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DECISION THE COMPTROLLER GENERAL OF THE UNITED STATES WASHINGTON, D.C. 20548

FILE: B-203681 DATE: September 27, 1982

MATTER OF: International Communication Agency--East-West Center Grant Costs

DIGEST: 1. The East-West Center practice of placing letter of credit advances in savings account before transferring grant funds to cover previously issued checks, among other activities, resulted in premature advances of grant funds. As a result almost all interest earned appears to be attributed to these grant advances. Since Center has not traced these funds to non-Federal sources, interest earned by Center must be returned to the Federal Government under allocation formula presented by International Communication Agency.

2. East-West Center practice of charging International Communication Agency (ICA) grant with indirect costs, and also charging grants from other agencies with indirect costs in effect results in double charges for indirect costs. ICA should disallow and recover an amount equal to the indirect costs charged to other Federal grants that should not have been taken from ICA funds.

3. The Cost Principles that the International Communication Agency (ICA) requires of the East-West Center aside from OMB's management direction, are limited by the general rules applicable to accounting for appropriated funds and the program authorization under which they are expended. By accepting a grant conditioned on the cost principles adopted by ICA, the Center will be committed to using these principles on the ICA grant.

The Acting Associate Director for Management of the United States International Communication Agency (ICA) has asked for our decision and recommendation on three unresolved issues that arose from an audit of the East-West Center (the Center), an organization funded through the ICA. These issues concern:

(1) Whether the Center may keep any interest earned by it on funds advanced to it pending expenditure for the purposes for which they were received;

(2) Whether the Center is entitled to keep overhead received from other Federal programs where the Center used funds from the ICA to pay for the overhead costs, and;

(3) Whether the Office of Management and Budget (OMB) cost principles contained in OMB Circular A-21, "Cost Principles for Educational Institutions," apply to the Center in its accounting for funds received from the ICA as well as from other Federal programs.

As explained below we conclude (1) that the Center may not retain any interest it earned on funds advanced to it by ICA or other Federal agencies, (2) that to the extent that overhead has been paid more than once from Federal funds, that amount in excess of the reasonable overhead costs of the Center must be returned to the Federal Government, and (3) that ICA should adopt cost principles consistent with those contained in OMB Circular A-21 although these principles should be modified to conform to ICA program authority. The principles established by ICA should be applied by the Center in accounting to the Government for its costs.

According to the Acting Associate Director, the Center is largely funded by ICA under authority of the National Security Act of 1960 (22 U.S.C. § 2054 (1976)) which directed the Secretary of State to provide for the establishment of the Center. Acting upon this authority the Department of State entered into an agreement with the University of Hawaii in 1960 for the establishment and maintenance of the Center. In 1975 the Center became (under the laws of the State of Hawaii) a nonprofit public educational corporation, legally independent of the University of Hawaii. According to the September 1978 Memorandum of Understanding between the Center and ICA, the Center is neither a governmental agency nor a part of any governmental agency, Federal or State. The ICA was given responsibility for administering the program with the Center under Reorganization Plan No. 2 of 1977. In 1979 the ICA conducted an audit that resulted in the three unresolved questions presented for our decision.

Status of the East-West Center

The Center has presented its position on the issues in dispute in a September 7, 1981, letter from its President Pro Tem and a March 15, 1982, letter from its President. In his letter, the President Pro Tem notes that the basic question in each of the disputed issues is the nature of the Center's relationship to the Federal Government. He characterizes the Center as "a national educational institution of the United States * * *," while the ICA views the Center as an educational institution independent of the Federal Government, which receives grants of Federal funds just as many other educational institutions receive grants of Federal funds. We agree that this fundamental dispute is the root from which the issues in question stem.

It is the Center's position that the National Security Act of 1960 established the Center as a national educational institution to carry out a program to promote international education, cultural, and related interests of the United States. The Center stresses the relationship between the Federal Government and the State of Hawaii that created the Center as a corporation with the sole purpose of operating the Center in furtherance of the Mutual Security Act of 1960. From these circumstances the Center argues that the Center's relationship is different than that between the Government and a private contractor. The Center further believes that the Memorandum of Understanding of September 28, 1978, between the Center and the ICA reflects the unique nature of the Center and its methods of operation. The President Pro Tem further points out in his letter that the governing body of the Center includes members nominated by the Federal Government. Also the ICA's Associate Director for Educational and Cultural Affairs serves as an ex officio member. The President Pro Tem also considers it significant that funds are specifically appropriated for the Center by the Congress.

