DCA Best Practices Manual For

Reviewing State and Local Governments

State/Local-Wide Central Service Cost Allocation Plans

And Indirect Cost Rate Proposals

U.S. Department of Health and Human Services
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DCA BEST PRACTICES MANUAL FOR REVIEWING

STATE AND LOCAL GOVERNMENTS

STATE/LOCAL-WIDE CENTRAL SERVICE COST ALLOCATION PLANS

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I. INTRODUCTION

This best practices review manual (hereinafter referred to as “the manual”) was developed to assist Division of Cost Allocation (DCA) staff in reviewing and negotiating state/local-wide central service cost allocation plans and indirect cost rates for state, local and Indian tribal governments. The manual addresses a number of important issues and subject matters, and presents DCA best practices that should be followed in planning and conducting reviews of proposed state/local-wide central service cost allocation plans and indirect cost rates. Alternative approaches and allocation methods are presented and discussed as appropriate. The development of billing rates for internal service funds and other interagency services is also discussed at length. Although the manual is intended to be reasonably detailed and comprehensive, it is not a substitute for professional experience and judgment. DCA staff should consider the complexity of the proposal, the level of Federal reimbursement, and prior experience with the governmental unit when planning the review.

The Office of Management and Budget (OMB) issues cost principles for all Federal agencies that award grants and contracts to state and local (including tribal) governments. Title 2 of the Code of Federal Regulations (2 CFR), Subtitle A, Chapter II, part 225 - Cost Principles for State, Local and Indian Tribal Governments (OMB Circular A-87) (hereinafter referred to as “the Circular”) establishes principles for determining costs applicable to those grants and contracts. The Circular contains general principles for determining allowable costs, both direct and indirect. It also contains information and guidance concerning the development and submission of state/local-wide central service cost allocation plans, indirect cost rates and public assistance cost allocation plans. This manual addresses the review and negotiation of state/local-wide central service cost allocation plans and indirect cost rates. Guidance with regards to public assistance cost allocation plans is provided in a separate best practices review manual.

The Circular was originally issued in 1969, with a number of revisions since that time. In May 1995, the Circular was completely updated and reissued including expanded guidelines in a number of areas that had produced conflicts and confusion during the preceding 25 years. Among the changes to the Circular were increased documentation requirements for salaries and wages, expanded allowability of certain interest expenses and clarification of policies with regard to pension and post-retirement health benefits. Of particular significance was the new requirement for extensive documentation in support of internal service funds, self-insurance funds, and fringe benefits. It also included, for the first time, a special attachment dealing specifically with public assistance cost allocation plans. The changes to the Circular are, in part, the reason this manual was originally prepared.

Subsequent revisions to the Circular are as follows:

- In August 1997, there was a minor modification to the Circular. Paragraph e. was added to Appendix A, section A.3. OMB authorized conditional exemption from OMB administrative requirements and cost principles for certain Federal programs.

- In May 2004, OMB amended the cost principles in OMB Circulars A-21, A-87 and A-122. The changes were meant to simplify the cost principles by making the descriptions of similar cost items consistent across the Circulars, where possible, and clarify existing policy. The changes were not meant to add restrictions or modify current requirements.

- In August 2005, OMB relocated the Circular to 2 CFR, Subtitle A, Chapter II, part 225 as part of an initiative to provide the public with a central location for Federal governmental policies on grants, and other financial assistance and non-procurement agreements.

The objective of the Circular is to provide specific and consistent principles and standards for determining costs of Federal awards carried out through grants, cost reimbursement contracts, and other agreements with governmental units. These principles are for the purpose of cost determination and are not intended to dictate the extent of Federal reimbursement for a program or project. There is a basic assumption that governmental units are responsible for the efficient and effective administration of Federal awards, and the Circular does not attempt to impose specific organization or management techniques to assure proper and efficient administration of Federal awards. The negotiator should keep these basic concepts in mind when drawing conclusions about the allowability of costs assigned to Federally financed activities.

The Circular contains five appendices: Appendices A and B address allowable costs and include specific guidance on various selected costs; Appendix C provides information related to state/local-wide central service cost allocation plans; Appendix D relates to public assistance cost allocation plans; and Appendix E deals with indirect cost rate proposals. As previously noted, this manual will provide DCA staff with recommended review procedures for state/local-wide cost allocation plans and indirect cost rate proposals. Public assistance cost allocation plans are dealt with in a separate best practices review manual.

In addition to the Circular, the Department of Health and Human Services (HHS), in coordination with OMB, has developed an implementation guide entitled, “A Guide for State, Local and Indian Tribal Governments” (ASMB C-10). The ASMB C-10 is intended to assist governmental units in applying the principles and standards contained in the Circular. It was issued in April 1997 by the HHS, Office of Audit Resolution and Cost Policy in accordance with the mandate contained in the Circular. The ASMB C-10 provides interpretation of the provisions of the Circular, and will also provide the negotiator with answers to many of the issues concerning cost policy not specifically addressed in the Circular.

Questions or clarifications regarding the information presented in this best practices manual should be directed to Janet Turner, State and Local Government National Specialist, by e-mail at janet.turner@psc.hhs.gov. Questions specific to a grantee should be directed to the cognizant DCA Regional Office.

II. GENERAL REVIEW

This section provides general review steps that are standard when either reviewing a state/local-wide cost allocation plan or an indirect cost rate proposal. Detailed review steps for the specific types of proposals are addressed in subsequent sections of the manual.

A. PRELIMINARY REVIEW

STEPS	COMMENTS
1. Determine whether the proposal package is complete, in sufficient detail to permit an adequate review, and is in a format that can be readily followed by the negotiator.	The proposal package should include: • The proposal itself, including detailed schedules on the composition and allocation of all allocated, billed or indirect cost centers. • A copy of the Comprehensive Annual Financial Report (CAFR) and/or any other financial records supporting the amounts included in the proposal. • A detailed and understandable reconciliation of the costs included in the proposal to the CAFR and/or any official accounting records. • A signed Certificate of Cost Allocation Plan or Certificate of Indirect Costs as required by the Circular. • An explanation of any significant increases in individual cost centers or rate components (e.g., a proposed central service or significant indirect cost rate component that is more than 10 percent

STEPS	COMMENTS
	higher than the level negotiated for the prior year). • Any other information specifically requested by the DCA as a condition of prior negotiation agreements. The submission requirements for the specific types of proposals are contained in later sections of this manual.
2. Review the prior negotiation workpapers and determine the following:	
a. When was the last on-site review conducted?	
b. Were there any findings/recommendations contained in the most recent OMB A-133 Single Audit report that should be considered in the current review?	Review the OIG Clearance Document to determine if agreed-to adjustments have been included in the proposal.
c. Review negotiation adjustments and ensure corrections were included in the current proposal.	If the corrections were not made, or conditions were not fulfilled, appropriate adjustments should be made.
d. Did the negotiation agreement contain any conditions? If so, has the grantee complied with those conditions?	
e. If fixed rates/amounts were negotiated, does the carry-forward amount in the current proposal agree with the prior written carry-forward agreement?	

STEPS	COMMENTS
3. By comparing the submission with prior negotiations, identify any aspects of the proposal which appear out-of-line and are not fully explained or discussed in the proposal package.	
4. Reconcile the proposal to the financial statements.	For specific steps, see Section B, Reconciliation of Proposal to Financial Statements, below.
5. "Test-check" the mathematical computations to ensure their accuracy.	These verifications and the extent to which the verifications were made should be noted on the proposal, workpapers, etc.
6. Perform a trend analysis of the cost pools, allocation bases and/or indirect cost rates.	For specific steps, see Section C, Trend Analysis, below.
7. Determine if the grantee is proposing any cost/rate increases beyond those based on historical costs.	Proposals which include projected costs usually require a more detailed review. See separate sections of this manual for a more thorough discussion of projected cost increases.
8. Based on the results from the prior review steps, determine the areas of the proposal that appear to require an in-depth review and/or an on-site review.	On-site reviews are usually required for state-wide cost allocation plans and indirect cost proposals from agencies that receive substantial Federal funding.

B. RECONCILIATION OF PROPOSAL TO FINANCIAL STATEMENTS

Costs included in the cost allocation plan or indirect cost rate proposal must ultimately be reconciled to the Comprehensive Annual Financial Report (CAFR) or other official accounting records. The reconciliation process will generally require the use of detailed accounting records such as appropriation statements or similar budget and expenditure documents. These documents are the official accounting records of the state/locality and are the source of the expense information contained in the CAFR. The information in these statements should provide the necessary information to determine that costs have been properly categorized as allowable or unallowable. The review is incomplete without this reconciliation.

STEPS	COMMENTS
1. Reconcile the proposal to the CAFR and/or other official accounting records.	Total costs for each agency should be reconciled first to the Statement of Expenditures or similar document. These documents are the source of the expenditure information included in the CAFR. In many cases the amount reported in the CAFR will be the sum of a number of appropriation accounts and may include reclassifications or other adjustments. A careful examination of these accounts is necessary to *e*nsure that all appropriate costs have been included in the proposal. It will also enable the negotiator to identify any unallowable or unallocable costs.
2. Once the negotiator is assured that the costs included in the proposal agree with the CAFR/financial statements, adjustments for unallowable or additional costs should be examined for appropriateness.	Refer to the Circular, Appendix B, for a discussion of allowable and unallowable costs. Additional costs not recorded on the books of account, such as “use allowances”, must be reviewed for adequate support. Additional information regarding the reconciliation and verification of costs included in the proposal is contained in sections of this manual dealing with specific types of rate/cost allocation proposals.

C.

TREND ANALYSIS

A trend analysis of the costs, rates, and allocation bases should be performed during the preliminary review for all state/local-wide cost allocation plans and for those indirect cost rates where significant federal funds are involved. A trend analysis can usually be completed in a short time and may provide the negotiator with insight into the areas of the proposal needing a more detailed review.

STEPS	COMMENTS
1. Complete a detailed trend analysis of the cost pools, allocation bases, and/or indirect cost rates as appropriate. The analysis should compare costs for a minimum of three years.	There are a variety of areas in which a trend analysis may be useful. For cost allocation plans, both the costs being allocated and the bases used to allocate the costs should be considered. This will allow the negotiator to determine not only cost centers with significant increases, but also important shifts in the allocation of those costs among various benefiting agencies. For indirect cost rate proposals, it is critical to analyze changes in both the indirect cost base and the indirect cost pool. Finally, the trend analysis will identify new cost centers included in the proposal. Additional guidance on trend analysis as it relates to specific types of proposals is contained in later sections of this manual.
2. Evaluate the governmental unit's justification for any significant changes or additions.	If the governmental unit has not included the required justifications, the negotiator should request them immediately.

D.

FILE DOCUMENTATION

The negotiation workpaper files should contain sufficient documentation to support the negotiation of the state/local-wide cost allocation plan or indirect cost rate. The workpaper files should include, but not necessarily be limited to: worksheets and schedules developed during the review; correspondence with the grantee requesting additional information and the responses; documentation of telephone conversations or of interviews/meetings; file notes; etc.

STEPS	COMMENTS
1. The workpaper files should clearly document:	
a. The areas of the proposal that were reviewed.	For significant areas reviewed, the workpapers should have a summary narrative identifying the scope of work, the specific review steps taken and the results of the review.
b. The significant areas of the proposal that were not reviewed and why.	
c. The adjustments made to the proposal, the reasons for the adjustments and supporting computations.	
d. How the approved costs/rates were computed and negotiated.	
e. How cost avoidances, if any, were computed.	Cost avoidance must be calculated according to DCA policy.
f. Recommended follow-up review steps for future reviews, if any.	
g. The required certifications.	

E.

