LEGAL SERVICES CORPORATION

45 CFR Part 1630

Costs Standards and Procedures

AGENCY: Legal Services Corporation.

ACTION: Final rule.

SUMMARY: This final rule establishes a new Part 1630 prescribing standards and procedures for determining allowable costs for grants and contracts under sections 1006(a)(1) and 1006(a)(3) of the Legal Services Corporation Act (Act), and for recovering disallowed costs. The Legal Services Corporation ("Corporation" or "LSC") has not previously promulgated regulations establishing a comprehensive set of costs standards and procedures, except to the extent that they were contained in the Audit and Accounting Guide for Recipients and Auditors (Audit Guide) and in LSC Instruction 83-8. This new rule is intended to provide recipients with clear and simple standards and procedures so recipients can determine which costs are allowable, which costs require prior approval, how such approval is obtained, and how review of disallowed costs is obtained.

EFFECTIVE DATE: September 12, 1986.

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SUPPLEMENTARY INFORMATION: On February 20, 1985, the Corporation published a revision of the Audit Guide for comment (50 FR 7150). As comments were received and reviewed and revision progressed, it became evident that separate regulations establishing costs standards and procedures for resolution of questioned costs issues should be developed. Accordingly, on August 29, 1985, the Corporation published in the **Federal Register** a proposed new Part 1630 on costs standards and procedures (50 FR 35102). The revised Audit Guide was published on November 29, 1985 (50 FR 49276). After review of comments received and further study, the Corporation, on April 21, 1986, published a revised Part 1630 for further comment (51 FR 13532). Eighty-two timely comments were received and an additional forty-two thereafter. All comments were considered. In addition, two Committees of LSC's Board of Directors ("Board"), the Committee on Operations and Regulations, and the Committee on Audit and Appropriations, heard comments at several meetings. During the same period, Corporation staff has had informal discussions with commenters. After carefully considering all oral and written comments, the Board on June 27, 1986, adopted a final rule. This final rule establishes a new Part 1630 to prescribe standards and procedures for determining allowable costs for recipients of grants and contracts under sections 1006(a)(1) and 1006(a)(3) of the Legal Services Corporation Act ("Act"), (42 U.S.C. 2996 et seq.), and for recovering disallowed costs.

For some time the Corporation, through the Board Committees on Audit and Appropriations, and on Operations and Regulations, has been working with Corporate staff to improve Corporate and recipient accountability for the federal funds entrusted to the Corporation. The need for clear and concise standards governing the determination of allowable costs, and for recovery of misspent tax dollars, became abundantly clear in the process of developing a comprehensive revision of the Audit Guide and in the processing of costs disputes. Numerous items of questioned costs had remained unresolved for several years, and had occasioned sporadic adversarial activity which left programs uncertain of what to expect. Many of the pending items resulted from failure of various programs to obtain prior approval of certain obviously necessary expenditures, even though such programs had requested approval repeatedly from an LSC regional office for more than a year. Some programs had good reason to believe that the Corporation's regional offices would not give approval in a reasonable and timely manner, and simply ignored the prior approval requirement so that they could continue to serve clients in a business-like manner.

As these understandable problems with regional offices (especially the Southern Regional Office) came to the attention of new Corporate managers, priority was given to resolving back issues and to approving many pending items in situations where it was clear that the expenditure was reasonable and necessary for the service of clients, even though prior approval had not been obtained as required. As a means of eliminating future problems of this type, Corporate staff proposed new language for this regulation to prevent the Corporation from challenging costs because of lack of prior approval, unless the Corporation had made timely objection to the request for approval. The Corporation intends to give priority to ensuring prompt response to all such requests, especially those needing expedited action. This concern is explained further under § 1630.6 below.

