



Memorandum

Date " MAR -6 1997

From Deputy Inspector General
for Audit Services

Subject Report on Proposed Changes to the Office of Management and Budget Circular A-21
Regarding the Financial Management of Recharge Centers (CIN: A-09-96-04003)

To Terrence J. Tychan
Deputy Assistant Secretary for
Grants and Acquisition Management

Attached are two copies of the United States Department of Health and Human Services (HHS), Office of Inspector General's (OIG) report, entitled, "Report on Proposed Changes to the Office of Management and Budget Circular A-21 Regarding the Financial Management of Recharge Centers." This report discusses ways to clarify guidance provided in the Office of Management and Budget (OMB) Circular A-21 regarding the financial management of recharge centers at universities.

A recharge center operates as an in-house enterprise that provides goods and services to individual users and other operating units on a cost reimbursement basis. Generally, Circular A-21 requires each center to operate as a closed, self-adjusting system. By closed, we mean that all allowable expenses and revenues related to operating a center should be recorded in the center's accounts. By self-adjusting, we mean that the fund balance should accumulate the surplus or deficit of the operation of a center such that the billing rate can be adjusted to keep the fund balance within a reasonable range. However, we found that inadequate policies and controls over recharge centers at 15 universities we visited resulted in \$1.9 million in overcharges to the Federal Government. The \$1.9 million related to 21 of the 87 recharge centers reviewed. Specifically, recharge centers:

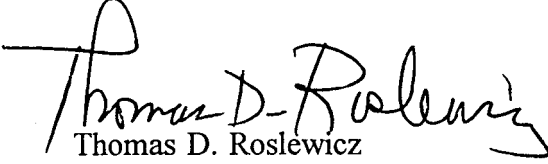
- ◆ accumulated surplus fund balances and deficits which were not used in the computation of subsequent billing rates;
- ◆ overstated billing rates by transferring funds from center accounts or including unallowable costs in rate calculations;
- ◆ billed users inequitably; and
- ◆ used recharge center fund balances (surpluses or deficits) inappropriately to calculate facilities and administrative (F&A) cost rates.

Page 2- Terrence J. Tychan

We believe the absence of adequate policies, procedures and controls in Section J.44 of Circular A-21 resulted in significant diversity among universities in the management of recharge center finances and the accumulation of surplus **fund** balances. We believe that Circular A-2 1 should be revised to include improved guidance regarding the financial management of recharge centers. This would include the creation of criteria for developing and reviewing billing rates, and accounting for and applying surplus and deficit balances. Generally, we are recommending policies that are patterned. **after** those used by State and local governments and found in **OMB** Circular A-87.

We would appreciate your views and the status of any **further** actions taken or contemplated on our recommendations, within the next 60 days. Any questions or **further** comments on any aspect of the report are welcome. Please call me or have your staff contact Joe Green, Assistant Inspector General for Public Health Service Audits, at 301-443-3582.

To facilitate identification, please refer to Common Identification Number **A-09-96-04003** on all correspondence relating to this report.



Thomas D. Roslewicz

Attachments

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REPORT ON PROPOSED CHANGES TO
THE OFFICE OF MANAGEMENT AND
BUDGET CIRCULAR A-21 REGARDING
THE FINANCIAL MANAGEMENT OF
RECHARGE CENTERS**



JUNE GIBBS BROWN
Inspector General

MARCH 1997
A-09-96-04003



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Subject Report on Proposed Changes to the Office of Management and Budget Circular A-21
Regarding the Financial Management of Recharge Centers (CIN: A-09-96-04003)

To Terrence J. Tychan
Deputy Assistant Secretary for
Grants and Acquisition Management

This final report discusses ways to clarify guidance provided in the Office of Management and Budget (OMB) Circular A-21 regarding the financial management of recharge centers at universities. A recharge center operates as an in-house enterprise that provides goods and services to individual users and other operating units on a cost reimbursement basis. The objective of this report is to recommend changes to Circular A-21 based on an evaluation of the Office of Inspector General (OIG) reviews of recharge centers.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Generally, Circular A-21 requires each center to operate as a closed, self-adjusting system. By closed, we mean that all allowable expenses and revenues related to operating a center should be recorded in the center's accounts. By self-adjusting, we mean that the fund balance should accumulate the surplus or deficit of the operation of a center such that the billing rate can be adjusted to keep the fund balance within a reasonable range. However, we found that inadequate policies and controls over recharge centers at the 15 universities we visited resulted in \$1.9 million in overcharges to the Federal Government. The \$1.9 million related to 21 of the 87 recharge centers reviewed. Specifically, recharge centers:

- ◆ accumulated surplus fund balances and deficits which were not used in the computation of subsequent billing rates [page 6];
- ◆ overstated billing rates by transferring funds from center accounts or including unallowable costs in rate calculations [page 8];
- ◆ billed users inequitably [page 10]; and
- ◆ used recharge center fund balances (surpluses or deficits) inappropriately to calculate facilities and administrative (F&A) cost rates* [page 10].