REFERENCE MATERIALS

- 2 CFR Part 225, Cost Principles for State, Local and Indian Tribal Governments (OMB Circular A-87)
- OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations
- ASMB C-10, A Guide for State, Local and Indian Tribal Governments
- HHS Grants Policy Statement/Grants Policy Directives
- 45 CFR Part 16, Procedures of the Departmental Grant Appeals Board
- 45 CFR Part 74, Uniform Administrative Requirements for Awards and Subawards to Institutions of Higher Education, Hospitals, Other Nonprofit Organizations, and Commercial Organizations (Departmental Implementing Regulations for OMB Circular A-110)
- 45 CFR Part 92, Uniform Administrative Requirements for Grants and Cooperative Agreements to State, Local, and Tribal Governments (Departmental Implementing Regulations for OMB Circular A-102)
- Internet Websites:
  - DCA Website – http://rates.psc.gov/
  - OMB Circulars - www.whitehouse.gov/omb/grants/grants_circulars.html
  - GASB Statements - www.gasb.org/
  - FASB Statements - www.fasb.org/
  - HHS Office of Grants - http://www.hhs.gov/grantsnet
  - CFR Sections - www.gpoaccess.gov/cfr/index.html
  - DAB Decisions - www.hhs.gov/dab/
  - Actuarial Standards of Practice - www.actuarialstandardsboard.org/asops.htm

See separate sections for specific reference material related to individual areas.

III. STATE/LOCAL-WIDE COST ALLOCATION PLANS

Most governmental units provide certain services, such as motor pools, computer centers, purchasing, accounting, etc., to operating agencies on a centralized basis. Since Federally supported awards are performed within the individual operating agencies, there needs to be a process through which these central service costs can be identified and assigned to benefiting activities on a reasonable and consistent basis. The central service cost allocation plan (commonly referred to as the state-wide cost allocation plan or SWCAP and for local governments, local-wide cost allocation plan or LOCAP) provides that process.

A. PRELIMINARY REVIEW

STEPS	COMMENTS
1. Determine that the plan is accompanied by all required supporting documentation:	Where a local-wide cost allocation plan is being negotiated, the word "state" should be read as "local" for this step and all subsequent steps.
a. A certification signed by the authorized state official as required by the Circular.	The documentation required to support the plan may vary depending on the circumstances involved in the negotiation. The items listed here are considered to constitute the minimum documentation necessary to permit an evaluation of the plan.
b. The state's official financial statements.	
c. An organization chart that shows the state-wide organizations rendering services, all the state departments/ agencies receiving the services, and all the departments/agencies not receiving the services.	
d. Exhibit A in an electronic spreadsheet file.	See Section E, Concluding Step 5 below.
2. Determine whether the plan, as a minimum, contains:	Also, see Section C.i) a, Internal Service Funds Preliminary Step 1 below for additional requirements for

STEPS	COMMENTS
	Section II Internal Service Funds.
a. The nature of the services provided and their relevance to Federal grants and contracts.	
b. The items of expense included in the central service costs.	
c. The methods used in distributing the costs.	
d. Listings of both state departments/agencies rendering the services and those receiving the services.	
e. A summary schedule showing the allocation of each service to the specific benefited agencies.	
3. Determine whether all central services (allocated and billed) are accounted for by Sections I and II of the plan.	To assure that duplicate charges do not occur, the plan must account for all central service costs, including those which are billed to the user departments/agencies and institutions (e.g., state hospitals or universities).
4. Coordinate the negotiation with interested Federal agencies.	Federal agencies interested in participating in a negotiation will notify the negotiator. In these cases, the interested agency should be notified upon the receipt of a proposal or audit report on the organization and asked to advise the negotiator of any factors that should be taken into account in the negotiation. If the Federal agency has not received a copy of the proposal or audit report, the negotiator should send (or arrange for the state or audit

STEPS	COMMENTS
	agency to send) a copy of the document to the agency. If a formal negotiation is deemed necessary, the agencies which expressed an interest in participating in the negotiation should be invited to send a representative to the pre-negotiation conference as well as to the formal negotiation conference. If an agency does not wish to send a representative to either of these two conferences, the negotiator will act on behalf of that agency. After the negotiation is concluded and an agreement issued, a copy of the agreement will be posted to the DCA website.
5. Review negotiation agreements, cost allocation plans, correspondence, and workpapers applicable to prior years to determine:	
a. Whether the state has complied with the terms and conditions of the prior negotiation related to the development of future cost allocation plans.	In prior negotiations, advance agreements may have been established for future negotiations to preclude disputes or problems or to help ensure equitable cost determinations in the future. Examples of such agreements include those involving the performance of special studies or refinements in allocation bases, the treatment of certain types of costs, or changes in the state's accounting system.
b. Whether the "carry-forward" amount was correctly computed and included as part of the plan (if central service costs were approved on a "fixed" basis in prior years).	If a central service is excluded from the proposed cost allocation plan used to fix the amounts for a given fiscal year, the State may not subsequently claim a carry-forward adjustment for the omitted central service. See Attachment B for example carry-forward computations.

STEPS	COMMENTS
c. What adjustments were made in the prior year's negotiation.	
d. What follow-up items, if any, were recommended to be performed in future reviews.	
6. Review the organization chart and the amount of Federal grant/contract costs incurred by each organization receiving the central services to determine the services which should be most thoroughly evaluated because of their ultimate impact on grant/contract costs.	
7. Complete a trend analysis of the cost pools and allocation bases.	For the analysis of the allocation bases, select high Federal subvention agencies to determine if the percentage of costs allocated to these agencies has changed. The state needs to account for any significant increases.
8. Obtain a copy of the OMB A-133 Single Audit report. Determine if there are any audit findings that affect the scope of the review.	If the applicable OMB A-133 Single Audit report has not been issued, review the most recent audit report.
9. Determine the appropriate level of negotiation effort and whether or not an HHS audit is needed.	Final determination on these matters may not always be possible at this point. However, they should be made as early in the negotiation process as possible. If the negotiator concludes that an audit is necessary, he/she needs to identify the specific areas which the

negotiator feels are critical to the determination of the reasonableness of the proposal and which cannot be satisfactorily evaluated without an on-site audit review. A special audit request should be sent to the Regional Audit Director. The request should indicate the specific reason(s) why the audit is needed and should include the negotiator's recommendations on the scope of the audit. If an audit is conducted, the negotiator should discuss the scope of the audit with the auditor to determine whether the specific areas of the proposal are being adequately covered during the audit. The negotiator should not duplicate the work being performed by the auditor.

10. Reconcile the plan to the state's financial statements or other financial documents used to support the plan.

If the amounts do not reconcile and if they cannot be readily reconciled via telephone, the state should be requested to submit additional data.

B. SECTION I COSTS

The allocated costs of the central service cost allocation plan are commonly referred to as "Section I" costs. These central service costs are allocated to benefiting operating agencies on some reasonable basis (e.g., number of warrants issued, number of employees). These costs are not billed on an individual fee-for-service or similar basis.

i) REVIEW OF COSTS

STEPS	COMMENTS
1. Determine if any new allocated central service costs were added.	Review the justification for including the item as a Section I cost. See ASMB C-10, Question 4-2 for the carry-forward treatment of costs for new central services.
2. Determine whether the costs included in the plan appear to be allowable, reasonable and allocable to Federal awards.	For definitions of cost allowability, reasonableness and allocability, refer to the Circular, Appendix A, paragraph C, 1 - 3. Unless specifically unallowable, central services benefit Federal programs if they benefit the program directly or if they are necessary for the overall operations of departments/agencies performing the programs.
3. Determine whether the central services costs in the plan exclude unallowable costs in accordance with Appendix B of the Circular. Some examples of unallowable costs are as follows: a. Alcoholic beverages (3) b. Bad debts (5) c. Contingencies (9)	The numbers next to each item refer to the section number in Appendix B of the Circular which prescribes the handling of these costs. These are examples, and are not intended to be a comprehensive list of all unallowable costs.

STEPS	COMMENTS
d. Donations and Contributions (12.a) e. Entertainment (14) f. Equipment and other capital expenditures (15) g. Fines and penalties (16) h. Fund raising (17.a)	
i. General government expenses (19)	See Step 5 below.
j. Investment management (17.b) k. Legal expenses for prosecution of claims against the Federal government (10.b) l. Lobbying (24 & 28.d)	
4. Review the following costs to determine whether they have been treated properly in the cost allocation plan: a. Depreciation or use allowances: (1) Determine that the value of the assets for depreciation/use allowances purposes was properly established. (2) Determine that cost of land and the portion of assets that are Federally financed or financed with grantee matching contributions have been eliminated from the computation. (3) Determine that a combination of the depreciation and use allowance methods have not been used for a single class of fixed assets.	The value for depreciation/use allowances purposes is acquisition cost. This cost should reflect the actual amount recorded in the records of the state or, if cost records do not exist, an estimate of the acquisition cost, which is usually based on an independent and professional appraisal. Where such appraisals are used, care should be exercised to ensure that the amount used reflects the cost at the time of purchase and not replacement cost at the time of the appraisal. Where depreciation or use allowances are material in amount, the negotiator should determine that the valuation bases are proper and, if the amounts are based on appraisals, that such appraisals were performed by independent and professional appraisers or by other reliable methods (e.g., insurance valuations).

STEPS	COMMENTS
(4) If depreciation is proposed, determine that the depreciable lives that have been established are reasonable.	In the absence of historical usage patterns, guidance in this area can be found in the Circular, Appendix B, section 11.d or IRS depreciation guidelines.
(5) Determine that the depreciation methods used result in an equitable allocation of costs to the time periods in which the assets are used.	Depreciation methods other than the straight-line method should not be accepted unless the circumstances fully justify their use (i.e., when it can be demonstrated that assets are being consumed faster in the earlier years than in the latter years of their useful lives).
(6) Determine that the charges for use allowances or depreciation are adequately supported by property records. The aggregate amount of the use allowances and depreciation applicable to the asset (including any imputed depreciation applicable to periods prior to charging of use allowances as well as depreciation after the conversion) may not exceed the total cost of the asset.	When the depreciation method is followed, depreciation records indicating the amount of depreciation taken each period must also be maintained. If the organization converts from use allowance to depreciation, future depreciation on each asset should be computed as if the asset has been depreciated over its entire useful life (i.e., from the date the asset was acquired to the date it is expected to be disposed of or withdrawn from active use).
(7) If use allowances are proposed, determine that a factor no greater than 6 2/3 percent has been used for equipment and 2 percent has been used for buildings.	
b. Rental costs	Refer to the Circular, Appendix B, section 37, for limitations on the amount of rental costs that may be charged to Federal awards under various types of leasing

STEPS	COMMENTS
	arrangements (e.g., sale and leaseback arrangements, less-than-arms-length leases or capital leases).
5. Determine whether the central service costs which are allocated in the plan properly exclude the "general costs of government."	The "general costs of government" are not explicitly defined in the Circular. They have been construed, however, to include the general costs required to carry out the overall responsibilities of the state or local unit of government. The principal examples of these costs are those incurred in operating the governor's office and those incurred in operating state/local legislative bodies. This does not preclude the recovery of special, identifiable expenses incurred pursuant to the administration of Federal grants/contracts in one of these normally unallowable activities.
6. Determine that applicable portion of the costs of department/agency heads and their immediate staff are excluded from the plan, if there are any unallowable functions reporting to them.	
7. Determine whether appropriate consideration was given to any "applicable credits" in the determination of the expenses included in the plan.	Income generated by activities conducted by the state agencies providing central services and certain negative expenditure types of transactions should be used to off-set or reduce expense items (e.g., sale of scrap and publications, parking fees, cafeteria income, purchase discounts and rebates, etc.).

ii) REVIEW OF COST ALLOCATION METHODS

The central service costs are normally distributed on a number of different bases dependent upon the element of cost being distributed. This area is critical to the propriety of the plan. The negotiator, therefore, should thoroughly analyze the bases to determine whether their use results in an equitable distribution of costs to the benefiting activities.