The Corporation has utilized the wealth of guidance and experience developed by federal agencies in their efforts to safeguard tax dollars granted to a wide variety of entities. Various Circulars of the Office of Management and Budget (OMB) reflect the wisdom and experience accumulated over time by federal entities. Circular A-122 ("Cost Principles for Non-profit Organizations") was particularly instructive and many sections of Part 1630 were patterned on its provisions. Although the Corporation has adopted, adapted, or incorporated by reference many of the standards and policies of the Circulars, it has, nevertheless, taken care to make such modifications and changes as it felt necessary to meet the needs of providers of legal services and to ensure accountability for federal grant funds under the Act.

The following provisions are of particular significance:

Section 1630.2 Definitions.

Section 1630.2 defines "questioned costs", "allowed costs" and "disallowed costs".

As proposed, these definitions and several other sections could have been interpreted to reach private as well as federal funds beyond the mandate of section 1010(c) of the LSC Act. That section forbids recipients from expending private funds for any purpose forbidden by the Act. Many commenters questioned our approach. Some questioned our authority to examine any expenditure of private funds. The Board has no doubt about its authority to carry out the Congressional purpose concerning section 1010(c), or any other provision of the Act. It recognizes, however, that the across-the-board approach of applying section 1010(c) to the entire regulation could present unforeseeable situations and uncertainties. Accordingly, the Board decided to address section 1010(c) in a completely new section of the regulations and make clear that the restrictions of the other sections of this part apply only to LSC funds. Accordingly, a new section 1630.12 has been added to address private funds in relation to section 1010(c). All other references to such funds, in the definitions or elsewhere in the regulations, have been deleted.

Section 1630.2 also defines "recipient". A "recipient" under this part is not the same as a "recipient" under section 1600.1 of the regulations or as defined in section 1002(6) of the Act. Both of those definitions deal only with

a "recipient" under section 1006(a)(1)(A) of the Act. Since this part sets costs standards and procedures for all grants and contracts under sections 1006(a)(1) and 1006(a)(3) of the Act, the definition of "recipient" for purposes of this part is expanded to reach all those receiving grants or contracts under these provisions.

Section 1630.3 Burden of Proof.

Paragraph (a) of the section places the burden of proof on the recipient at all times. This is appropriate since the recipient is responsible for the activities and expenditures involved, as well as for all supporting documentation. Paragraph (b) clarifies that where a recipient claims that the funds used to pay for a questioned cost are not subject to a particular restriction, the recipient has the burden of showing that the funds were not subject to the restriction. A recurring problem has been caused where recipients have accumulated fund balances from successive years' fundings, and have claimed that payments for activities forbidden by particular appropriations riders or other restrictions were made from fund balances of earlier years when the particular prohibitions or restrictions were not applicable.

Many comments focused on proposed § 1630.3(b)(2) which established a presumption in situations where funds having different restrictions are held or are accounted for in such a manner that auditors have difficulty tracking funds and determining if all restrictions have been obeyed. Many commenters appeared concerned that the prohibition against commingling funds in the same account would be too great a burden for programs. The Corporation decided that since the section requires the program to bear the burden of proof, a specific prohibition against commingling unrestricted funds in the same account with funds subject to a statutory restriction was unnecessary. If a recipient has ever commingled funds, its burden would be difficult to meet.

Section 1630.4 Standards governing allowability of costs under Corporation grants or contracts.

Section 1630.4 sets forth the basic standards and criteria which govern the allowability of costs for grants and contracts under sections 1006(a)(1) and 1006(a)(3) of the Act.

Several comments complained about the clarity of the terminology used in this section. Words such as "total costs," "direct costs," "indirect costs," "allowable costs," "unallowable costs," and "allocable costs" were cited as examples of uncertain meaning. These terms are taken from the circulars and are words of art used consistently when discussing federal costs principles. They are the subject of authoritative and neutral interpretations and rulings by numerous courts and agencies and can be interpreted by reference to relevant literature and consultation with experts. Reliance on standard language and interpretations to the extent practicable should give maximum consistency and predictability of result to recipient decision-makers.

Paragraph (a) establishes nine general criteria governing allowability of costs. These criteria do not apply to non-LSC funds.