* The May 8, 1996 revision to Circular A-21 changed the term "indirect cost rates" to "facilities and administrative (F&A) cost rates." We use the term F&A throughout the report.

The ambiguity and lack of specific instructions in Circular A-21 may have contributed to the significant diversity in practice at universities. As such, we believe that the starting point for improving university oversight of recharge centers is to revise Section J.44 of Circular A-21 in a manner similar to the recently revised OMB Circular A-87, "Cost Principles for State, Local and Indian Tribal Governments." Thus, we identify ways to clarify the criteria in Circular A-21 regarding the financial management of recharge centers. This would include the creation of criteria for developing and reviewing billing rates, and accounting for and applying surplus and deficit balances.

The Deputy Assistant Secretary for Grants and Acquisition Management (DASGAM) concurred with our recommendation to have the Assistant Secretary for Management and Budget (ASMB) request that OMB incorporate our proposed criteria into Circular A-21. We also received comments from the Council on Governmental Relations (COGR) which comprises 140 research-intensive universities in the United States and helps develop policies and practices related to the administration and conduct of Federal research and training. COGR generally agreed with our findings and recommendations and offered to assist in publicizing the report's recommendations. The DASGAM and COGR comments are summarized following the **RECOMMENDATIONS** section and appended in their entirety to this report (see APPENDICES A and B).

BACKGROUND

This review is an expansion of our initial nationwide review of recharge centers at 12 universities (CIN: A-09-92-04020). Our initial review showed that 11 of the 12 universities did not maintain adequate accounting systems and records to allow for the development of billing rates based on actual costs or for the identification of surplus or deficit fund balances. These weaknesses resulted in some recharge centers: (1) accumulating surplus and deficit fund balances that were not adjusted for in subsequent billing rates; (2) including duplicate or unallowable costs in billing rates; (3) including recharge center costs in the calculation of F&A cost rates; (4) using recharge center funds for unrelated purposes; and/or (5) billing some users at reduced rates. These weaknesses caused billing rates to be overstated, resulting in overcharges of \$3.2 million to the Federal Government at the 12 universities. Due to the widespread nature of the problems encountered in our initial review of 12 universities, we decided to expand our coverage to other large universities with recharge centers. For our current review and report, we worked in partnership with the universities to evaluate recharge center operations and re-emphasize our recommendations to Circular A-21, which have not yet been adopted by OMB.

RECHARGE CENTERS

Recharge centers at universities, also known as specialized service facilities or internal service centers, operate as in-house enterprises. The centers typically include motor pools, telecommunications, computer centers, supply stores, animal care facilities, and other

specialized services. These centers provide goods and services to individual users and other operating units. The costs of providing goods and services are recharged to users, including federally sponsored agreements, based on established billing rates and actual usage of services. Generally, billing rates are calculated by dividing estimated costs for providing a service by the projected number of services to be provided during a given period. Rates should be reviewed periodically for consistency with the long-term plan and adjusted, if necessary.

OFFICE OF MANAGEMENT AND BUDGET CIRCULARS

The OMB Circulars A-21 and A-133 provide guidance on the costs charged to Federal grants and contracts by specialized service facilities. Circular A-21, "Cost Principles for Educational Institutions," provides universities with guidelines for determining direct costs, and facilities and administrative costs to charge federally sponsored agreements. Costs charged to Federal grants and contracts by specialized service facilities must meet requirements set forth in Circular A-21. The OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions," and the Compliance Supplement to A-133, details compliance requirements that should be considered by independent auditors in planning, performing and reporting on organization-wide audits of educational institutions.

OBJECTIVE, SCOPE, AND METHODOLOGY

OBJECTIVE

The objective of this report is to recommend changes to OMB Circular A-21 based on an evaluation of the OIG reviews of recharge centers at 15 universities. The objective of the individual reviews at 15 universities was to work in partnership with the universities to assess controls over the financial management of recharge centers. The universities performed the preliminary survey work while we evaluated the policies and internal control procedures of recharge centers for compliance with Circulars A-21 and A-133. Specifically, we determined whether there were adequate controls to: (1) establish, monitor and adjust billing rates to eliminate accumulated surpluses and deficits; (2) prevent the use of recharge funds for unrelated purposes and exclude unallowable costs from the calculation of recharge rates; (3) ensure that Federal projects were billed equitably; and (4) exclude recharge costs from the calculation of the F&A cost rates.