STEPS	COMMENTS
1. Determine whether the bases chosen by the state are appropriate for allocating each central service.	Any method of distribution which will produce an equitable distribution of the cost can be used. In selecting one method over another, consideration should be given to the additional effort required to achieve a greater degree of accuracy. Suggested bases are shown in Part 4.6.2 of the ASMB C-10.
2. Determine whether the proposed bases include all activities which benefit from the central services being allocated, including all departments/ agencies benefiting from the services, and where appropriate: a. Activities associated with general funds b. Activities associated with restricted, special purpose, or other funds c. Grants and contracts d. State institutions (e.g., hospitals, universities) e. Costs used for cost sharing or matching	

STEPS	COMMENTS
purpose	
f. Non-state organizations which receive services (e.g., an affiliated foundation, a local government agency, etc.)	
3. Determine whether the data included in the bases (e.g., square footage, number of employees, time studies, etc.) are current and accurate.	
4. Determine that activities supported by "flow-through" funds have been properly treated.	In some state departments/agencies, notably the Departments of Education, the state acts mainly as a conduit of certain grant funds which "flow through" the state to local units of government and, in some cases, to other types of organizations (e.g., universities, non-profit institutions, etc.). In such cases, the activities supported by the funds generally do not receive central services from the state and, therefore, should normally be excluded from the base(s) used to allocate the central service costs.
5. If the proposed base is state operating expenditures, determine if recipient payments are excluded.	Inclusion of recipient payments (e.g., financial assistance, food stamps or medical vendor payments) in the base will distort the distribution of costs to benefiting departments/ agencies.

C. SECTION II COSTS

The billed costs of the central service cost allocation plan are commonly referred to as “Section II” costs. These central service costs are billed to benefiting agencies and/or programs on an individual fee-for-service or similar basis. These costs include internal service funds, self-insurance funds and fringe benefit funds.

i) INTERNAL SERVICE FUNDS

The internal service funds (ISFs) and other billed services (e.g., general fund revolving fund/accounts) might include billings for:

- Services provided, e.g., automated data processing, motor pool, etc.
- Payments made centrally and charged to departments based on established allocation percentages, e.g., telephone costs based on the number of instruments, utility costs based on square footage.
- Supplies requisitioned at inventory cost plus a mark up for administrative cost.

STEPS	COMMENTS
a. PRELIMINARY STEPS	
1. For each ISF or similar activity with an operating budget of $5 million or more, determine whether the plan contains: a. A brief description of each service. b. A financial report balance sheet. c. A revenue/expense statement with revenues broken out by source (e.g., regular billings, interest earned, etc.).	Although the documentation is required by the Circular for those ISFs with operating budgets of $5 million or more, the negotiator has the option of requesting any of the information for ISFs with operating budgets less than $5 million. This is applicable when reviewing smaller state governments.

STEPS	COMMENTS
d. A listing of all non-operating transfers (as defined by GAAP) into and out of the fund.	
e. A description of the procedures (methodology) used to charge the costs of each service to users, including how billing rates are determined.	
f. A schedule of current rates.	
g. A schedule comparing total revenues (including imputed revenues) generated by the service to the allowable costs of the service under the Circular, with an explanation of how variances will be handled.	For example format, see Attachment A or ASMB C-10 Illustration 4-7. For funds which utilize multiple billing rates (e.g., data processing funds), a separate reconciliation schedule for each billing rate may be required.
h. A schedule of billed services (by user and consisting of all revenues, including unbilled, uncollected and imputed revenues).	See ASMB C-10, Illustration 4-6 for an example.
2. Ensure that all ISFs are identified by reviewing: a. Internal Accounting Manuals b. Financial Statements (Certified, Internal, other) c. Budget Documents d. Discussions with appropriate state/local personnel	Data on ISFs should have been submitted from the entity in accordance with the Circular. The negotiator should be aware that these requirements are also applicable to activities that function like ISFs but are not formally setup as an ISF. The financial statements may only indicate in sub-schedules the existence of centralized service accounts but reviews of accounting manuals and discussions with appropriate state/local personnel would be required to

STEPS	COMMENTS
	identify all ISFs. Discussions will also highlight areas where functions are "Memo Billed."
3. Review all ISFs to identify:	
a. Those that are central service versus those of an operating department.	A Department of Corrections may run a farm, operate a laundry, build furniture, etc., for which an ISF was established. A Department of Health may charge out for laboratory services. Responsibility for the review of these funds may be coordinated with the cognizant Federal agency for the state/local department providing the services.
b. The specific nature of the central service function.	
c. All potential users.	
d. Those with potential Federal recoveries.	These central service costs can be a direct charge to a Federal program, an overhead account at the operating department level or a charge to a Section I central service function which is subsequently allocated to Federal programs.
4. Obtain a copy of the latest audit to identify departments/agencies with Federal funds and potential problem areas. This would include: a. OMB A-133 Single Audit or other independent audits b. HHS OIG audits c. State internal audits	If there is no audit, the negotiator should be alerted to the fact that there may not be a complete tracking of sales and related accounts receivable. Potential problems may be that charges are based on revenue received rather than charges for total usage of the services provided.

STEPS	COMMENTS
5. For new ISFs, discuss with appropriate state/local personnel to determine: a. When the fund was first established. b. How the fund was initially funded (capital transfer, etc.). c. Existence of external and/or internal financial statements. d. Manner in which services are charged out, i.e., billing rate system or cost allocation procedures.	Billing rate steps are described in Step 1, below, and cost allocation procedures steps are described in Step 2, below.

b. REVIEW OF BILLING MECHANISMS

Normally under a billing rate system, a formal schedule of user rates is published and used for charging purposes; whereas under cost allocation procedures, the actual costs of the period (e.g., monthly, quarterly) are charged out to the users of the service during the respective periods on the actual allocation statistics for the period.

STEPS	COMMENTS
1. Review billing rate system, as follows: a. Review current billing rate schedule of charges and obtain support for rates to determine if data is current and accurate, and unallowable costs are excluded.	Federal funds are usually billed upon usage of specific service with funds transferred at that point from the Federal program to the ISF. State funds may be handled in the same manner or the entire funds appropriated to operating departments may be transferred to the ISF at the beginning of the state year setting up payable/receivable amounts in their respective accounts. Under the latter approach, the billings to state programs during the year only result in reductions to payable/receivable accounts.

STEPS	COMMENTS
b. Determine whether the rate provides for all costs, e.g., fringe benefits, SWCAP, etc.	A problem consistent with the billing method is that the billing rate may provide for replacement of assets rather than depreciation on existing equipment.
c. Review the schedule of billings by user to determine if all users (including outside the governmental entity) are billed the same rate for the same service. Also, ensure that any differences in billing state and non-state functions are fully explained.	Assets, such as motor vehicles, may be purchased directly under Federal awards. The consistency principle must be applied where the same department is being billed for a central service such as motor pool. However, as a general rule, separate billing rates for Federal programs should not be required from those that a state uses for its own purposes.
d. Determine that serviced departments are not overbilled because of another department's underbilling.	Any costs allocable to a particular Federal award or cost objective should not be charged to other Federal awards to overcome fund deficiencies. In other words, the over recovery of expenses from one billed service center should not be used to offset the under recovery of another service center. See the Circular, Appendix A, Section C, 3, c.
e. Identify procedures followed by service and serviced departments where billings exceed original appropriated amounts.	
f. Review rate base to determine whether it equitably distributes the cost of the service provided.	
g. Determine if past profit/loss is properly treated.	
NOTE: Once a billing rate system is established	The review should address the need for multiple rates. In

and approved, key aspects of the billing rate system should be selectively reviewed with each subsequent submission to assure compliance with the approved procedures.

addition, outside expertise may be needed (e.g., ADP reviews).

2. Review cost allocation procedures, as follows:

   a. Review the method used to bill out the cost.

   Under this approach, costs are charged out on a periodic basis (e.g., monthly) based on actual usage during that period.

   b. Determine the composition of cost. The data should be current and accurate, and unallowable costs excluded.

   Comments noted above for billing rate systems apply here also. In addition, the review must include the identification of non-recurring items and instances where bills are paid by the state in lump sum as opposed to the same billing cycles as it charges its users. If these costs are charged out based on one month's statistics it could result in charging inappropriate programs.

   c. Determine if all users are charged on the same basis.

   d. Determine that serviced departments are not overbilled because of another department’s underbilling.

   e. Identify procedures followed by service and serviced departments where billings exceed original appropriated amounts.

   f. Review charge out base (i.e., allocation statistics) to determine whether it equitably distributes the cost of the service provided.

NOTE: Once a system is reviewed and approved, it should be selectively reviewed in the future to assure compliance with the approved procedures.

c. REVIEW OF RECONCILIATION OF NET ASSETS/RETAINED EARNINGS

STEPS	COMMENTS
1. Review annual reconciliation of net assets (previously called retained earnings), i.e., the schedule comparing total revenue (including imputed revenue) to the allowable costs. Need to determine if variances were properly treated.	Sample format is shown as Attachment A. Other formats may also be acceptable.
a. Determine whether funds which utilize multiple billing rates/functions should be required to have separate reconciliation schedules for each billing rate/function.	For example, an ISF may consist of both ADP and telecommunication services where each function separately identifies its own revenues and expenditures. An overall fund balance may not be appropriate, because excess charges may occur in one billed service but undercharges may occur in other billed services. In addition, various users do not utilize each billed service to the same extent.
b. Verify the accuracy of the reconciliations to supporting documents (e.g., CAFR). Also, math check the schedules.	
c. Review the accuracy of the beginning A-87 Net Asset balances.	If the fund has not been reviewed or if adjustments have not been made for overcharges in prior years, the beginning balance is the Net Asset balance on the state's CAFR including allowable adjustments (e.g., transfers in/transfers out, unallowable/allowable costs, imputed interest). If the fund has been reviewed in prior years, the beginning balance will be the ending balance from the

STEPS	COMMENTS
	previous year's reconciliation schedule. However, if adjustments for excess reserve balances have been made, then the starting balance would be the fund balance that was allowed to be retained at the end of the previous year.
d. Determine that the A-87 Revenue reflects total charges for all services provided for the year whether billed or not.	If some users were not billed for services (or not billed at a full rate), a schedule showing the full imputed revenues should be provided (see ASMB C-10, Illustration 4-6). The revenue should also include all other revenues the fund earns from its operations and interest earned on reserves.
e. Verify the accuracy of interest earned or imputed interest. Review fund statements to determine if applicable credit has been given for earnings on ISF cash balances. If earnings are not reported, the negotiator should impute the interest amount and determine through discussions with state personnel how cash balances are invested.	When known, actual earnings should be used. However, if the state commingles its funds, earnings may be imputed by applying the government's rate (e.g., the state's Treasury Average Rate of Return) to the monthly average cash balance for the year.
f. Review the expenditure amounts to ensure that unallowable costs are excluded and that remaining costs meet the Circular requirements.	Common problem areas: - Replacement costs. - Expensing of capital assets rather than depreciating.
g. Review the allowable reserve to determine if the amount is excessive. Review by individual billed service within the fund, if material.	ISFs are dependent upon a reasonable level of working capital reserve to operate one billing cycle to the next. A working capital reserve as part of the retained earnings of up to 60 days allowable cash expenses is considered reasonable. See ASMB C-10, Question 4-10 and

STEPS	COMMENTS
	Illustration 4-7 for detailed instructions on computing allowable reserves for ISFs, and for general funded ISFs.
h. Review the details for the fund transfers made during the year.	All funds transfers need to be reviewed in detail. Determine if the grantee has correctly classified transfers as “operating” vs. “non-operating”. Sometimes non-operating transfers are inappropriately classified as operating transfers on the Reconciliation. An operating transfer directly results from the provision of goods or services to customers, or is otherwise directly related to the principal and usual activity of the fund. Operating transfers should be part of expenditures in Part I of the Reconciliation. However, if the transfer is for purposes other than originally billed and reimbursed by the Federal programs (for example, transfers to the General Fund for general purposes of the State government or transfers to other funds to cover the other funds’ deficiencies), then the transfer is non-operating. For non-operating transfers, the State should refund the Federal government for its share at the date of transfer. The only exception to this requirement is if the State has enough contributed capital (Part II of the reconciliation) to make the transfer from Part II contributed capital, in which case a refund may not be necessary. However, if the State does not have sufficient contributed capital, and the State does not refund the Federal share at the time of the unallowable non-operating transfer, DCA should seek repayment of the Federal share of the transferred funds, including interest from the date of

transfer. In this case of an untimely refund, the State's refund of the Federal share should be paid from the Fund that received the transfer-out, usually the General Fund. The reason for this is that if the State pays the untimely refund of the Federal share from the ISF's reserves, this causes an additional unallowable diversion of ISF funds, thereby necessitating a larger refund. The interest rate assessed prior to our determination letter would usually be the State Treasurer's Average Rate of Return. If the State does not make the refund within 30 days of the determination letter, then interest at the current Private Consumer rate will be assessed in accordance with Department regulations at 45 CFR Part 30.13.

i. Determine if there is an excess fund balance and whether an adjustment is required.