Since the issues raised by ICA all concern funding questions, it is unnecessary for us to characterize precisely the relationship between the Center and the Federal Government. However this relationship may be described for any other purpose, the fundamental legal relationship under which ICA funds the Center is that of grantor agency to grantee. Under 22 U.S.C. § 2055 (1976), ICA is authorized to provide for the following:

> "* * * the establishment and operation in Hawaii of an educational institution to be known as the Center for Cultural and Technical Interchange Between East and West, through arrangements with public, educational, or other nonprofit institutions * * *."

This language gives the ICA authority to develop and fund the Center ("* * * arrangements with public, educational, or other nonprofit institutions * * *."). There is no suggestion in the statute that ICA was supposed to operate the Center itself, nor is there any indication that the Center, once established and operating, was to be a wholly or partially owned Federal corporation or other Federal instrumentality. Thus the Center, as the recipient of ICA funding, would clearly stand in a grantor-grantee relationship with the ICA. In the agreement between the Center and ICA, the Center is described as receiving grant-in-aid funds from ICA. Also see 41 U.S.C. § 504 (Supp. III, 1979) which generally describes the Federal grant relationship.

A grant relationship is not an unusual relationship nor does it diminish the status or value of the grantee with respect to the Federal Government. Even the States which are an integral part of the Federal system receive most of the funds which they receive from the Federal Government through grants. See, e.g., Aid to Dependent Children, 42 U.S.C. §§ 601 et seq. (1976), and Medicaid, 42 U.S.C. §§ 1398 et seq. (1976).

The Center, which was originally a part of the University of Hawaii, is now incorporated under the laws of Hawaii. It is clearly an entity separate from the Federal Government no matter how dependent it is on the Government for support or how effectively it carries out the Federal policy behind its funding. As previously noted, this is expressly stated in the Memorandum of Understanding. The closeness and precise nature of the relationship of the Center and the Government are not relevant to our decision so long as we have concluded that the Center is not part of the Government. Moreover, the appropriation from which it is funded specifically speaks of the method of funding the Center as a grant. See, e.g., Pub. L. No. 95-86, 91 Stat. 424 (1977); Pub. L. No. 95-431, 92 Stat. 1042 (1978). Accordingly, we conclude that the Center is a Federal grantee subject to the rules that apply to funds received under a grant relationship with the Federal Government.

Interest Earned on Advances of Funds

The dispute over entitlement to the interest earned by the East-West Center is not, in this instance, over the general principle of whether the Government is entitled to interest earned on advances of grant funds, 1/ but rather whether the entire amount of funds that ICA bases its interest calculations on are Federal advances. The Center urges that the interest be prorated between "appropriated funds [the ICA grant]" and other Center funds according to a recommendation made by its accounting firm. The Center also urges that such a proration never had been questioned in prior audits and that the interest income has been spent entirely in furtherance of the purposes set forth in the legislation authorizing Center activities.

According to the ICA audit findings, however, this proration is largely misstated due to the method by which the Center uses its letter of credit authority, invests in Treasury Certificates, and

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1/ For a discussion of the general rule on interest earned on advances of grant funds, see 42 Comp. Gen. 289 (1962). If the Center were a state agency or instrumentality, it would be entitled to keep the interest earned on advances of grant funds under the Intergovernmental Cooperation Act of 1968, 42 U.S.C. § 4213 (1976); 59 Comp. Gen. 218 (1980).

pays creditors. The ICA audit indicates that the Center places letter of credit advances in a savings account before transferring the funds to its checking account to cover previously issued checks when they are presented for payment. The Center also transfers funds from the savings account to the checking account for the purpose of buying interest-bearing Treasury Certificates of Deposit. An internal memorandum, dated May 12, 1980, by the ICA audit staff describes how the Center accumulates interest, as follows:

> " * * * The only non-U.S. Government deposit was on August 10, 1978 when a contribution from the Government of Japan in the amount of $100,000 was deposited for check clearing purposes and the funds were immediately transferred out on August 15, 1978. As indicated in the audit report, proceeds of $305,000.06 from cashing in a Certificate of Deposit were redeposited to the savings account on September 26, 1978.[2/] Consequently all of the funds in savings account No. 85-307374 on which interest income was earned are clearly identifiable as being attributable to U.S. Treasury funding. As indicated, the account was credited with $33,014.57 of interest income during the fiscal year. The balance on hand in the account at September 30, 1978 was $1,409,464.76, an increase of $863,307.98 during the fiscal year. During November 1978, $2,070,000 was transferred to the checking account which contained a beginning monthly balance overdraw of ($98,326.69). Out of the above deposits, $1,000,000 was used to purchase Certificates of Deposits redeemable approximately one year later. * * * Based on the above documentation, there appears little question that the EWC [the Center] was drawing down Letter-of-Credit funds in excess of actual need and that the entire interest income earned was attributable to U.S. Government funding. Treasury Letter-of-Credit drawn down fund request reflected -0- when in fact the EWC had substantial U.S. Government funds on hand in the form of aforementioned Certificates of Deposits. Further, since the EWC was billing other U.S. Government Agencies for indirect cost recoveries which the Center was not