SCOPE

We reviewed the results of the OIG reports on audits of recharge center controls at 15 universities in Fiscal Years (FYs) 1995 and 1996. We evaluated the reports to determine whether university recharge centers were operated in compliance with Circular A-21 and other Federal guidelines.

Generally, the universities selected for review received significant Federal funding as reported by the National Science Foundation, which ranks the universities based on annual funding received from the Federal Government, and were not included in the initial review. In FY 1992, 10 of the universities reviewed were in the top 50 educational institutions receiving the largest amount of Federal funding for research and 4 universities were in the second 50. From the 15 universities, we selected a total of 87 recharge centers for detailed review based on several factors. The primary factors were total charges to Federal grants and contracts, unusual variations in fund balance, and size of the fund balance in relation to annual revenues. We did not review departmental service units which generally provide services to a particular department, college, or school.

METHODOLOGY

To accomplish our objective, we analyzed the 15 audit reports and compared the results to the previous report on recharge centers entitled, "Summary Report on Audits of Recharge Centers at 12 Universities," (CIN: A-09-92-04020), issued January 24, 1994. In our analysis, we applied the principles of Circulars A-21 and A-133 and good management practices regarding the treatment of recharge centers. To identify criteria for good management practices, we used the principles in Circular A-87, revised on May 17, 1995, which provides principles for determining costs applicable to Federal programs which are operated by State and local governments.

Working in partnership, we consulted with two universities and held discussions with selected members of the Council on Governmental Relations (COGR) regarding the development of our audit methodology. The COGR is an association of leading research-intensive universities that helps develop policies and practices reflecting both Federal and university interests and obligations in Federal research and training. At the completion of our audit, we provided COGR with a copy of our draft report for their review and comment. We also solicited and obtained assistance from several universities to develop and test an internal control questionnaire which we used in our audits. The internal control questionnaire was designed to help universities identify control weaknesses in the operation of their recharge centers.

To identify the universities for detailed review, we requested recharge center account balances from 31 universities. Based on our analysis of the account balances, we selected 15 universities for detailed review. At the 15 universities, we requested assistance from internal auditors and other personnel to evaluate internal controls and complete the internal control questionnaire. We verified and analyzed the universities' responses to the internal control questionnaire during on-site reviews and issued reports which recommended ways to improve internal controls. We relied on university accounting records to analyze fund balances on recharge accounts. To determine which centers were not operating on a cost reimbursement basis, the auditors identified recharge centers which were clearly accumulating or maintaining excess balances over a 3-year period. Specifically, the reports disclosed surpluses for centers that consistently accumulated surplus balances which exceeded 30 days of normal operating expenses or with balances that were steadily increasing over the 3-year period without

appropriate rate adjustments. The reports also included recommendations to improve the internal control structure regarding financial management of recharge centers.

The work at individual universities was performed at various times between September 1994 and September 1995. The results of the 15 audits were reviewed and summarized in San Francisco, California, during November 1995 through June 1996.

FINANCIAL MANAGEMENT OF RECHARGE CENTERS

We found that there was a wide variation in the financial management of recharge centers among universities. In our current review, 6 of the 15 universities had not established any formal policies and procedures for recharge centers. Nine of the 15 universities had policies and procedures which were not fully in conformance with Circular A-21, or had adequate policies and procedures but did not analyze or adjust billing rates as required by Circular A-21. The inadequate policies and controls over recharge centers resulted in \$1.9 million in overcharges to the Federal Government at 21 of the 87 recharge centers reviewed.

| POLICIES AND PROCEDURES Number of Universities | | |
|---|---------------------------|---------------------------|
| | <u>Current Review</u> | <u>Initial Review</u> |
| No Formal P&Ps | 6 | 2 |
| Inadequate & Not Followed P&Ps | 9 | 9 |

The ambiguity and lack of specific instructions in Circular A-21 may have contributed to the wide variation in the financial management of recharge centers because it did not provide clear guidance for universities to develop adequate policies, procedures, and performance measures. As such, we believe that the starting point for improving university oversight of recharge centers is to revise Section J.44 of Circular A-21 in a manner similar to the recently revised Circular A-87.