Variances may be handled as adjustments to future billing rates, cash refunds, credits to individual programs, or, if less than $500,000, as a Section I allocated cost. If a method other than a cash refund is negotiated, an interest assessment may need to be considered.

REFERENCE MATERIAL

The following material can be helpful to the negotiator during the review of internal service funds:

- **HHS Departmental Appeals Board Decisions**

No. 1336 New York (Allowable Costs of State-Owned Buildings)
No. 1766 Wisconsin (Excess Reserves)
No. 1802 Missouri (Allocating State Unemployment Insurance Taxes)
No. 1811 Michigan (Cash Repayment of ISF Overcharges)
No. 1822 Idaho (Repayment of Transferred Funds)
No. 1872 Colorado (Repayment of Transferred Funds/Applicable Credit)

No. 1876 New Mexico (Unallowable Offsetting of Overcharges/Cash Repayment)
No. 1994 Michigan (Rebates/Applicable Credits)
No. 2010 Arkansas (Unallowable Offsetting of Overcharges)
No. 2047 Arkansas (Unallowable Offsetting of Overcharges)

ii) INSURANCE

State and local governments may either purchase insurance from a third party or self-insure, or a combination of both. Self insurance involves establishing reserves for future losses instead of purchasing commercially available insurance. Some common types of self-insurance funds include workers' compensation, unemployment insurance, and severance pay. Self-insurance can also cover property, liability, health, dental and life insurances.

The Circular, Appendix B, Section 22, Insurance and Indemnification, contains specific guidance regarding the allowability of self-insurance costs. Unless specifically disallowed, contributions to a reserve for self-insurance are generally allowable where the type and extent of coverage, and the rates and premiums, would have been allowed had the insurance been purchased to cover the risks.

"Pay as you go" funding (paying for losses when they occur or to the extent funds are available) is an alternative to establishing reserves. However, "pay as you go" is not a self-insurance fund, and the allowability of costs as a result of losses incurred by an entity using such an approach is severely limited by the Circular, Appendix B, Section 22.

The Circular and ASMB C-10 list the submission requirements for self-insurance funds. The effort required to review this area will depend on the level of Federal participation in the funds, and what information is submitted for the self-insurance funds. The review steps are as follows:

STEPS	COMMENTS
1. Identify all types of insurance coverage, and determine for each type of insurance whether the State purchases insurance or self insures, or a combination of both. For self insurance, determine whether the State funds reserves or uses "pay as you go" funding (see Step 7 below for reviewing "pay as you go" insurance). This can be determined by reviewing:	Insurance may be funded by: - Establishment of Internal Service Fund. - Accounting for funding within the General Fund.

STEPS	COMMENTS
a. Internal Accounting Manuals	
b. Financial Statements and notes	
c. Budget Documents	
d. Discussion with appropriate state personnel	
2. Obtain copies of applicable financial statements, including actuarial reports.	If financial statements are not available, the fund manager should have some internal statements for use.
3. Determine which insurance coverages, identified in Step 1, are charged to Federally funded programs.	Only those coverages ultimately charged to Federally funded programs should be considered for review. For those insurance coverages with Federal participation, estimate the federal share of the annual cost or fund balance of the insurance being reviewed. Where the federal share is limited, we cannot expect to exert much influence on the reserve balances maintained. Our focus should be on determining whether federal programs are paying the same per unit costs as state funded programs, and whether unallowable transfers/diversions have been made from any fund reserves.
4. For insurance coverages identified in Step 3, determine the specific coverage, the cost, and the mechanism used to charge Federal programs.	Depending on the coverage, Federal programs could be charged through the central service plan (Section I), billing rates to departments (Section II), “pass-thru” vendor bills, fringe benefit rate, or other mechanisms. Review should include determining the reasonableness of the method(s) used to allocate the cost of insurance.

STEPS	COMMENTS
5. If the organization has changed from purchased insurance to self-insurance, obtain rationale for conversion and a comparison of before and after rates. If rates have increased significantly, obtain an explanation for the increases.	For most of these changes you can only reasonably expect to be kept informed as to the current situation. If you believe there are significant overcharges or excessive reserves, consult with your branch chief early in the review process for guidance in how to resolve your concerns.
6. Where funded reserves are used:	
a. Obtain and review the rationale and support for the year's insurance expense.	
- If actuarially determined, obtain and review a copy of the study.	The level of Federal participation of the balance should be considered in the extent of the review of the actuarial report. Review the report for the following: - Does it identify the three reserve balance components identified in the Circular, Appendix B, Section 22, d, (3)? - Does it contain rate recommendations? - Are the rate recommendations used by the state to fund the reserve? - Do the assumptions appear reasonable? - How have recent investment earnings (i.e. stock market) impacted the reserve balances? - Determine the state's plans concerning increasing or reducing the fund balance in the future.

- If historical experience, obtain supporting data.	
- If created by law/statute, obtain a copy and note any pertinent provisions.	
b. Reconcile expenses to the financial statements.	Accrual basis of accounting should be used. Cash basis will not reflect true reserves because cash statements will only reflect users paying for services rather than actual costs of services provided during the accounting period to all users.
c. Review expense support to identify:	Examples:
- Contingencies included	Catastrophic losses, etc.
- Unallowable costs under the Circular	Coverage of Federal Government Property.
- Unallocable costs	Coverage for false arrest, tort claims, etc. that would be considered as costs of general government and not of benefit to the Federal programs.
d. Review fund statements to identify:	
- Extent of contributed capital	Depending on source of contribution, this part of the reserve balance would not be a potential credit to the Federal government.
- How interest and other investment earnings on reserves are accounted	All interest and other investment earnings must be credited to the reserve to ultimately be used for the

STEPS	COMMENTS
for.	purpose of the fund.
- Reserve balances that represent an aggregate of different types of insurance, (e.g., medical malpractice, general liability, auto insurance) must be analyzed separately. The entity must be requested to separate the revenues, expenses, and reserves by type of insurance.	Federal participation can vary significantly among the different types of insurance.
- Reserve balance amounts and support to demonstrate the reserve is not excessive.	Determination must be made on the need for a reserve and explanation of any level in excess of claims run-off. That includes claims that are: submitted and adjudicated, but not paid; submitted but not adjudicated; or incurred but not submitted.
- The purpose of intergovernmental transfers such as "Amounts due the General Fund" and similar accounts/ transactions.	Such accounts/transactions may include unallowable transfers of excess reserve balances or interest/ investment income from the fund.
e. Have entity identify all transfers during the year other than charges for self-insurance.	Federal programs must be credited their share, including earned or imputed interest from the date of transfer, if the transfer is not for self-insurance payments or return of contributed capital.
f. Verify all funds, programs, etc. are charged consistently.	All users should be charged the same rate for the same service. Do all state agencies/departments pay their costs in the

STEPS	COMMENTS
	same manner? If not, determine if the "cost per" is the same for federally funded programs as it is for non-federally funded programs. As a result, Federally funded programs may be charged inflated actuarially determined rates based on state funded programs underpaying their costs in previous years. Do funds flow directly from state agencies to the insurance fund? If not, additional opportunities for transfer of funds for other uses exist. If funds are not transferred promptly, interest earnings may in effect be transferred for other uses.
g. Determine the reasonableness of the allocation or charging basis depending on the specific insurance coverage.	Overall average rates of certain components may not be appropriate, e.g., workers' compensation expenses may vary significantly from department to department based on employee classifications i.e., office worker, mechanic, laboratory worker, etc.
7. Where "Pay as You Go" method is followed:	
a. For liability and property insurance, assure compliance with the Circular, Appendix B, Section 22*.*	
b. For fringe benefit type insurance (e.g., unemployment, workers compensation, health, etc.), determine whether the amounts proposed represent "employee benefits in the form of employers' contribution or expense" for the current year, and such amounts are properly	The entity may use trust or agency funds to account for these items. You should determine: - The basis of the grantee's expense, i.e., the amount paid to the fund or the actual payment from the fund. (If the expense is handled as an agency fund rather than a trust fund, the expense

STEPS	COMMENTS
determined and allocated. Refer to the Circular, Appendix B, Section 8, d, (5).	of the period should be the payments from the fund. An agency fund is basically a holding account and the payment from the fund is the true expense of the period.) - Whether there were any transfers from the fund to the general fund. - Extent of interest earned and need to credit Federal programs, etc.
c. Determine reasonableness of the allocation bases.	Allocations should be based on benefits received.
8. Where the cost of administering these programs is charged as either part of the billing rates or allocated as a Section I activity, you must assure that only costs applicable to the state activity are included for allocation.	Many states administer fringe benefit programs such as health, dental, pension, etc. for both themselves and other governmental entities such as local governments. The methodology for charging administrative costs of the program must result in federally funded programs not paying more than their share of these administrative costs. The state must use some combination of (1) charging the non-state entities their relative share of the administrative costs and (2) paying for them with only state funds.

REFERENCE MATERIAL

The following material can be helpful to the negotiator during the review of self-insurance funds:

- **HHS Departmental Appeals Board Decisions**

No. 1635	**Alabama (Transfers of self-insurance reserves and related interest)**
No. 1668	**Oklahoma (Diversion/transfer of group insurance collections for other purposes)**
No. 1893	**Louisiana (Inconsistent Billings between Federal and non-Federal programs)**

iii) FRINGE BENEFITS

The following guidance on the review of fringe benefits is primarily based on the general requirements of the Circular, as well as specific requirements contained in Appendix B, section 8. d., e., and f. of the Circular. In addition, the negotiator should be aware of publications of both the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB) that provide information and guidance on accounting for the cost of various fringe benefits. A listing of applicable publications is contained in the guide at the end of this section.

STEPS	COMMENTS
1. The following information should be submitted by the grantee as part of its proposal:	
a. Listing of fringe benefits (FB's) and the annual cost of each.	
b. Current FB policies for each FB listed including coverage and funding.	After the initial review, the grantee should only submit the policies when there are changes.
c. Method used for budgeting and charging FB's to Federal awards.	
d. Future changes in FB policies or charging/ budgeting methods.	Multiple rates may be necessary if there are different classes of employees or pension systems.
e. FB proposal.	
f. Reconciliation to financial statements (CAFR) or other official expenditure reports for each component of the FB proposal.	

STEPS	COMMENTS
g. Copies of any state, CPA, or other audits of any FB component.	Including annual reports prepared by/for Retirement Systems, Insurance Commissions, etc.
h. Copies of the most recent actuarial reports.	An actuarial valuation should be performed at least every two years.
i. Any applicable state laws or regulations concerning any of the FB's.	
2. Review the financial statements and especially any notes relative to FB costs.	The financial statements are an important source of background information on FB's and any changes with respect to their provisions. Information on the status of reserves and transfers of funds will also be found in the financials.
3. Discussions should be held with appropriate grantee representatives to obtain a complete understanding of the methods used to both charge and budget FB's, including budgeting, accounting and recovery of all FB cost claimed for Federal reimbursement.	Several methods can be used by the grantee in the accounting for the various FB costs. The scope of review will vary depending on the method followed, e.g.: • FB's appropriated centrally where an average rate is developed, similar to an indirect cost rate, and charged to federal awards. An internal billing system is used only for federal funds and other third parties; there is no billing for grantee funded programs. • FB's appropriated at the department level resulting in internal billings for all funds. Billing rates may be based on: - Average rates developed for individual FB components under the same process described for central appropriations above.

