease with seven-year payout terms. From our observation, the furnishings purchased exceeded the quality that is necessary for the

performance of Federal contracts. WestEd purchased about \$31,000 of furniture for the executive offices of this building between January and April 1997. These costs were originally allocated among WestEd's contracts. After we inquired as to how these costs were recovered, WestEd reclassified these costs to a general fund account.

WestEd Response:

The space referred to by the auditor was remodeled to house senior executive staff who were to be located at or relocated to the Los Alamitos facility. The space available had been previously used for storage and had never undergone improvements since the building's construction 25 years earlier. Hence, extensive renovation was necessary.

The offices are furnished in a manner comparable to the office suites provided for senior staff in the non-profit and government sectors. The space questioned by the Report represents less than 3,500 square feet of a total of the more than 93,000 square feet occupied by WestEd staff.

I.G. Report:

B. WestEd included CEDaR dues in its contract charges.

In FY 1996, WestEd paid \$60,000 in dues to the Council for Educational Development and Research (CEDaR), a trade organization for the regional educational laboratories. The dues were based on WestEd's fulltime staff count. Of the \$60,000 a total of \$4,200 was charged to the general fund, and \$55,800 was allocated to WestEd's contracts and indirect departments based on direct labor hours. OMB Circular A-122, Attachment A, Paragraph A provides that for costs to be allowable, such costs must be reasonable, allocable and necessary for the performance of the contract.

OCFO developed a guideline that limits allowable CEDaR dues to 0.2 percent of WestEd's revenue.² Under this guideline, \$51,500 in CEDaR dues could be charged to WestEd contracts. Of the \$4,300 (\$55,800 minus \$51,500) of CEDaR dues that would be unallowable under the guideline, we estimated that \$953 was direct charged to the OERI contract and \$413 was included in WestEd's indirect cost base. OCFO could disallow all or a portion of the CEDaR dues costs.

² WestEd's revenue sources and amounts are listed in the Background Section of this response.

WestEd Response:

The questioned costs are allowable under Paragraph 25 (a), Attachment B, of OMB Circular A-122, which provides that:

“Costs of the organization's memberships in civic, business, technical, and professional organizations are allowable. . . .”

CEDaR was a professional association, and its membership costs were an allowable cost as stipulated under the above cost principle.

The guideline referred to in the Report limiting the recovery of the costs on government contracts has no standing in either law or regulation. It was never published in the Federal Register, disseminated in any official federal publication, or even transmitted by letter either prior to, or during, the time period relevant in this instance. The fact that it was “developed,” as the Report notes, is inconsequential. It was and is simply not part of the public record. No contractor can be held to a standard that it has no reasonable means of knowing exists.

Furthermore, the suggested guideline is completely arbitrary. Any standard of reasonableness requires an assessment of benefits received in relation to their costs. The application of similar standards involve asking a prudent person whether he or she would make such a purchase under the circumstances. Indeed, they can only be determined on a case-by-case basis in which the exact details of the transaction are assessed.

To our knowledge neither the auditors, in person, nor their Report, contests whether or not the services and value received from CEDaR were reasonable. Instead they offer that, “OCFO could disallow all or a portion of the CEDaR costs” by relying on a “developed,” unofficial, nonpublic policy that would limit dues to .2 percent of revenues seemingly independent of the cost and value of the services provided by the association.

WestEd has and will continue to insure that we pay only those dues that are reasonable and necessary to obtain the services we require from our professional association.

The CEDaR dues are an allowable cost in their entirety, as has been determined by every examination of such costs over the past 20 years.

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