Generally, Circular A-21 requires each center to operate as a closed, self-adjusting system. By closed, we mean that all expenses and revenues related to operating a center should be recorded in the center's accounts. Generally, funds should not be transferred out of a center's accounts, but if transfers are made, an appropriate credit should be given to all Federal users. In addition, costs for unallowable items or for activities unrelated to the purpose of a center should not be charged to the center. By self-adjusting, we mean that the fund balance should accumulate the surplus or deficit of the operation of a center such that the billing rate can be adjusted to keep the fund balance within a reasonable range. Specifically, we found that recharge centers:

- ◆ accumulated **surplus fund balances and deficits** which were not used in the computation of subsequent **billing rates**;

- ◆ overstated billing rates by **transferring funds** from center accounts or including **unallowable costs** in rate calculations;
- ◆ **billed users inequitably**; and
- ◆ used recharge center **fund balances** (surpluses or deficits) inappropriately to **calculate F&A cost rates**.

FUND BALANCES AND BILLING RATES

Our current review disclosed that 13 universities had excessive surplus balances and 5 had deficit balances in recharge accounts. In our initial review, six universities had surplus balances and four had deficit balances. Surplus funds occur when the amounts billed for services exceed the cost of providing such services. Deficits occur when amounts billed are less than the actual costs.

| SURPLUS AND DEFICIT FUND BALANCES | | |
|--|------------------------------|------------------------------|
| Number of Universities * | | |
| | <u>Current Review</u> | <u>Initial Review</u> |
| Surplus Balances | 13 | 6 |
| Deficit Balances | 5 | 4 |

* Some universities had both surplus and deficit balances.

The prevalence of large accumulated fund balances and deficits in recharge centers indicates that the cost reimbursement basis is not always being followed in practice. Section J.44.c of Circular A-21 states that universities are not allowed to recover more than the aggregate costs of recharge center services and requires rates to be reviewed periodically and adjusted if necessary. Billing rates and fund balances are linked and, in a closed system, centers with excessive rates accumulate surpluses. We found that universities did not always monitor fund balances to assess the appropriateness of current billing rates. We also found that excessive surplus balances occurred because of the absence of policies related to working capital reserves, inadequate controls related to the development of billing rates, and inadequate guidance for the review and adjustment of billing rates.

FUND BALANCES AND WORKING CAPITAL

Although Circular A-21 makes no provision for working capital, we found that universities attempted to justify the accumulated fund balances by saying that recharge centers needed working capital. However, we found that universities often did not have a policy establishing a reasonable level of working capital or the treatment of interest earned by such funds. Circular A-21 should be revised to define a reasonable level of working capital for centers. Similar to Circular A-87, each recharge center should be permitted to maintain a reserve of up to 60 days of allowable cash expenditures (excluding depreciation/use allowance) for

normal operating purposes. Surplus funds could then be defined as the retained earnings of a center in excess of the allowable working capital reserve. If Circular A-21 is revised to allow for working capital, we believe it should also specify that interest earned on fund balances be credited to center accounts and used to reduce billing rates.

DEVELOPMENT OF BILLING RATES

Although 9 of the 15 universities in our current review had developed policies and procedures for the financial management of recharge centers, none of the universities had adequate controls to ensure that billing rates were based on cost, and reviewed and adjusted as appropriate. Circular A-21 does not provide adequate guidance to universities for developing cost studies to support billing rates. Universities used a variety of methods for setting rates such as using market prices or a cost-plus basis. We believe that cost studies, which some universities already use, is an effective and preferable method for determining allowable costs and setting billing rates. We believe the use of cost studies is implied in Circular A-21 and clearly stated in Circular A-87 and the Compliance Supplement to Circular A-133. The use of a cost study would ensure that the center's rates are developed based on three components: (1) estimated revenues based on projected units of goods or services to be sold; (2) estimated allowable costs related to providing the goods or services; and (3) the year-end surplus or deficit balance.

REVIEW AND ADJUSTMENT OF BILLING RATES

Universities are required to review billing rates to ensure that recharge centers do not recover more than the actual costs of providing goods and services. However, the guidance provided for reviewing billing rates in Circular A-21 was unclear and subject to varying interpretations which may have resulted in the accumulation of surplus fund balances. For example, Section J.44 states that recharge centers may recover the ***aggregate cost of the services*** over a ***long-term period***, and that centers should review rates ***periodically*** and adjust, ***if necessary***. Since these terms were ambiguous, universities effectively established their own criteria by defining them. For example, one university had not reviewed billing rates at five of its recharge centers for 2 to 5 years while another university stated that it used a rolling 5-year operating cycle for recharge centers.