STEPS	COMMENTS
	- Specific FB's identified with each department and departmental rates developed and billed accordingly. Individual rates needed because department experience varies, e.g., workers' compensation, unemployment, etc.
	- Specific FB's identified with individual employees and charged directly to the programs the employees are working on.
	The negotiator must assure him/herself that Federal programs have been charged in a manner consistent with other sources of funds, particularly state general funded activities.

Where the grantee uses the average rate method (whether it is a grantee-wide FB rate under a central appropriation process or a rate charged under the departmental approach) all of the following steps must be performed. Where FB's are specifically identified to individual employees, the negotiator must identify the method used to assign the specific FB costs and perform only those steps that are applicable.

STEPS	COMMENTS
4. Review of the Salary and Wages (S&W) base should include:	
a. Reconciliation to the financial statements.	
b. Complete description of the base, i.e., is it total S&W as recorded in the accounting system or are certain components excluded, e.g., over-time, part-time	The review must determine whether it is equitable to include S&W of part-time employees, etc., in the base. Some FB's, such as pension, may not apply to these employees. In such cases a separate FB rate may be

STEPS	COMMENTS
employees, etc?	appropriate.
c. Determine if all departments, divisions, agencies, etc., of the grantee are considered.	
d. Review actuarial reports.	
e. Determine if a multiple rate structure for different classes of personnel is needed.	Where there are several classes of personnel (e.g., public safety personnel, teachers, etc.), a multiple rate system may be needed or certain areas should be excluded because they skew the rate and have little relevance to Federal programs. Usually uniformed public safety personnel as well as judicial and legislative members should be excluded because they have high FB costs and little or no Federal reimbursement. The significance of this differential is usually, but not always, identified in the actuarial valuation of pension costs.
f. Determine the method followed by the grantee to account for vacation, holiday, sick or other leave (i.e., accrued when earned or pay-as-you-go).	See the Circular, Appendix B, section 8. d. (2), (3) and (4) for guidance on allowable costs. Particular attention should be paid to accrual methods of accounting to ensure appropriate credit when leave is used. Also, payments for unused leave when an employee retires or terminates employment must be allocated as a general administrative expense and should <u>not</u> be charged direct to the last program/project the employee worked on (see ASMB C-10 Question 3-6).
5. Review of pension costs should include:	
a. Identification of all pension costs by plan	In some cases, the state is responsible for funding the

STEPS		COMMENTS
	and basis of the recorded expense whether it's actuarially based or pay-as-you-go.	employer's share of pension costs for teachers and other local government employees. In such cases, the negotiator must include those costs in the assessment of allowable pension expenses.
b.	Determine which classes of personnel should be included in the pension rate for Federal purposes.	Usually police, judiciary and the like should be eliminated or separate rates should be developed.
c.	Verify that the pension expenditures recorded in the financial statements and the FB proposal are funded.	The Circular, Appendix B, section 8. e. (2) and (3) provides guidance on the timing of actual contributions to a pension system. In general, the costs must be funded within six months after the end of the fiscal year to be included in that year's expenses. Further guidance concerning allowable pension costs is also contained in ASMB C-10 on pages 3-8 through 3-10.
d.	Differences between expenses determined under GAAP and actual funding should be identified and explained.	Overfunding may occur in a year because funds are available. Such excess is not acceptable as a current period expense but is a prepaid expense which should be applied to a future period. (See the Circular, Appendix B, section 8. e. (3).) Underfunding will increase future costs due to interest lost and an increase in the unfunded liability of the pension plan.
e.	For plans based on actuarial methods of funding, obtain an analysis of the composition of the year's expenses.	This could include normal costs, amortization of prior service costs, life insurance, etc. The costs included could vary depending on the actuarial method used. The negotiator should also determine what assumptions, regarding timing of contributions, were made by the actuary for valuation purposes and whether or not they were followed. The effect on Federal reimbursement

should be considered.

Further information on the requirements of accounting for and reporting pension plan expenditures is also available in GASB Statement No. 25.

f. Determine if interest amounts included in pension costs are allowable.

Pension expenses may include an element of interest expense arising from several sources, e.g.,

Allowable:

- Unfunded liability from the establishment of the plan or changes to the plan (past/prior service costs).
- Unfunded liability created by a prior failure to adequately fund the plan in accordance with actuarial determinations because of a lack of funds or other considerations.
- Unfunded liability caused by the use of outdated actuarial assumptions.

Unallowable:

- Late payments to the pension fund.
- Delay in contribution caused by a state mandate.

g. The grantee, where possible, should be requested to identify the various unfunded liabilities and their amortization periods. Each should be reviewed for allocability to Federal programs.

Review may highlight areas where the allocability to Federal programs is questionable.

STEPS		COMMENTS
h.	Review the pension plan's financial statements to determine if the fund is maintaining a contingency reserve which has not been included in the actuarial computations.	Failure to consider all funds held by the pension system could understate assets and result in excess contributions.
i.	If pension obligation bonds (POBs*)* were used to liquidate some or all of the unfunded liability, were Federal regulations and guidelines followed?	See OMB interpretation dated 1/31/94. If this was done in a prior period, determine if the actuary or single auditor has reported any changes. Some grantees have refinanced POBs. While the 1994 policy statement did not discuss refinancing of the POBs, it is DCA's opinion that if the aggregate cost of the refinanced POBs is less costly than the POBs it replaces, the refinanced POBs would be acceptable under the 1994 policy statement. Conversely, if the aggregate cost of financing the POBs is more costly than the POBs it replaces, the excess cost would not be allowable. This interpretation is consistent with the 1994 policy that made the original POB allowable if it accomplishes the same purpose at a lower cost.
j.	Where early retirement programs are initiated determine their allocability to Federal programs and, that required prior approval was obtained.	Refer to ASMB C-10, Question 3-13 for further information.
k.	Review actuarial assumptions and computations to determine if any areas require further consideration.	

STEPS		COMMENTS
l.	Review the pension plan, trust agreement, etc., to determine if it is possible for the grantee to access the pension funds for reasons other than the payment of pensions. Ascertain if any withdrawals or diversion of assets have taken place.	If the grantee withdraws funds from the pension system for general fund purposes, such a transfer would require an appropriate credit, including interest from the date of withdrawal, to the Federal government. This issue is most likely to present itself during times of economic downturn and can be an attractive alternative to raising taxes. Such transfers/withdrawals will most often be identified in the CAFR and/or the annual report of the pension fund. If the State does not refund the Federal share at the time of the transfer, then the refund should usually be paid from General Funds, as additional pension reserves should not be diverted for the untimely refund.
m.	The funding status of the plan should be reviewed to determine if there is apparent overfunding. The state should explain the overfunding and how it will be liquidated.	The funding status of the plan should be viewed in the "long run." Potential overfunding should be discussed with both the state and its actuary to obtain a thorough understanding of the status of the plan.
n.	Where the state administers the pension plan, determine how administrative costs are handled, i.e., part of the pension rate, separately recovered as a Section I cost, other.	Ensure amounts are not duplicated. In addition, costs associated with administering portions of the pension plan not related to state employees (local government employees, teachers) should be identified and not included in any allocation at the state level.
o.	The method used to compute the state contribution to the pension plan should be compared to the method used to compute charges to Federal programs.	The negotiator should satisfy him/herself that the state contribution is the same percentage of S&W as is used to claim Federal reimbursement. Where the state amount is based on estimated S&W, it may be necessary to make an adjustment to reflect actual S&W cost at year end to equalize the contribution, if the state uses a specific identification method to charge pension expense.

6. Review of Other Fringe Benefits

   a. Determine if amounts and benefits are allowable and reasonable.

   b. Verify that coverage is the same for all employees.

   c. Obtain an analysis of the portion of cost paid for current/retired employees, e.g. health insurance.

The employer share of post-retirement health insurance may be funded on a pay-as-you-go basis or actuarially determined, similar to pension costs. In some cases post-retirement health insurance may be paid by the pension system and treated as an element of the pension rate. Consistent treatment of this, and all costs, is extremely important. “Pay-as-you-go” costs must be allocated as a general administrative expense to all activities, and should not be charged direct to the last program/project that the retiree worked on. Allowability of costs for post-retirement health insurance is addressed in the Circular, Appendix B, Section 8, f. Allocability is addressed in the Circular, Appendix B, Section 22, d. (4) and e.

In 2004, GASB issued Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions, which requires state and local governments to report their costs and obligations for post-employment healthcare and other post-employment benefits (called “OPEBs”) much like they now report pension plan obligations. Many state and local governments will be accruing large liabilities for these

		OPEBs. The accrual is only allowable if it is calculated and funded in accordance with the Circular, Appendix B, Section 8f. In addition, some grantees are issuing bonds to fund OPEBs. The bond interest is not allowable.
d.	Determine the reasonableness of including the cost of retiree's benefits in the FB pool.	Adjustments may be necessary because: • Some employees, like police, may have shorter service requirements to qualify for a pension. Such employees would therefore make up a larger proportion of retirees. An adjustment would be necessary to compensate for these employees where the health costs are higher and there is little or no Federal involvement. • Assure that amounts paid by retirees through direct contribution or reduction of pension benefits are properly credited against total cost of the benefit.
e.	Determine if there were any rebates or other applicable credits which should be considered in arriving at the allowable costs (e.g., rebates of unemployment compensation insurance, life insurance dividends/rebates, etc.).	
f.	Determine if any FB is handled through Trust or Agency Funds. If so, obtain appropriate financial statements/annual reports for review.	This could highlight transfers to the general fund, interest earned on funds awaiting disbursement, or other areas requiring further review. Note that interest can be earned on the employer contribution portion as well as the

employee withholdings for Social Security, Federal taxes withheld, etc. Interest earned on both employee and employer contributions may be a proper credit against Federal programs.

g. Determine if coverage is consistent among all employee groups and, the grantee treats the cost of benefits consistently for both Federally and non-Federally funded personnel.

If benefits for any group are higher than another, the need to adjust the FB rate computation must be considered. This is especially true for Workers' Compensation or Unemployment Insurance where expense could vary significantly between departments or other employee groups.

h. In some cases the grantee may elect to be self-insured for certain FB's (e.g., workers' compensation and unemployment). In such cases, the negotiator should assure him/herself that the costs are allocated in accordance with the Circular.

The Circular, Appendix B, Section 22, e. requires such costs to be "allocated as a general administrative expense to all activities of the governmental unit." It is not appropriate to allocate these costs directly to the program to which the employee receiving the benefit had been assigned.

i. For FB's that are self-insured, see separate section of this guide for further review steps.

REFERENCE MATERIAL

The following is a list of publications and other guidance, in addition to the Circular, which can be helpful to the negotiator during the review of fringe benefits:

- **Actuarial Standard of Practice No. 4**
  "Measuring Pension Obligations"
  Actuarial Standards Board, 10/93

- **Governmental Accounting Standards Board (GASB) Statement No. 16**
  “Accounting for Compensated Absences”
  11/92

- **GASB Statement No. 25**
  “Financial Reporting for Defined Benefit Pension Plans and Note Disclosure for Define Contribution Plans”
  11/94

- **GASB Statement No. 26**
  “Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans”
  11/94

- **GASB Statement No. 27**
  “Accounting for Pensions by State and Local Government Employees”
  11/94

- **GASB Statement No. 43**
  “Financial Reporting for Postemployment Benefit Plans Other than Pension Plans”
  04/04

- **GASB Statement No. 45**
  “Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions”
  06/04

- **FASB Statement No. 43**
  “Accounting for Compensated Absences”
  11/80

- **FASB Statement No. 74**
  “Accounting for Special Termination Benefits paid to Employees”
  08/83

- **FASB Statement No. 87**
  “Employers’ Accounting for Pensions”
  12/85

- **FASB Statement No. 106**
  “Employers’ Accounting for Postretirement Benefits
  Other Than Healthcare”
  12/90

- **FASB Statement No. 112**
  “Employers’ Accounting for Postemployment Benefits”
  11/92

- **FASB Statement No. 132**
  “Employers’ Disclosures about Pensions and Other
  Postretirement Benefits”
  02/98

- **HHS Secretary’s Letter to Governors**
  Charging of different contribution rates to Federal and state programs and diversion of Trust Fund Reserves.