Paragraph (a)(1) provides that the expenditure must actually have been incurred during the term of the grant or contract. Some commenters were concerned that the paragraph could forbid the use of funds carried over to the next year pursuant to Part 1628. The paragraph makes specific reference to Part 1628 to clarify that there is no intent to change the scope of that Part. Several commenters were also concerned that the paragraph could forbid accrual accounting. There is no such intention. The phrase "actually incurred after the effective date of the grant or contract" is consistent with the accrual method of recording expenses and revenues.

Paragraph (a)(2) provides that the cost must be reasonable and necessary for (1) the provision of legal services to eligible clients, or (2) the accomplishment of another function specified in the grant or contract application as approved by the Corporation. Although the language as originally proposed was quite similar to the pertinent federal circular language from which it was derived, commenters were concerned that the reference to "another function" could be construed to exclude activities now being performed because they were not "legal services for eligible clients." Accordingly, the second half of the provision has been revised to specify that where an activity is identified and supported in the application and specifically approved by the Corporation it is allowable.

Paragraphs (a)(5) and (a)(6) are not redundant, as some commenters may have believed. Paragraph (5) means that a recipient cannot have two standards, one for Corporation work and one for non-Corporation work. The purpose is simple: to prevent "gold-plating" of those activities funded by tax funds, whether as a way of shifting costs to those activities (e.g., paying staff a much higher rate on LSC work than on other work) or from misguided generosity or lax management. Paragraph (5) does permit a recipient to use LSC funds to pay for overhead for activities that could be charged to LSC funds where the grant from non-LSC sources does not provide for overhead. The provision deals only with business, managerial, accounting, and similar policies. It does not address programmatic or legal strategy decisions. Paragraph (6) means that accounting practices must be consistent over time. For example, a recipient could not change allocations as follows: allocate the salary costs of its administrative staff to an LSC-funded activity as opposed to a non-LSC eligible activity such as criminal defense work, for the first time period (e.g., month, quarter) on the basis of the number of active LSC eligible versus non-LSC eligible cases, for the second period allocate on the number that are closed during the period, and for the third period allocate on the number of attorneys in respective divisions, each time using a basis that maximizes the allocation of costs to the LSC-supported activity. Changes in accounting practices should be infrequent, well-justified, noted in financial reports, and, when significant, discussed in advance with LSC.

Paragraph (a)(8) is a standard federal provision to ensure that, where a federal program requires the grantee to raise matching funds to expand the services provided with limited federal funds, these funds must be raised from a source other than the federal treasury and taxpayer. The paragraph provides that a cost allowed against a grant or contract of the Corporation may not also be used as matching funds to meet the non-federal share of another federal program. Various commenters were concerned that other program funds, such as those from Administration on Aging, could be affected by the provision. Accordingly, the proviso "unless permitted by law" has been replaced with a requirement that the agency whose funds are being matched shall determine in writing that Corporation funds may be used for the non-federal matching requirements of the laws the agency enforces. Where a *bona fide* written determination is made by the federal, state, or local agency providing funding to the recipient, the use of LSC funds for matching purposes will not be questioned by LSC pursuant to this provision.

Paragraph (a)(9) provides for adequate and contemporaneous documentation of records and for their availability during normal business hours. As published for comment, this provision also sought to ensure that there would be no opportunity for alteration between the

me records are requested and the time an auditor or other LSC representative is given access to the records. This proposal was made to avoid situations where records might be changed to avoid discovery of violations or unallowable costs. Many commenters noted that it is common for mistakes, and other changes and corrections, to be made at the end of a fiscal period to balance the books, and that this is normal accounting practice. Some noted that they have to delete confidential client information before opening their books and noted that such deletions could be considered "alterations". The Corporation's sole concern was with the danger of deliberate alteration for improper purpose, e.g. deception. Routine corrections of errors and of mistakes, which are generally accepted in accounting and auditing, and removal of client names, and other information to protect client rights, were not our concern. It is fundamental to an audit that the auditor must be able to assure that there is no opportunity for alteration or creation of records between the time the auditor indicates interest in particular records or transactions by making specific requests nd the time access to such records is rovided. In addition, materials properly subject to the attorney-client privilege should not be intermingled with fiscal records. A recipient could violate section 1006(b)(3) of the Act through a breach in client confidentiality if it does not generally restrict a client's secrets to that client's case file but scatters them through other records. Where an auditor seeks records, such as those relating to client trust funds or to expenditures in support of particular cases, it is acceptable if the records are pulled from their normal file and privileged information is obscured or redacted in the presence of the auditor.