When recharge centers do not develop billing rates based on cost, users, including federally sponsored research, may be overcharged for services. To ensure that federally sponsored projects are charged the appropriate costs, Circular A-21 should require universities to review billing rates at least annually and to adjust rates when fund balances exceed a pre-defined level.

TRANSFERS AND UNALLOWABLE COSTS

When universities transfer funds from recharge centers or include unallowable costs in recharge accounts, both practices work to overstate the billing rates. In our current review, we found that six universities inappropriately transferred funds from recharge accounts. When such transfers are made, revenue collected is not matched with charges to users and is not available to reduce the billing rates in subsequent periods. Five universities also included unallowable costs in the computation of the billing rates. Billing rates should be based on the actual, allowable costs for providing the services or goods of the center.

| TRANSFERS AND UNALLOWABLE COSTS | | |
|---|-----------------------|-----------------------|
| Number of Universities * | | |
| | <u>Current Review</u> | <u>Initial Review</u> |
| Transfers | 6 | 4 |
| Unallowable Costs | 5 | 9 |
| * Some universities had both transfers and unallowable costs. | | |

TRANSFERS

Recharge centers at six universities transferred funds from recharge accounts (1) to reserve accounts for the purchase of equipment and other assets, and (2) to other accounts for disbursements unrelated to the purpose of the centers. Since the transferred funds were not used to reduce the appropriate billing rates, users of the recharge centers, including federally sponsored agreements, were overcharged.

We found that surplus funds were transferred inappropriately or disbursed for purposes unrelated to the center, netted against deficit balances in other centers, or used in the calculation of F&A cost rates. Since a recharge center obtains its revenue from a specific set of users, any disposition of fund balances should be distributed to the original users in relation to the amounts contributed. Although Circular A-21 is silent regarding transferring funds from center accounts, the Compliance Supplement to Circular A-133 interprets Circular A-21 for auditors by requiring them to determine whether a refund was made to the Federal Government for its share of any amounts transferred. Circular A-21 should be revised to specify that surplus and deficit balances should be used in the calculation of billing rates for the center which accumulated the surplus or deficit, or that the Federal share of surplus be refunded to the appropriate Federal agency annually.

EQUIPMENT AND OTHER ASSETS. Recharge centers at five of the six universities we reviewed transferred funds to reserve accounts for equipment replacement, building construction and capital improvements. However, the amounts transferred exceeded recoveries made from depreciation or use allowance, effectively using billing rates to recover amounts in excess of costs which is not consistent with Circular A-21. Although Circular

A-21 allows institutions to recover the cost of equipment, buildings and capital improvements, the amount recovered should be based on depreciation or use allowance. In addition, generally accepted accounting principles (GAAP) requires the cost of an asset to be depreciated over its expected useful life. In our initial review, 4 of the 12 universities transferred funds in this manner from recharge accounts resulting in overcharges to Federal projects.

UNRELATED DISBURSEMENTS. Two of the six universities transferred or disbursed funds from four recharge center accounts for purposes unrelated to the activity of the center. In this way, users of the center were charged for costs which did not relate to providing the center's goods or services. For example, in our current review, one university transferred funds from three recharge centers to other centers to pay for start-up costs or to reduce deficits.

If a university transfers funds from a center, the Federal share of the transferred funds should be refunded to the Federal Government. The Compliance Supplement to Circular A-133 requires the auditor to determine "*whether a refund has been made to the Federal Government for its fair share of any amounts thereof which have been removed or borrowed from the fund.*" The Compliance Supplement also states that the methods used to adjust for accumulated over/under recoveries should distribute these amounts in reasonable proportion to the same users as were originally billed for the services which created the accumulation. Using surpluses from one recharge center to offset deficits in another center would not meet this requirement because some sponsored projects do not use recharge centers and some use certain recharge services more than others.

UNALLOWABLE COSTS

In our initial review, we found that 9 of the 12 universities allowed recharge centers to charge unallowable costs to recharge accounts resulting in overcharges to Federal agreements. Unallowable costs are those costs associated with items which are (1) not in accordance with GAAP, (2) specifically treated as an unallowable cost by Circular A-21, or (3) not related or beneficial to the operation of the recharge center. The most frequent type of unallowable cost we found was related to the improper treatment of assets as expenses, a violation of GAAP. Expensing the cost of an asset, whether by charging the total cost of the asset to the recharge account upon purchase or by transferring funds to a reserve account to cover the acquisition costs of the asset (as described above in the *TRANSFERS* section), resulted in overcharges to users of the recharge center, including federally sponsored agreements.