- **Interest on Unfunded Pension Liability Bonds**
  Letter from Norwood J. Jackson, Jr., OMB, to Gary M. Talesnik, HHS
  01/94

- **HHS Departmental Appeals Board Decisions**

No. 8	**Connecticut (Consistent application of pension billing rates)**
No. 29	**Rhode Island (Consistent application of pension billing rates)**
No. 314	**Indiana (Consistent application of pension billing rates)**
No. 1034	**Massachusetts (Conversion from pay-as-you-go to actuarial method)**
No. 1465	**West Virginia (Offsetting contributions to pension funds)**
No. 1592	**California (Qualifying state contributions to pension reserves)**
No. 1608	**Texas (Health insurance reserves related to new members)**
No. 1635	**Alabama (Transfers of self-insurance reserves and related interest)**
No. 1659	**Maine (Offsetting contributions to pension funds)**

D. UNIVERSITY GENERAL OBLIGATION BOND INTEREST

A state college or university will frequently claim interest expense incurred through the issuance of state general obligation bonds (GOB). This GOB interest expense is usually recorded at the state level and therefore is not included in the university financial records. If a state university wishes to propose GOB interest expense as part of the university Facilities & Administrative (F&A) rate proposal, the state must propose GOB interest as part of the Statewide Cost Allocation Plan. The GOB interest may be approved as a "Section I" cost or it can be approved in the SWCAP transmittal letter, based upon whether the state proposes GOB interest as a "Section I" cost or as an addendum to the SWCAP.

i) REVIEW OF GOB INTEREST EXPENSES

University GOB interest expenses which are associated with the otherwise allowable costs of building acquisition, construction, or fabrication, reconstruction or remodeling completed on or after October 1, 1980 is allowable subject to the conditions in the Circular, Appendix B, section 23.b, 1 – 4. Financing costs (including interest) paid or incurred on or after September 1, 1995 for land or associated with otherwise allowable costs of equipment is allowable, subject to the conditions in the Circular, Appendix B, section 23.b, 1 – 4.

STEPS	COMMENTS
1. Determine whether the state has proposed GOB interest for state universities as part of the SWCAP. If the state has proposed university GOB interest, determine whether the plan contains: a. The annual GOB interest expense broken out by GOB issuances, including bond issuance dates and amortization schedules. b. The annual GOB interest expense broken out by university system or university	Annual GOB interest expense must be identified to specific capital projects/buildings. However, large states may issue GOBs that are used for more than one university system or campus. In this case, it may not be feasible for the SWCAP negotiator to review the detailed allocations to each building or project. At a minimum, the GOB interest must be identified to the university system. In addition, the university must provide sufficient detail in the university proposal to identify the GOB interest to particular projects/buildings. Smaller states may be able to provide this level of detail as part of the SWCAP submission.

STEPS		COMMENTS
	campus.	
c.	If appropriate, the GOB interest broken out by individual capital project or building.	Many states have a legislatively-approved Annual Capital Improvement Project Report, or other similar reports, which may identify for which capital projects the bond proceeds, were used.
2.	Verify actual interest payments and reconcile to the CAFR or supporting schedules.	
3.	Obtain the financing agreement(s) including the prospectus and schedule of loan payments.	This agreement should contain the amount and purpose of the loan; as well as the applicable interest rate(s), term of the loan, the lender and the maturity schedule.
4.	For major GOB-funded state university projects, determine the percent of financing for the acquisition of the building or renovation of the existing facility (this determination would be made for each individual project).	For debt arrangements over $1 million, a reduction of interest expense is required unless the State or university makes an initial equity contribution to the asset purchase of 25 percent or more. The reduction will be an amount equal to imputed interest earnings on excess cash flow. See ASMB C-10 Illustration 3-1 for an example.

ii) REVIEW OF GOB INTEREST ALLOCATION METHODS

GOB interest should be identified to individual capital projects. However, the level of detail provided in the SWCAP will vary depending upon the size of the state. Very large states may have GOB issuances that benefit multiple university systems. In this case, it may be appropriate for the SWCAP negotiator to approve the amount of GOB interest allocable to each university system. The university negotiator would then review the allocation of GOB interest to individual campuses and buildings. In smaller states, it may be possible for the SWCAP negotiator to review the allocation of GOB interest to individual campuses and capital projects/buildings.

STEPS	COMMENTS
1. Review the state's GOB issuances to determine the benefiting state agencies. GOB issuances may benefit a single university campus or they may benefit all of the state's universities and colleges and even other state agencies.	The State's annual listing of legislatively approved capital improvement projects, or other similar reports, should be obtained and reviewed.
2. Determine whether the state's GOB issuances are allocated equitably to all benefiting state agencies. For example, the state may allocate GOB interest based upon the amount of GOB proceeds that are provided to each agency or campus for each benefiting capital project.	

iii) CONCLUDING STEPS

1. Report the allowable university GOB interest in either the SWCAP Transmittal Letter or the SWCAP Section I Exhibit A.

2. Provide a copy of the Transmittal Letter or Exhibit A to the respective DCA Branch Chief for Colleges & Universities.

E. CONCLUDING STEPS

STEPS		COMMENTS
1.	Determine whether there are any significant anticipated changes in the state's operations (e.g., organization structure, accounting system, etc.) that should be taken into account in negotiating provisional or fixed central service costs.	Normally these costs should be based on the actual costs for the state's most recently completed fiscal year. However, if the state anticipates significant changes in its operations that would affect the costs, the state would be permitted to use appropriated budget amounts which reconcile to official documents.
2.	Determine whether an advance agreement covering future negotiations should be established.	Advance agreements should be established when they are needed to preclude future disputes or problems or when they will help ensure equitable cost determinations in the future. Examples of areas where these agreements may be needed include (a) the performance of special studies or analyses in the development of future plans, (b) changes or refinements in allocation bases, (c) the treatment of certain types of costs, (d) changes in the agency's accounting system, etc. If an advance agreement is established it should be included in the letter transmitting the Negotiation Agreement.
3.	Complete a Summary of Negotiations.	A summary of negotiations should be prepared which shows the amounts negotiated that are different from the amounts submitted, and the reasons for the negotiated differences. The summary should be sufficiently detailed to permit an independent reviewer to quickly understand how the negotiated amounts were arrived at. It should also identify how cost avoidances, if any, were computed. See Part II, Section D for file documentation requirements.

STEPS	COMMENTS
4. Prepare a list of follow-up review steps, if any, to be performed in future reviews.	
5. Transmit the Negotiation Agreement, <u>including the electronic file of the final negotiated Exhibit A,</u> to DCA headquarters in Washington, D.C., or to the designated respective field office employee responsible for transmitting agreements to headquarters.	The SWCAP information, including Exhibit A, will be made available to Federal agencies via the government's intranet.

IV. INDIRECT COST RATE PROPOSALS

Indirect costs are those that have been incurred for common or joint purposes. These costs include (i) the indirect costs originating in each department or agency of the governmental unit carrying out the Federal awards, and (ii) the costs of central governmental services allocated through the central services cost allocation plan. Indirect costs are usually charged to Federal awards by the use of an indirect cost rate.

A. PRELIMINARY REVIEW

STEPS	COMMENTS
1. Determine whether a rate is needed.	A rate is needed if the state or local agency has any awards that provide for the reimbursement of indirect costs. However, if only training awards that limit reimbursement to eight percent of total direct costs are involved, a rate is not required. In accordance with Circular, Appendix E, section D.1.b., governmental units or agencies that OMB has not assigned a Federal cognizant agency, must develop an indirect cost rate proposal in accordance with the requirements of the Circular and maintain the proposal and related supporting documentation for audit. These governmental units are not required to submit their proposals unless they are specifically requested to do so by the cognizant agency responsible for reviewing, negotiating, and approving indirect cost proposals. Where a local agency only receives funds as a sub-recipient, the primary recipient will be responsible for negotiating and/or monitoring the sub-recipient's plan. A

STEPS	COMMENTS
	negotiated rate is not required with DCA.
2. If a rate is required, determine whether it is the agency's first negotiated rate with HHS.	The establishment of the initial rate with an agency is critical. This negotiation will set the tone for subsequent negotiations. As such, dollar involvement should not be the principal factor in determining the level of effort to be expended. Extra effort should be expended at this time to ensure that the grantee understands Federal requirements and that the agency's accounting system and method of operation can accommodate these requirements.
3. Determine whether coordination is necessary with other Federal agencies.	See comments for Part III, Section A, Step 4. Also, see Step 9 below, regarding the procedures to follow when restricted indirect cost rates are required for the U.S. Department of Education programs.
4. Determine whether the proposal submission is complete and that all of the necessary supporting data and documentation has been submitted. The submission, at a minimum, should include the following:	This documentation may vary depending upon the particular circumstances involved in the negotiation. The items listed here are considered to constitute the minimum documentation necessary and will normally have been requested in previous correspondence with the agency.
a. The rate(s) proposed, including subsidiary worksheets and other relevant data, cross-referenced and reconciled to the financial data.	The proposal should include detailed schedules on the composition and allocation of all indirect cost centers. If a fixed rate is involved, the proposal should also include a schedule that computes the rate along with the carry-forward adjustment (examples of carry-forward computations are included as Attachment C).
b. A copy of the financial data (financial	In many cases state and local government agencies will

	STEPS	COMMENTS
	statements, expenditure reports, etc.) upon which the rate(s) are based.	not have certified financial statements but will have statements that have been audited by state or local auditors and will submit these statements in lieu of certified statements.
c.	The approximate amount of direct base costs incurred under Federal awards. These costs should be broken out between salaries and wages and other direct costs.	The agency should also indicate the amount of salaries and wages (or total direct costs) incurred under grants and contracts which limit indirect cost reimbursement.
d.	A Certificate of Indirect Costs signed by the authorized official.	See the Circular, Appendix E, section D.3. for an example of the required certification.
e.	An organizational chart and functional statement(s) noting the duties and/or responsibilities of all units that comprise the agency.	If the agency submitted these documents with a previous proposal, only revisions to them need to be submitted with the subsequent proposal.
5.	Determine that the proposal is adequately cross-referenced and reconciled to the financial data. In addition, support should be provided for non-agency expenditures, such as use allowance/depreciation expenses and central service costs (both Sections I and II), that are included in the proposal.	Since the grantee is primarily responsible for reconciling the proposal to the financial data, an inordinate amount of time should not be spent on this by the negotiator. If the amounts do not reconcile and if they cannot be readily reconciled via telephone, the agency should be requested to submit additional data.
6.	Review prior proposals, negotiation workpapers, Negotiation Agreements and other correspondence maintained in the file to ascertain what adjustments have been made in previous years. Determine whether these corrections were included in the current proposal.	

	STEPS	COMMENTS
7.	Determine whether any advance agreements were established in prior negotiations and, if so, whether the grantee complied with the agreements for the proposal currently under review.	In prior negotiations, advance agreements or letters to grantee delineating discrepancies that should be corrected in their future proposals may have been established for future negotiations to preclude disputes or problems or to help ensure equitable cost determination in the future. Examples of such agreements include those involving (a) changes in the agency's accounting system, (b) performance of special studies or analysis in connection with the development of future proposals, (c) changes or refinements in allocation bases, (d) the treatment of certain types of costs (e.g., rent, depreciation, computer costs, idle facilities costs), and (e) limitations of certain costs. In some cases, a prior rate may have been accepted with the condition that the agency takes certain actions in the development of future proposals.
8.	If fixed rates are proposed, verify the carryforward computations.	See example at Attachment C.
9.	Determine whether a restricted or special rate(s) is needed or whether separate rates are needed for major organizational components of the agency.	Guidelines on the use of restricted and special rates are contained in the cost principles. Separate rates for major organizational components of a department/agency are generally not required. However, they should be considered where the dollars involved are substantial and the characteristics of certain organizational components of the agency are such that there is reason to believe that they generate significantly different levels of indirect costs than other components. This is true for an agency which includes significantly different types of operations (e.g., state mental health departments and subordinate

STEPS	COMMENTS
	state hospitals). The U.S. Department of Education (ED) requires "restricted" indirect cost rates for use on some ED programs awarded to state agencies for which HHS is cognizant. ED should inform DCA of those state agencies, for which HHS is cognizant, needing restricted rates. The negotiator should review the proposal to ensure the required restricted rate has been included. When the negotiator receives a proposal which includes a restricted rate, a copy will be provided to ED for review and comment within 30 days of receipt of the grantee's proposal. Within 90 days of receipt of the proposal from DCA, ED will notify DCA in writing or by E-Mail of any recommended adjustments. If the negotiator does not receive ED's comments within 90 days, the negotiator should contact ED to determine if there are any objections to approval of the rate as proposed. Based on ED input, DCA will negotiate the rate as part of the normal process.
10. Review the OMB A-133 Single Audit report and determine if there are any audit findings/ recommendations that affect the current review.	If there were previous audit findings, determine that corrective actions have been addressed in the current proposal, if appropriate. If the applicable A-133 Single Audit report has not been issued, review the most recent audit report.
11. Determine the appropriate level of negotiation effort and whether or not a HHS audit is needed.	See comments for Part III, Section A, Step 9.