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2/ This Certificate of Deposit, according to ICA's audit, was purchased by the Center in March of 1978 from a withdrawal from the First Hawaiian Bank savings account that is traceable to a March letter of credit withdrawal of nearly $3 million.

in fact paying out as expenditures enabled in part the surplus cash build-up in the First Hawaiian Bank Savings Account."

Accordingly, in an August 28, 1980, letter to the East-West Center, ICA asserted that the Center's allocation of interest failed to recognize that the Center is required to return interest earned on advances of Federal funds from whatever source and not only funds from ICA. This letter suggested the following approach to arrive at an agreement with the Center:

"USICA Grant and All Other Federal Funds / All funds (excluding income from interest donated services and investments) -% to be applied to interest income

FEDERAL

"Appropriation	$12,200,000
"Restricted grants (1,520,160 - 239,021)	1,281,139
"Indirect cost recovered	225,252
"Total USICA grant and other Government funds	$13,706,391

ALL FUNDS

"General operating total	$13,499,240
"Restricted operating	1,520,160
Total Funds	$15,019,400
"Less:	
Investment Income	$ 28,143
Miscellaneous Income	72,976
Donated Service	429,352
Total deducts	$ 530,471
All funds adjusted	$14,488,929

"Federal $13,706,391 / "All funds $14,488,929 = 94.6% income on Federal Funds

"This approach would allow the Center to retain approximately 5.4% of the interest income earned which could possibly be interpreted as non-government.

"We therefore recommend that since FY 78, 94.6% of the Center's income was derived from Federal funds that percentage should be applied to the investment and interest income as follows:

"Certificates of Deposits	$13,876
Interest on Savings Account	33,015
Total Income	$46,891
Allocation of 94.6%	44,359
Refunded to U.S. Treasury	18,691
Amount due U.S. Treasury	$25,688

"This approach would be applied to interest and investment income for FY 77, 78, 79, and 80."

According to the Center, ICA's analysis should take into account in its allocation base the existence of fund balances and reserves and not only use revenues. It notes that interest is earned on cash balances not revenue. The Center also takes the position that $500,000 from non-Federal sources was earmarked for reserves which earned interest at a higher rate than the savings account rate. As to the interest earned on other Federal source funds, the Center takes the position that these funds "on the average * * * did not generate funds available for investment."

Based on a letter from their accounting firm, the Center offered the following alternative analysis of the facts concerning interest earnings:

"Total interest income for 1978		$46,891
Less:		
Endowment fund interest income	$ 57	
Estimated interest income earned on the Center's fund balances ($482,000 x 6%)	28,920	29,977
"Remaining interest income		17,914
"Percentage due the Federal government (the 94.6% per ICA's letter dated August 28, 1980 adjusted for grant revenue earned rather than gross grant additions)		.957
"Interest due the Federal government		17,144
"Less amount already paid		18,691
Estimated over payment to the Federal government		$ 1,547"

In a draft audit report prepared for the Center by its audit firm dated April 30, 1980, the auditors describe at page 14 how the Center handled the letter of credit withdrawals.

> "The Center maintains a telephonic savings account in to which letter of credit draws from ICA and AID are deposited. They also have two checking accounts, a general checking account and a payroll checking account. Through automatic telephone transfers, funds are shifted from savings to checking to cover checks disbursed. Generally, the checking accounts maintain small balances so as to maximize interest earnings.
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> "The Center's financial records clearly reflect the sources of all funds and account for each source separately.
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> "At the beginning of each year, other funds are used to pay for items properly chargeable to the appropriation pending the release of funds for the new fiscal year. When appropriation funds became available, the advanced funds are invested at better than bank rates. We believe interest earned on these funds can be retained by the Center and may be expended on costs allowable to achieve the purposes of P. L. 86-472 [the National Security Act of 1960]."