In our current review, some universities also treated the acquisition cost of equipment and inventory incorrectly. These costs were recorded as expenses in the year of purchase. Also, one center included charges unallowable under Circular A-21 in its rate proposal. Expenses that are not related to the operation of a center or which do not benefit a center's purpose also overstate billing rates. Circular A-21, Section J.44 on specialized service facilities,

should specify that unallowable costs or costs for activities not related or beneficial to the operation of a recharge center should not be used in the determination of the billing rate.

INEQUITABLE BILLING OF USERS

In our current review, 3 of the 15 universities allowed recharge centers to bill users at different rates for the same services. At one university, a center improperly provided discounted rates to certain users. At the other two universities, two centers provided discounted rates to customers which utilized a high volume of services. In our initial review, we found that 2 of 12 universities did not bill all users for recharge services or billed certain users at reduced billing rates, resulting in overcharges to Federal agreements.

| INEQUITABLE BILLING OF USERS | | |
|-------------------------------------|-----------------------|-----------------------|
| Number of Universities | | |
| | <u>Current</u> | <u>Initial</u> |
| | <u>Review</u> | <u>Review</u> |
| Not Billing All Users Equitably | 3 | 2 |

Section J.44.c of Circular A-21 requires that billing rates not discriminate between federally and nonfederally sponsored activities, including university internal activities. If recharge centers provide preferential treatment to a subset of users by billing them at reduced rates, other users would have to be billed at rates in excess of cost to recover uncollected revenues. Therefore, universities which choose to provide certain recharge services to specific users at no cost or at reduced rates should ensure that recharge centers account for both the actual and imputed revenues in calculating the rates in the center's cost study. Including both actual and imputed revenues in billing rate calculations would ensure that those users billed at the full rates do not subsidize the unbilled or underbilled users of the center. If the imputed revenue related to those users billed at no cost or reduced rates are not used to calculate the center's billing rates, federally sponsored research could be overcharged even though a center did not accumulate a surplus fund balance. Consequently, Circular A-21 should be revised to require universities to establish procedures to assure that all users are billed equitably and billed users are not subsidizing unbilled or underbilled users.

FUND BALANCES INCLUDED IN F&A COSTS

Recharge center costs should be used to determine billing rates, but not F&A cost rates. In our current review, 3 of the 15 universities included recharge center surplus and deficit balances in the calculation of F&A cost rates. This practice was also identified at two universities in our initial review. Circular A-21 is silent on the need to keep recharge center costs separate from the F&A cost rate calculation. However, using fund balances in the computation of F&A cost rates tends to allocate costs or credits to all projects rather than to the specific subset of projects which benefitted from the operation of the recharge centers. We believe the absence of specific guidance in Circular A-21 contributed to the universities'

| FUND BALANCES USED FOR F&A COST CALCULATION Number of Universities | | |
|---|----------------------------------|----------------------------------|
| | <u><i>Current Review</i></u> | <u><i>Initial Review</i></u> |
| Fund Balances in F&A Costs | 3 | 2 |
| Duplicate Recovery of Costs | 0 | 3 |

practice of including recharge costs in the F&A rate calculations. When a surplus balance (which occurs when revenues exceed expenses) is included as a credit in an F&A cost pool, the F&A cost rate may be understated. In this way the users of the center would be overbilled, but the resulting credit would be allocated to all sponsored agreements through a lower F&A cost rate and would not be refunded in reasonable proportion to the same users

as were originally billed. Conversely, when a deficit balance (expenses exceed revenues) is included in an F&A cost pool, the F&A cost rate may be overstated and the center's billing rate would be understated.

Furthermore, duplicate recovery of recharge center costs would occur if a university included recharge balances in the F&A cost rate calculation and also used the fund balance in the computation of subsequent billing rates. Although we did not identify this problem in our current review, we found that 3 of the 12 universities in our initial review had included recharge center surplus and deficit balances in its F&A cost proposal and billing rate calculations. This resulted in duplicate recovery of costs which is not consistent with the cost principles.

CONCLUSION

Generally, Circular A-21 requires each recharge center to operate as a closed, self-adjusting system. By closed, we mean that all expenses and revenues related to operating a center should be recorded in the center's accounts. By self-adjusting, we mean that the fund balance should accumulate the surplus or deficit of the operation of a center such that the billing rate can be adjusted to keep the fund balance within a reasonable range. However, we found that universities accumulated excessive surplus fund balances which were not used to adjust subsequent billing rates, overstated rates by transferring funds to other accounts and by charging the center with unallowable costs, billed users in an inequitable manner, and improperly used recharge center fund balances to calculate indirect cost rates.