It was suggested that the phrase "upon reasonable notice" be inserted before the words "during normal business hours". Notice that is reasonable under the circumstances is now provided as a matter of course on all visits, and this practice will continue. In instances where there are indications of some kind of misconduct, routine notice procedures could provide time and opportunity to create, alter, hide or destroy records. An unannounced visit during normal business hours would be "reasonable" under such circumstances. Consequently, the suggested language ould not properly be used to deny ccess. It could be an excuse, however, o delay or otherwise frustrate access. Accordingly, the proposal was rejected.

Section 1630.4(b) deals with reasonableness of costs. The test is the behavior of a prudent person under the circumstances. The section notes that in the case of recipients which receive the bulk of their funds from the Corporation or other federal sources, where there is no competitive market or business test, particular care must be taken in determining the reasonableness of expenditures.

Several commenters were concerned about the reference and suggestions were made that the language be changed or modified. No change has been made, however, because the Corporation does not believe that change would improve the Provision. The language recognizes that where a recipient does not have a continuing competitive obligation to control costs, it may not expend sufficient energy in that area. It is the obligation of the auditor or monitor to recognize this possible tendency and to be particularly alert in this area.

Several commenters were also concerned about the directive in paragraph (3) of section 1630.4(b) to look at whether the individuals concerned acted with prudence, considering their responsibilities to the clients, the recipients, the public at large, the Corporation, and the federal government. Several commenters suggested that the individuals involved have no obligations to the public at large or to the federal government. The Corporation disagrees. Congress has made very clear that the Corporation is responsible directly to it. H.Rep.No. 95-310, 95th Congress, 1st Sess., May 13, 1977, p.6; S. Rep.No. 95-172, 95th Cong., 1st Sess., May 16, 1977, p.3. The Corporation is required to assure that recipients comply with the provisions of relevant laws and regulations, and with the terms of the awards. Consequently, it seems clear that those who work for recipients or carry out program objectives for them are responsible to the taxpayers through the Corporation and the Congress. No change has been made in the provision.

Section 4(c) deals with allocable costs. A cost is allocable to a particular cost objective in Proportion to the relative benefits received. An allocable cost must also be treated consistently with other costs incurred for the same purpose in like circumstances. Consistent treatment in allocating among cost objectives is a basic goal.

Paragraphs (c)(1) (i), (ii) and (iii) provide specific guidelines for allocating costs. Paragraph (c)(1)(i) states that if a cost is incurred specifically for a grant or contract the cost must be allocated to that grant or contract. The attorney exclusively serving LSC clients is an example where costs are incurred specifically for the LSC grant or contract. Paragraph (c)(1)(ii) applies to cases where costs benefit more than one cost objective and can be allocated in reasonable proportion to the benefits received. An attorney serving eligible clients 60% of the time and participating in non-LSC activities 40% of the time must have his or her salary and benefits allocated accordingly. Paragraph (c)(1)(iii) provides for the allowability of costs having no direct relationship to any particular cost objective. Overhead, continuing legal education, and subscriptions may be examples of necessary costs which in some circumstances may not have a direct relationship to any particular cost objective. These costs must be allocated on a reasonable basis, in accordance with the relative benefits received, to the various cost objectives. For example, the cost of electricity may be allocated to cost objectives based on the percentage of staff time devoted to each cost objective.