B. REVIEW OF COST ALLOWABILITY

To be allowable, costs must be (a) reasonable, (b) allocable to the government sponsored activities, (c) treated in conformance with any specific limitations, conditions or exclusions prescribed in the applicable cost principles, and (d) treated consistently (i.e., assigned to benefiting activities in a consistent manner). The steps set forth in this section are designed to help ensure that the criteria for cost allowability are met.

STEPS	COMMENTS
1. Determine whether the proposed expenses were incurred within the period under review.	Normally, if the expenses as shown in the proposal reconcile to the financial data it can be assumed that they were incurred within that period.
2. Determine through the completion of a trend analysis whether the proposed costs by expense categories are reasonable.	The prior years' figures maintained in the file should be used in preparing a trend analysis that compares detailed costs for a minimum of three years. The negotiator should request from the grantee an explanation of any significant increases in the proposed indirect cost pool.
3. Determine whether the proposed indirect costs benefit Federal awards.	Generally an expense that is necessary to the overall operation of the department/agency is allocable to Federal awards. When there is a multi-tier distribution involving more than one pool, the criterion is - does the expense benefit all activities included in the particular distribution base?
4. Review the financial data to determine if there are any applicable credits or expense off-sets.	Income generated by the activities in the indirect cost pool and certain negative expenditure types of transactions should be used to off-set or reduce the expenses in the indirect cost pool (e.g., the sale of scrap,

STEPS	COMMENTS
	parking fees, cafeteria income, purchase discounts or rebates, etc.).
5. Review the proposal and financial statements to determine whether the indirect cost pool includes unallowable costs. Some examples of unallowable costs include:	Unless otherwise noted, the numbers next to each item refer to the section number in Appendix B of the Circular which prescribe the handling of these costs.
a. Equipment and capital expenditures (15)	Capital expenditures are allowable as direct costs if they are approved by the awarding agency. They are not allowable as indirect costs but instead are recovered through depreciation or use allowances.
b. Alcoholic beverages (3)	
c. Bad debts (5)	
d. Contingencies (9)	
e. Contributions and donations (12)	
f. Legal expenses for prosecution of claims against the Federal government (10.b.)	
g. Entertainment (14)	
h. Fines and penalties (16)	
i. Fund raising (17)	
j. General government expenses (19)	
k. Lobbying (24 & 28.d.)	
l. Underrecovery of costs under Federal agreements	Refer to Circular, Appendix A, paragraph F.3.b.
6. Review the following costs to determine whether they are properly treated.	The costs listed here are particularly sensitive and should therefore be thoroughly reviewed when dictated by materiality.
a. Depreciation or use allowance:	

STEPS	COMMENTS
(1) Determine that the value of the assets for depreciation/use allowance purposes was properly established.	The value for depreciation/use allowances purposes is acquisition cost except where the asset was donated to the agency by a third party. Where the asset was donated by a third party, the value is the market value at the time of donation. Where acquisition cost is used it should reflect the actual amount recorded in the records of the state or, if cost records do not exist, an estimate of the acquisition cost, which is usually based on an independent and professional appraisal. Where such appraisals are used, care should be exercised to ensure that the amount used reflects the cost at the time of purchase and not replacement cost at the time of the appraisal. Where depreciation or use allowances are material in amount the negotiator should determine whether the valuation bases are proper and, if the amounts are based on appraisals, that such appraisals were performed by independent and professional appraisers or by other reliable methods (e.g., insurance valuations).
(2) Determine that cost of land and the portion of assets that are Federally financed or financed with grantee matching contributions have been eliminated from the computation.	
(3) Determine that a combination of the use charge and depreciation methods has not been used for a single class of fixed assets.	

STEPS			COMMENTS
	(4)	If depreciation is proposed, determine that the depreciable lives that have been established are reasonable.	In the absence of historical usage patterns, guidance in this area can be found in the Circular, Appendix B, section 11.d (1) or IRS depreciation guidelines.
	(5)	Determine that the depreciation/use allowances on idle facilities have been properly handled.	See Step 6.d. below.
	(6)	Determine that the depreciation methods used result in an equitable allocation of costs to the time periods in which the assets are used.	Depreciation methods other than the straight-line method should not be accepted unless the circumstances fully justify their usage (i.e., when it can be demonstrated that the assets are being consumed faster in the earlier years than in the latter years of their useful life). See the Circular, Appendix B, section 11.e. and f.(3) for guidelines on treatment of building components.
	(7)	Determine that the charges for use allowances or depreciation are adequately supported by property records.	When the depreciation method is followed, depreciation records indicating the amount of depreciation taken each period must also be maintained.
	(8)	If use allowances are proposed, determine that a factor no greater than 6 2/3 percent has been used for equipment and 2 percent has been used for buildings.	
b.	Rental costs.		Refer to the Circular, Appendix B, section 37, for limitations on the amount of rental costs that may be

		charged to Federal awards under various types of leasing arrangements (e.g., sale and leaseback arrangements, less-than-arms-length leases and capital leases).
c.	Specialized facilities (e.g., computer centers).	The inclusion of the costs of these types of facilities in the indirect cost pool should not be allowed when they are material in amount or when the facilities benefit a limited number of activities. Normally, costs of this nature should be charged directly to benefiting activities via a schedule of rates designed to recover their total costs. The costs of the facility should consist of its direct costs as well as its allocated share of indirect costs, including general administration, operations and maintenance, depreciation/use allowances, fringe benefits, etc. Variances between the actual costs of the facilities and the direct charges to benefiting activities in a given period should be adjusted in accordance with the Circular.
d.	Idle (excess) facilities or capacity.	Idle facilities are defined as completely unused facilities that are in excess of the institution's current needs. Idle capacity is the unused capacity of partially used facilities (i.e., the difference between 100 percent capacity and actual usage of the facility). See the Circular, Appendix B, section 21.
7.	Determine whether state or local central service costs have been included in the proposal and, if so, that they are properly supported.	To be allowable, the costs must be supported by a cost allocation plan prepared by the state or locality. For plans prepared by the state, they must be approved by HHS/DCA. The state's cost allocation file should be reviewed to determine whether the cost allocations were

STEPS	COMMENTS
	approved and whether they agree with the proposed costs. The localities must also prepare cost allocation plans but are generally not required to obtain approval unless specifically requested to do so by the cognizant Federal agency. If there is no indication that the plan required approval, the institution should be queried as to whether the locality prepared a plan and, if so, the proposed amounts should be accepted.
8. Review fringe benefit costs.	Since the fringe benefit policies of a state or local government usually apply uniformly to all its agencies, the review of such policies are performed during the review of the central service cost allocation plan. Therefore, the negotiator should verify that the treatment of fringe benefits in the indirect cost rate proposal is consistent with the central service cost allocation plan.
9. Determine if the types of costs included in the indirect cost pool are consistently treated as indirect costs.	The department or agency should be queried to determine whether any costs included in the indirect cost pool have also been charged to any Federal awards as direct costs. Where such costs are charged directly, they should be removed from the indirect cost pool except to the extent that they apply to indirect activities.

C. REVIEW OF ALLOCATION BASES

The allocation bases are the methods by which indirect costs are allocated to benefiting activities. For multiple allocation base proposals, the agency's indirect costs benefit its major functions in varying degrees and are accumulated into separate cost groupings. Each grouping is then individually allocated to benefited functions by means of a base which best measures the relative benefits. For simplified proposals, a single base is used to allocate all indirect costs to benefiting activities, including grants and contracts.

The base selected for each allocation should be the one which results in an equitable allocation to benefiting activities and is practical under the circumstances. The Circular and ASMB C-10 contain criteria for the selection of appropriate bases as well as suggested bases that generally are considered to be equitable. However, a base different from the suggested base may be used if the suggested base is either inequitable or impractical. The steps contained in this section are designed to help ensure that the bases used result in an equitable allocation of costs. Except where otherwise noted, these steps apply equally to both multiple allocation base and simplified proposals.

STEPS	COMMENTS
1. Determine that the proposed bases result in an equitable distribution of indirect costs.	Generally, if the proposed bases conform to the suggested or required bases they should be accepted. However, there may be circumstances which indicate that an inequity will result if a suggested base is used. For example, total expenditures exclusive of capital expenditures is a suggested base. However, the existence of major subcontracts will usually require the use of a modified total expenditure base excluding major subcontracts or a different base such as salaries and wages.
2. Determine that the proposed bases include all activities which benefit from the indirect costs that are allocated, including where appropriate:	

STEPS	COMMENTS
a. Activities associated with general funds	
b. Activities associated with restricted, special purpose, or other funds	
c. Grants and contracts	
d. State institutions (e.g., hospitals, universities)	
e. Costs used for cost sharing or matching purposes	
f. Non-state organizations which receive services (e.g., an affiliated foundation, a local government agency, etc.)	
g. Unallowable <u>activities</u>	Unallowable costs must be included in the direct costs if they represent <u>activities</u> to which indirect costs are properly allocable. Unallowable activities include unallowable compensation costs, such as public relations, fund raising, and investment management activities.
h. <u>Services</u> donated to the agency by third parties.	The value of donated services utilized in the performance of a direct cost activity shall, when material in amount, be considered in the determination of the agency's indirect costs or rate(s) and, accordingly, shall be allocated a proportionate share of applicable indirect costs. Also, see ASMB C-10, Question 2-15.
3. Determine whether the data included in the bases (e.g., square footage, number of employees, time studies, etc.) are current and accurate.	This step applies only to multiple allocation base proposals. The negotiator may be able to reconcile the data to central service cost allocation plan statistics.

D. CONCLUDING STEPS

STEPS	COMMENTS
1. Determine whether there are any significant anticipated changes in the level of the institution's activities, its organization structure, or its accounting system that should be taken into account in the negotiation of a provisional, fixed or predetermined rate(s).	Normally this rate(s) is based on the actual costs for the most recently completed fiscal year. However, if the agency anticipates significant changes in its operations that should affect the costs, the changes should be reflected in the establishment of the rate(s).
2. Determine whether an advance agreement covering future negotiations should be established.	Advance agreements should be established when they are needed to preclude future disputes or problems or when they will help ensure equitable cost determinations in the future. Examples of areas where these agreements may be needed include (a) changes or refinements in allocation bases, (b) the treatment of certain types of costs, (c) changes in the agency's accounting system, and (d) limitations of certain costs. If an advance agreement is established it should be included in the letter transmitting the Negotiation Agreement.
3. Negotiate the appropriate type of rate(s) (e.g., provisional, fixed, predetermined, or final) and complete negotiation agreement form.	Contact will more than likely be maintained with the agency throughout the review of the proposal. The negotiator at the conclusion of the negotiation should contact the agency to (a) summarize the adjustments (if any) and the term or conditions incident to the acceptance of the rate(s) and (b) gain concurrence on a final position. Guidance on the circumstances under which costs

should be negotiated on a provisional, final, fixed or predetermined basis are as follows:

- Provisional rates will be used only in those situations in which the negotiator has little confidence in the rate proposed and cannot negotiate a rate which will fairly reflect an agency's operations during the period to which the rate applies. Provisional rates should also be used when (i) the propriety of the rates are contingent upon the occurrence of a future event which is uncertain at the time of negotiation or (ii) the agency plans to reorganize or otherwise substantially change its operations in the future. When a provisional rate is established, a final rate must be negotiated when the actual costs for the period become known.