We believe that the incomplete and unclear guidance in Section J.44 of Circular A-21 may have hampered universities regarding the development of adequate policies, procedures, and controls for recharge centers. The absence of adequate policies, procedures, and controls resulted in significant diversity among universities in the management of recharge center finances and the accumulation of surplus fund balances. We believe that Circular A-21 should be revised to include improved guidance regarding the financial management of recharge centers. This would include criteria for developing and reviewing billing rates, and

accounting for and applying surplus and deficit balances. Generally, our recommendations are patterned after policies included in Circular A-87.

RECOMMENDATIONS

We recommend that the Assistant Secretary for Management and Budget propose the following changes to Circular A-21 that would include criteria for:

- (1) Establishing, monitoring and adjusting billing rates to eliminate accumulated surpluses and deficits:
 - ◆ Require cost studies as a basis for establishing billing rates;
 - ◆ Require universities to review billing rates at least annually and adjust rates if the fund balances exceed a pre-defined level of reasonableness;
 - ◆ Permit a reserve for working capital similar to that proposed for Circular A-87 by stipulating that a recharge center surplus fund should not exceed 60 days of allowable cash expenditures (excluding depreciation/use allowance) for normal operating purposes; and
 - ◆ Credit recharge center accounts with interest earned on fund balances.
- (2) Preventing the use of recharge funds for unrelated purposes and exclude unallowable costs from the calculation of recharge rates:
 - ◆ Specify that surplus and deficit balances be used in the calculation of billing rates or that Federal share of surplus be refunded to the appropriate Federal agency annually;
 - ◆ Require all Federal projects be credited or refunded the Federal share of funds transferred from or used for purposes unrelated to the operation of the center; and
 - ◆ Specify that unallowable costs or costs for activities not related or beneficial to the operation of a recharge center should not be used in the determination of the billing rate.
- (3) Ensuring that Federal projects were billed equitably:
 - ◆ Require procedures be established to assure that all users are billed equitably and billed users are not subsidizing unbilled or underbilled users.
- (4) Excluding recharge costs from the calculation of the F&A cost rates:

- ◆ Specify that costs cannot be used in the computation of both the university's F&A cost rates and recharge center billing rates except for minor variances between billed and actual costs.

COMMENTS FROM THE DASGAM AND COGR AND OIG RESPONSE

In written comments dated January 23, 1997, the DASGAM concurred with our recommendation to have ASMB request that OMB incorporate our proposed criteria into Circular A-21 (see APPENDIX A).

In COGR's comments dated December 17, 1996, COGR generally agreed with the findings and recommendations made in our report, and offered to help publicize our final report and have universities adopt its recommendations. In addition, to ensure a more timely implementation of the criteria proposed in the **RECOMMENDATIONS** section, COGR believes that the proposed criteria should be included in the Compliance Supplement to OMB Circular A-133, which provides guidance to independent auditors in conducting compliance audits of educational institutions (see APPENDIX B).

* * * * *

We would appreciate your views and the status of any further actions taken or contemplated on our recommendations, within the next 60 days. Any questions or further comments on any aspect of the report are welcome. Please call me or have your staff contact Joe Green, Assistant Inspector General for Public Health Service Audits, at (301) 443-3582.

To facilitate identification, please refer to Common Identification Number A-09-96-04003 on all correspondence relating to this report.


Thomas D. Roslewicz

APPENDICES



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of the Secretary

Washington, D.C. 20201

JAN 28 1997

TO: Thomas D. Roslewicz
Deputy Inspector General for Audit Services

FROM: Terrence J. Tychan *Terrence J. Tychan*
Deputy Assistant Secretary
for Grants and Acquisition Management

SUBJECT: Financial Management of Recharge Centers - Draft
(A-09-96-04003)

We have examined the above referenced draft that reports the results of reviews of recharge centers at 15 universities. The IG recommends that the ASMB request that OMB issue revisions to OMB Circular A-21 that would essentially incorporate A-87 policies concerning internal service funds. We concur with this recommendation and will be presenting a strong case to OMB to adopt the IG's recommendation.