Paragraph (c)(2) states that costs allocable to a particular cost objective may not be shifted to other Corporation grants or contracts to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms or conditions of the grant or contract. This paragraph does not restrict the allocation of costs to particular cost objectives. An activity may be proper under a number of cost objectives, and an allocation of costs to any one of these cost objectives is permissible. However, allocation of costs to cost objectives which are restricted with respect to such funds is impermissible. This paragraph is consistent with the principles in paragraph (1) of this section and ensures an accurate accounting and proper cost allocation for every cost objective. It forbids a grantee or contractor from shifting costs from a grant or contract awarded by a non-LSC source to a a Corporation grant or contract when the costs could not have been borne by the Corporation award in the first place. A recipient could not meet a funding deficiency in a non-LSC account with LSC funds if the activities funded in the non-LSC account could not be undertaken with LSC funds. Thus, a recipient could not shift costs from a public funding source to a Corporation grant or contract if the non-LSC grant was awarded to provide criminal representation or to undertake activities restricted by Part 1612. This paragraph does not require a program to reject funding from any source that did

not include funds sufficient to cover all indirect costs associated with the activity funded so long as the activity funded serves LSC-eligible clients and cases. This paragraph permits a program to charge the basic LSC field grant for activities partially, but not wholly, funded by other sources, so long as the activities funded consist of services for LSC-eligible clients.

There will usually not be a serious "allocation" problem regarding LSC funds if all of a recipient's activity is eligible for LSC funding under its grant or contract, even though a recipient may receive other funds. When a recipient has both an LSC function and a non-LSC function (e.g., criminal defense work), all or some of its costs must be "allocated" between these two functions. For example, if a staff attorney works exclusively serving eligible LSC clients, the attorney's salary and benefits would be allocable to the LSC grant or contract. On the other hand, if an attorney works 60% of the time serving eligible LSC clients and 40% of the time in non-LSC activities, the attorney's salary and benefits must be allocated proportionately between the LSC grant or contract and some other cost objective (grant, project, service or other activity). Section 1630.4(c) repeats in standard grant accounting terms, the general principle that this division must be done on some kind of rational basis reflecting the benefits of the work performed for each cost objective. If the recipient has two divisions, such as an LSC division and a criminal division, and neither works in the other's area, all direct costs of the LSC division would be charged to LSC without the need for allocation; only "joint" costs, such as rent, utilities, or the salaries of administrative employees who perform management and accounting work for both divisions, would have to the "allocated". Whenever possible, costs should be charged directly. Thus, if the two divisions are housed in separately rented buildings, each could be charged its own rent. Some phone systems have the capacity to charge all long-distance calls to the division of the employee making that call, or even to the particular case being worked upon. Depending upon actual circumstances, accountants may agree upon a number of ways of making allocations, such as attorney hours, number of cases, number of employees, total direct costs, etc. For instance, if the LSC division of a program incurred $200,000 in directly chargeable costs and the criminal division of that program incurred $100,000 in such costs, LSC's share of a total of $90,000 in general overhead (e.g., program director's salary, administrative staff) would be $60,000, were the allocation based on the proportion of direct costs.

Paragraph (e) defines program income in terms consistent with Attachment D to Circular A-110 ("Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-profit Organizations—Uniform Administrative Requirements"). Some commenters were concerned about the effect of the new definition on fund balance calculations. Section 1628.2(a) of the regulations defines LSC "support" for fund balance calculation purposes as including (1) the basic award, (2) any income (including interest) derived from it, and (3) attorneys' fees, proceeds from sale of assets, and any other compensation or income attributable to the award. Paragraph (e) defines "program income" as including attorneys fees, proceeds from the sale of assets, service fees, and interest income. In effect, it defines "program income" as including all the items added to the basic award by § 1628.2(a) in arriving at LSC "support". This definition should have no effect on fund balance calculations.

A number of commenters were critical of the inclusion in program income of attorneys' fees awarded in cases funded with LSC grant funds. When the grant or contract pays all the costs of a particular activity, it is to be expected that revenue from that activity is treated as derived from the grant or contract and subject to all the current LSC restrictions. Since the definition is completely consistent with the definition of LSC "support" in § 1628.2(a), and with the fund balance calculation process, we do not believe that the criticisms raise valid concerns.