When the Center entered into the basic agreement of July 1, 1975, it agreed to the letter of credit procedures to be provided by instruction from the Government (see Article III, paragraph 3 of the agreement). The second paragraph of the ICA letter of credit instructions that were provided the Center states that:

> "* * * the recipient organization commits itself to: (1) the practice of initiating cash drawdowns only when actually needed for its disbursements; (2) the timely reporting of cash disbursements and balances as required by USICA * * *."

There is apparently no dispute over what has happened; the dispute is essentially over the legal consequences of what has happened. The Center has made a practice of withdrawing grant funds and earning interest on these funds before disbursing them for grant purposes. The argument that some portion of this interest can be retained rests on a view of the unique Federal relationships under which the Center is funded. Under this view the Federal Government provides for basic institutional support of the East-West Center as an entity. Since we have concluded that the Center must be treated as a grantee, we consider the interest questions within this grant context.

From these facts it is apparent that the Center has been under a basic misapprehension about its Government funding stemming from its view of its unique status. Grantees may not take grant money prior to needing it for grant purposes and invest it. See Treasury Department Circular No. 1075, 31 C.F.R. § 205.4(a). While it may seem a prudent and benign practice from the grantee's point of view, it is an exceedingly expensive one for the Government. The Government must normally borrow money to make such advances (probably at much higher rates than grantees earn in savings accounts or even certificates of deposit). See B-146285, October 2, 1973. Furthermore, the interest, even where applied to grant purposes, serves as an augmentation of the program appropriation under which the grantee receives funds and accordingly it is beyond the authority of the grantor agency--in this case ICA--to approve its retention.

The Center does not dispute that some of the interest earned must be returned, but it argues that much of the interest earned is the result of cash balances and reserves rather than current grant revenues. It correctly points out that interest is earned on balances not on revenues in any case. However, it does not provide any explanation for the ICA audit finding that the cash balances and reserves are themselves the result of excessive advances of Federal funds.3/ Indeed, the fundamental argument the Center makes for its need for special cost principles, discussed below, is that it gets virtually no funds from non-Federal sources. Under such circumstances the proposed 94.6 percent allocation rate for interest appears to be reasonable, despite the fact that it is based on revenues. Given the fact that the letter of credit has been misused by the Center, the burden is on the Center to provide an alternative allocation that traces precisely the non-Federal portion of the balances upon which it asserts its claim to interest. Accordingly, based on the information before us, we conclude that the Center owes ICA $25,688 for interest earned during fiscal year 1978. If the interest question raised by the ICA audit was overlooked in prior audits, it has no bearing on the outcome in this instance since under our analysis, ICA is without authority to approve retention of this amount by the Center.

3/ We note that as a result of this practice the fund balance used by the Center to estimate interest income rose from $482,000 at the beginning of the fiscal year to $990,000 at its end.

Indirect Costs

As set forth in the voluminous materials before us, the Center's practice has been to charge all overhead or indirect costs to the ICA program on the ground that the Government, through ICA, is required to pay for the basic support of the Center's operations. Starting from this premise, the Center claims that charges against other Federal grants should be treated as if no indirect costs had been paid. This is explained on page 19 in the April 30, 1980, report by the Center's auditors (the Center uses the report to support its argument) as follows:

> "The primary focus of this USICA audit report and subsequent correspondence concerns the method of handling indirect cost recoveries. In accordance with the East-West Center Budget, Accounting, and Cost Principles Agreement signed by ICA on September 29, 1978, indirect cost recoveries for the year ended September 30, 1978 were handled as follows:
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> "1. For purposes of budgeting, estimated indirect cost recoveries from other than the ICA grant were deducted to arrive at the appropriation request.
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> "2. For purposes of accounting, most indirect expenses were charged to Fund Group I (the appropriation). Indirect cost recoveries from supplemental funding sources were recorded in Fund Group II (the Center's unrestricted general funds) and used to pay for program expenditures that otherwise would have been charged to Fund Group I (the appropriation).
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> "Since the underlying concept of the Center's budgeting process is an all-inclusive presentation, the only possible issue is that the Center arbitrarily, and for administrative convenience, used the appropriation to pay substantially all indirect costs and the indirect cost recoveries to pay other program expenditures. The fact still remains that the ICA grant has saved the amount of indirect costs recovered in support of the total education, research and training planned by the Center. Had these costs not been recovered, the appropriation request would have to have been for a greater amount in order to support the same level of programs."