While adding greater specificity to A-21 should enhance grantee understanding and compliance with the intent of A-21, the lack of specificity concerning recharge centers should not preclude us from taking immediate action. As was noted in the IG's report, sections of A-21 not dealing specifically with recharge centers provide more than adequate support and justification for questioning certain practices and costs. For example, the practice of reserving funds for the future replacement of equipment and capital improvements is unallowable under Section J.16 of A-21. (The Section prohibits capital expenditures except where they are prior approved by the awarding agency and are claimable as a direct cost. It follows that if capital expenditures are unallowable, then reserves for such expenditures constitute unallowable retained earnings.) Similarly, expenses charged to a recharge center that are not allocable to the center or to Federal programs are unallowable under the general tests of allowability under Section C. - Basic Considerations.

In reviewing summary data of audits issued over the last eighteen months, it appears that these issues, as a general rule, are primarily raised in audits performed by the HHS OIG. They tend to be absent in audits performed under the auspices of the single audits. Again, as noted in the IG report, the A-133 Compliance Supplement addresses many of these issues. Our obvious concern is whether the independent public accountants are adequately reviewing recharge center costs/billings.

In summary, while we will actively pursue with OMB changes to A-21, we believe we have existing rules that can be brought to bear to eliminate much of the abuse identified by the IG. Further, where questioned costs or practices are cited in either single audits or

IG conducted audits involving recharge centers, we will aggressively pursue recovery/corrective action based on the general provisions of A-21, regardless of the lack of specificity contained in Section J.44.

We appreciate the IG's efforts in this area and look forward to your Office's continued support. The ASMB contact on this matter is Ronald Speck on (202) 401-2751.

cc: Joseph Cook
Ronald Speck
Chuck Seed

COUNCIL ON GOVERNMENTAL RELATIONS

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December 17, 1996

Mr. Frank Zuraf
Director, PHS Audit Division
Public Health Service
Park Building, Room 1-30
12420 Parklawn Drive
Rockville, Maryland 20857

Dear Frank:

Thank you for sharing with us the draft Report on Proposed Changes to the Office of Management and Budget Circular A-21 Regarding the Financial Management of Recharge Centers. This demonstration of good will fosters an environment of partnership that allows the universities and the OIG to work together to reach the common goal of improving the management of recharge centers.

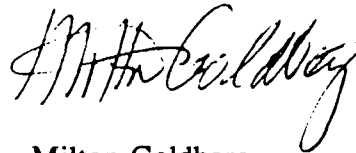
We support the basic underlying principle of Circular A-21 which calls for recharge centers to operate on a break-even basis. Therefore, we support the concept that accumulated surplus and deficit fund balances in recharge center accounts should be rolled forward and used in the computation of billing rates for the subsequent period. Further, we agree that such balances should not be transferred to outside accounts without providing appropriate adjustments to federal users for their proportional contributions to the surplus or deficit. We also agree that: (1) unallowable costs should be excluded from the rate calculation; (2) billing rates charged should be equitably applied to all users; and (3) no material amount of recharge center costs should be used to calculate facilities and administrative cost rates.

To ensure that the findings in the draft report are appropriately characterized and put into context, it would be useful to disclose the total dollar amount that was charged to federal agencies by the eighty-seven service centers for the period audited. This would place into perspective the \$1.9 million of federal overcharges asserted in the draft report. Additionally, each of the findings is displayed by number of universities in the draft report under the headings labeled Current Review and Initial Review, with no reference to the number of service centers to which the findings apply. In the current review of fifteen universities there were eighty-seven service centers audited (an average of approximately six centers per university) and in the initial review there were fifty-six service centers audited at twelve universities (an average of approximately five service centers per university). The relative difference between one out of twelve or fifteen and one out of fifty-six or eighty-seven is quite significant and could potentially overstate the frequency of a particular finding by five to seven times.

COGR would be pleased to work with the OIG to improve the overall management of university recharge centers, but we do not support revision of Circular A-21 as the way to accomplish that improvement. The process of revising Circular A-21 is a protracted and laborious one. While your draft report raises some problems that need to be addressed soon, nevertheless there is significant compliance by most universities. COGR can take the lead with the OIG in publicizing the report and urging that universities review their recharge center rates and bring them into line with the four recommendations contained in the report. Also, COGR would support inclusion of those criteria in the Circular A-133 Compliance Supplement that is now being updated to reflect the recent changes required by the single audit. Approaching the problem this way will assure that the recommendations are implemented on a more timely basis. This should provide sufficient guidance to recharge center management.

Again, thank you for the opportunity to comment.

Sincerely,

A handwritten signature in cursive script, appearing to read "Milton Goldberg".

Milton Goldberg
President