- Predetermined rates may only be negotiated in those situations where there is a high probability that the rate negotiated will result in a dollar recovery to the agency not in excess of the amount that would have been recovered had the rate been established on an "after-the-fact" basis. Predetermined rates are not authorized if there are contracts awarded to the grantee agency.

- Fixed rates with carry-forward provisions may be used except where the carry-forward adjustment would be difficult or impossible to make because:

  (i) the agency is unlikely to have active awards in the future periods to effect the carry-forward adjustment against,

(ii) the mix of Federal/non-Federal work performed by the agency from year to year is too erratic to permit a fair carry-forward adjustment,

(iii) the operating activities of the agency are unstable,

(iv) the negotiator is not satisfied that the rate proposed will approximate the actual rate.

- The negotiator should avoid setting fixed rates which result in major carry-forward adjustments. Consider setting limitations on the amount of permissible adjustment (e.g., spread over more than one fiscal year).

- If a fixed or predetermined rate is used, a provisional rate should normally be established to cover the period subsequent to the period covered by the fixed or predetermined rate. This will preclude potential problems in funding awards made after the expiration of the fixed or predetermined rate.

4. Complete a Summary of Negotiations.

A summary of negotiations should be prepared which shows the amounts negotiated that are different from the amounts submitted, and the reasons for the negotiated differences. The summary should be sufficiently detailed to permit an independent reviewer to quickly understand how the negotiated rates were arrived at. It should also identify how cost avoidances, if any, were computed.

STEPS	COMMENTS
	See Part II, Section D for file documentation requirements.

ATTACHMENT A

Reconciliation of Net Assets Sample Format

STATE OF ___________________________

____________________________________ FUND

RECONCILIATION OF NET ASSETS BALANCE TO FEDERAL GUIDELINES

FOR YEAR ENDING JUNE 30, 20___

PART I A-87 NET ASSETS BALANCE

				(000s)
A-87 NET ASSETS BALANCE JULY 1, 20___				
Balance Per Prior Year's Reconciliation of Fund to A-87			$0	
(Initial Year, Use CAFR Net Assets Balance at Beginning of Year Less Adjts - e.g., Contrib. Capital)				
Y 20 NET ASSETS INCREASE(DECREASE) Per CAFR				
A-87 Revenues (Actual and Imputed)				
From CAFR		$0		
Imputed Revenue (if applicable)		0		
Other-		0		
Total Revenues			$0	
Expenditures (Actual Costs):				
Per State's Financial Report		$0		
Less A-87 Unallowable Costs (e.g.)-				
Capital Outlay		(0)		
Projected Cost Increases/Replacement Reserve		(0)		
Bad Debt		(0)		
Other- (e.g., Gain on Disposal of Assets)		(0)		
Plus A-87 Allowable Costs (e.g.)-				
Indirect Costs From SWCAP		0		
(If Not Allocated in Section I Of SWCAP To User Depts/Programs)				
Depreciation or Use Allowance		0		
(If Not Included In Actual Costs Above)				
Other-		0		
OMB A-87 Allowable Expenditures			$0	
Adjustments:				
Imputed Interest Earnings on Monthly Average Cash Balance at State Treasury Avg. Rate of Return		0		
Other-		0		
Total Adjustments			$0	
A-87 NET ASSETS BALANCE JUNE 30, 20___	(A)			$0
Allowable Reserve	(B)		$0	
Excess Balance (A) - (B)			$0	

(If less than zero, the amount on (A) is the beginning A-87 net assets balance for the next year's reconciliation. If there is an excess balance, then the federal share should be returned to the federal gov't and the amount on (B) will be the beginning A-87 net assets balance for the next year.)

PART II A-87 CONTRIBUTED CAPITAL BALANCE

A-87 CONTRIBUTED CAPITAL BALANCE JULY 1, 20___			$0	
TRANSFERS Per CAFR (Supported By Official Accounting Records)				
Plus: Transfers In (e.g., Contrib. Capital)		$0		
Less: Transfers Out (e.g., Payback of Contrib. Capital, Other Users of Fund Net Assets		(0)		
Net Transfers			$0	
A-87 CONTRIBUTED CAPITAL BALANCE JUNE 30, 20___	(C)			$0

PART III A-87 ADJUSTMENTS BALANCE

A-87 ADJUSTMENTS BALANCE JULY 1, 20___			$0	
ADJUSTMENTS:				
Less: A-87 Unallowable Costs		($0)		
Plus: A-87 Allowable Costs		0		
Other-		0		
Total Adjustments			$0	
A-87 ADJUSTMENTS BALANCE JUNE 30, 20___	(D)			$0

PART IV RECONCILIATION OF A-87 NET ASSETS, CONTRIBUTED CAPITAL AND ADJUSTMENTS BALANCES TO CAFR BALANCE

RECONCILIATION OF A-87 BALANCES TO CAFR (Should Tie to the Fund Balance in the CAFR)	(A) + (C) + (D)	$0

ATTACHMENT B

SAMPLE FORMAT

CARRY-FORWARD COMPUTATION - ACCOUNTING ACTIVITY *
CENTRAL SERVICE COST ALLOCATION PLAN

	Initial Year			Subsequent Years				
	FY 2000			FY 2002				FY 2004
Recipient Department or Agency	Fixed FY 00	Actual FY 00	Difference Carry Fwd From FY 00 to FY 02 (Col 2 - Col 1)	Fixed FY 02 (Col 2 + Col 3)	Actual FY 00 (Same as (2))	Actual FY 02 Excluding Carry Fwd	Difference Carry Fwd From FY 02 to FY 04 (Col 6 - Col 5)	Fixed FY 04 (Col 6 + Col 7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Attorney General	$100,000	$68,513	($31,487)	$37,026	$68,513	$70,000	$1,487	$71,487
Commerce	$40,000	$39,384	($616)	$38,768	$39,384	$40,000	$616	$40,616
Office of the Governor	$18,500	$13,486	($5,014)	$8,472	$13,486	$20,000	$6,514	$26,514
Library, Archives & Public Records	$15,000	$13,560	($1,440)	$12,120	$13,560	$15,000	$1,440	$16,440
Social Services	$845,000	$1,090,834	$245,834	$1,336,668	$1,090,834	$1,500,000	$409,166	$1,909,166
Health Services	$290,000	$262,494	($27,506)	$234,988	$262,494	$250,000	($12,494)	$237,506
Veterans' Services	$25,250	$20,848	($4,402)	$16,446	$20,848	$22,000	$1,152	$23,152
Agriculture	$36,097	$39,971	$3,874	$43,845	$39,971	$45,000	$5,029	$50,029
Education	$121,741	$106,469	($15,272)	$91,197	$106,469	$110,000	$3,531	$113,531
State University	$35,400	$42,402	$7,002	$49,404	$42,402	$45,000	$2,598	$47,598
Corrections	$482,119	$440,106	($42,013)	$398,093	$440,106	$500,000	$59,894	$559,894
Emergency Services	$50,000	$49,253	($747)	$48,506	$49,253	$55,000	$5,747	$60,747
Transportation	$774,490	$485,517	($288,973)	$196,544	$485,517	$500,000	$14,483	$514,483
Other Agencies (1)	$1,230,000	$1,102,671	($127,329)	$975,342	$1,102,671	$1,328,000	$225,329	$1,553,329
	$4,063,597	$3,775,508	($288,089)	$3,487,419	$3,775,508	$4,500,000	$724,492	$5,224,492

(1) These agencies do not perform federally-supported programs.

* This is a sample only and is not intended to prescribe methods of charging costs.

ATTACHMENT C

SAMPLE FORMAT

CARRY-FORWARD COMPUTATION*
DEPARTMENT/AGENCY INDIRECT COST PROPOSAL
DEPARTMENT X

	Initial Year		Subsequent Years			
	FY 2004 (4)		FY 2006 (4)		FY 2008 (4)	
(a) Fixed Rate Per Negotiation						
Agreement (A/B) - Computed as follows:		10.0%		11.4%		9.4%
Modified Total Direct Cost (MTDC) Base (1)		$49,326,750 (B)		$49,387,950 (B)		$48,804,500 (B)
Indirect Cost Pool:						
Departmental Costs (1)	$4,701,230		$5,032,850		$4,587,450	
Department's Share of Central Service Costs (2)	231,440		279,300		352,810	
Carry-Forward	0		325,495		(371,468)	
Total Pool		$4,932,670 (A)		$5,637,645 (A)		$4,568,792 (A)
(b) Actual Costs Negotiated						
Computed as follows:						
Actual MTDC Base (3)		$49,387,950		$48,804,500		$51,001,000
Actual Indirect Cost Pool:						
Departmental Costs (3)	$5,032,850		$4,587,450		$4,862,700	
Department's Share of Central Service Costs (2)	231,440		279,300		352,810	
Carry-Forward	0		325,495		(371,468)	
Total Pool		$5,264,290		$5,192,245		$4,844,042
(c) Carry-Forward Computation:						
Recovered:						
Fixed Rate X Actual MTDC Base						
10.0% X 49,387,950		$4,938,795 (E)				
11.4% X $48,804,500				$5,563,713 (E)		
9.4% X $51,001,000						$4,794,094 (E)
Should Have Recovered:						
Actual Indirect Costs For:						
FY 2004		5,264,290 (F)				
FY 2006				5,192,245 (F)		
FY 2008						4,844,042 (F)
Underrecovery (F-E) - Carry-Forward to Subsequent Year		$325,495				$49,948
Overrecovery (E-F) - Carry-Forward to Subsequent Year				$371,468		

*This is a sample only and is not intended to prescribe methods of charging costs.

ATTACHMENT C

SAMPLE FORMAT

CARRY-FORWARD COMPUTATION*
DEPARTMENT/AGENCY INDIRECT COST PROPOSAL
DEPARTMENT X

*This is a sample only and is not intended to prescribe methods of charging costs.

NOTES

(1) In this illustration, the MTDC base amounts and the departmental indirect cost amounts used for purposes of computing fixed rates, were predicated on actual amounts incurred in a previous year (viz. FY 02 actual costs were used as FY 04 costs). A grantee organization may use more current information for fixing rates, where that information is available, and where in the opinion of the Federal negotiator, the data available is adequate and reasonable. Generally, however, most grantees prefer using historical data.

(2) These amounts should come from the approved State/local central service cost allocation plan (for State governments, Exhibit A of the statewide cost allocation plan agreement).

(3) Based on actual costs for the FY's 04, 06, and 08. These costs are normally known soon after the completion of each of these respective fiscal years, and are obtained from the grantee's records and reflected in the indirect cost proposals submitted to and approved by the cognizant Federal negotiator.

(4) A second cycle would be initiated for the odd number years (i.e., FY 05, 07, and 09) similar to the cycle illustrated on the previous page for the even numbered years. The initial year of the odd numbered years would be FY 05. The FY 05 fixed rate computation would be negotiated prior to the beginning of FY 05, would not include a carry-forward amount in the computation of the fixed amount, and would probably use FY 03 actual costs as a basis for fixing FY 05 costs.

(5) The sample on the previous page illustrates a department with a single indirect cost rate. Rather than use a single indirect cost rate, some departments will develop multiple rates, i.e., a separately computed indirect cost rate for each division in the department. The same procedures should be followed for a department or agency for which more than one rate is developed, except that a separate carry-forward amount must be computed for every division. The department's share of central service costs and share of departmental indirect costs will have been distributed to each division to arrive at divisional indirect cost rates, so that no special treatment needs to be accorded these costs on a divisional basis that has not already been stated for the single rate basis.