The Center's position rests on the reading of the special cost agreement contained in the Memorandum of Understanding of September 28, 1978, which indicates that there are two sets of cost and accounting principles. See Appendix A, page 2 of the agreement. We do not believe this agreement should be read as the Center would have us read it. First, the fact that there are separate costs principles does not mean that they should be inconsistent. The need for two sets of principles is consistent with the need to work out some special cost arrangements for the main Center grant, but does not suggest to us that the differences go beyond those specifically listed. Second, the indication that if surpluses in the Center's financial operations occur they will be available to the Center in succeeding budget periods, does not authorize the Center to build cash reserves out of Federal funds. Funds awarded grantees may remain available in succeeding budget periods without being withdrawn and held by the grantee. Under a letter of credit grantees should not withdraw funds unless they are needed for actual disbursements for grant purposes. Treasury Department Circular No. 1075, 31 C.F.R. § 205.4(a).

Accordingly, we have little difficulty in disposing of the question of indirect costs since the dispute seems to center not so much on the facts, but the Center's view of its special relationship with the Federal Government discussed above. We believe the classification of the Center as a grantee provides the answer. Any grantee must account for Federal funds in such a way as to satisfy the requirements of 31 U.S.C. § 628 (1976) which provides that appropriated funds are to be used only for the purposes for which they were appropriated. As indirect costs are merely an accounting tool to prorate overhead type costs among objectives that share the general benefits of such costs, any over-allocation is unauthorized since not for the purposes of the appropriation and must be returned to the Government. We agree with ICA that the Center has in effect been double billing the Federal Government to the extent it pays substantially all overhead from its grant from ICA and charges other Federal agencies for the same indirect costs from their grants. The amount of indirect charges to other Federal grants covered by ICA agreement costs should be disallowed by ICA and established as a claim against the Center. We note that this conclusion would not require the Center to take indirect costs from other funds that have been given under conditions that do not permit a portion to be expended for indirect costs. The ICA grant would normally be available to cover the indirect costs associated with expenditures from such restricted sources.

Cost Principle Applicable to Center

The last area of disagreement largely concerns a variety of specific cost principle questions that grow out of the ICA audit recommendation that OMB Circular A-21 should be applied in the future to the ICA grant to the Center. These questions range from an indirect cost issue discussed under the 1978 agreement and certain direct cost variations from the A-21 principles that the Center considers vital to its program.

The status of OMB Circular A-21 is a point that should be initially clarified. The agreement of 1978 between ICA and the Center in which cost principles are set forth governs the first two questions raised by ICA. This would have been so even if under the terms of the circular, ICA should have applied OMB Cicular A-21. OMB management circulars such as A-21 are not applicable to a grant unless the granting agency makes them applicable by regulation or by grant condition. Cf. B-203452, December 31, 1981 (OMB Circulars are management tools which do not have force of law). Where agencies adjust management circulars to accommodate them to their particular program needs, conflicting circular provisions are without effect. Cf., id. The issue is not before us, nor have we attempted to review, whether the 1978 agreement on cost principles conforms with OMB management circulars nor have we considered whether ICA is within its independent program authority where the agreement varies from the circulars. ICA should resolve any question as to which circular provisions should be applied directly with OMB.

The cost principles that may be adopted by ICA aside from OMB's management directions are limited by the general rules applicable to accounting for appropriated funds and the specific program authorization under which they are expended. We note that whatever cost principles are adopted in the future, legally they will be a result of ICA action. The Center by accepting the grant offered by ICA will be committed to accounting for ICA funds under the principles as adopted.

We see no reason to go further at this time. The title of A-21 "Cost Principles for Educational Institutions," seems appropriate to the Center, but each of the other OMB cost principle circulars are fundamentally consistent. Compare A-21 with A-87 "Cost Principles for State and Local Governments" and A-122, "Cost Principles for Nonprofit Organizations." The argument between ICA and the Center, once the indirect cost issue is resolved, deals with the policy questions of how far to go in establishing exceptions to the OMB cost principles. Since the ICA program with the Center is an institutional form of support as distinguished from the project grants contemplated in the OMB cost principle circulars, there would appear to be some justification for variations from the OMB cost principles, but the caution apparent in the ICA audit recommendation to limit the variations seems appropriate to us as well. As indicated, the determination of what cost principles should be applied is for ICA to make. Under our earlier analysis of the indirect cost issue, however, cost principles used in the future will have to avoid the Center's dual system that resulted in double billing of these costs.

Finally, we recommend that whatever cost principles are adopted, they should include a requirement that all audits be conducted under the Comptroller General's "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

Comptroller General
of the United States