In order to ensure that such revenue need not be recognized before payment was assured, the proposed paragraph (e) provided that program income was to be applied as a credit against grant or contract costs charged the Corporation at the time of actual receipt. Although the net result would not have been affected, this would have changed the method of calculating the fund balance. We have deleted the provision to eliminate any confusion concerning the calculation process and will rely upon generally accepted accounting practices which do not require the recognition of speculative revenue.

Advance Understandings

Paragraph (2) of § 1630.4(f) is a revision of proposed paragraphs (b) and (c) of § 1630.5 as published April 21, 1986. New paragraph (2) recommends that recipients try to enter into advance understandings in the sensitive areas of expenditures for travel and fees for training, for conferences, meetings where political activity is encouraged, or where staff of other LSC recipients are the primary participants, and for branch offices where a primary use is lobbying, legislative advocacy or formal rulemaking.

As originally proposed, § 1630.5 (b) and (c) would have required prior approval by the Corporation for certain travel, meetings and conferences, and office expense associated with lobbying, legislative advocacy, and formal rulemaking. Commenters were very concerned about the administrative and other burdens which such prior approvals would have placed on recipients and on the Corporation. A number of commenters noted that they had had delays of various lengths getting approvals under existing prior approval provisions. In the past, such approval authority was delegated to regional offices and there were, all too often, unreasonable delays. The Corporation has corrected these management problems and could now handle the requests for approval efficiently and on a timely basis. It decided, however, to place the proposed provisions of §§ 1630.5 (b) and (c) in the advance understanding section to express the Corporation's concern that recipients should ensure that all such expenditures are reasonable, necessary, and in full compliance with all applicable restrictions on the use of LSC funds. Due attention to these concerns will be exercised during audits and monitoring of recipients. The requirements for prior approval of these expenditures were accordingly deleted.

Guidance

Section 1630.4(g) provides that the OMB Circulars will be used for guidance in resolving cost questions to the extent that they are not inconsistent with applicable laws, rules, regulations, guidelines, and instructions and with the Audit Guide. These Circulars have already benefited from review and comment, have been in operation for many years, and have been the subject of extended interpretation and implementation. They are an excellent and neutral source of cost and accounting principles and decisions that can resolve many issues that will arise under this part but which the Corporation cannot now reasonably foresee.

Unallowable Costs and Prior Approvals

Section 1630.5(b) provides for prior approval of certain expenditures. In

esponse to comments, language was inserted to state that approval will not be denied unless the cost would be inconsistent with the standards and policies of this part, including the criteria set forth or incorporated by reference in §§ 1630.4 and 1630.5 or elsewhere in Part 1630. Normally, prior approval will be valid for only one year. For example, where a program obtains approval of a purchase on January 21, 1986, and does not complete the purchase by January 21, 1987, it must seek approval again. If the approval is for a lease which would last for several years or a contract for the purchase of property, then the approval allows compliance with the lease or contract if executed within a year; extensions, renewals, or modifications, of course, require approval if such actions, standing alone, would so require.

Cost of Counsel

For many years the Corporation has required recipients to get prior approval for costs of consultants and outside counsel in all matters (including those in which the Corporation has an adverse interest) in which the recipient—rather than an eligible client—is represented d the cost exceeds a set minimum. It as originally proposed that cost of ounsel in a matter in which the Corporation is an opposing party or has an opposing interest should be unallowable. The rationale was that it was illogical to provide funds for others to litigate against the Corportion and that other grant programs do not allow such costs. Many commenters vigorously opposed the proposal. Some claimed that it would create ethical problems and cited Rule 3.7 of the Model Rules of Professional Conduct and DR 5–101(B) and DR 5–102 of the Code of Professional Responsibility of the American Bar Association. We do not agree that the cited provisions necessarily posed ethical problems. See, e.g., ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY, DR 5–101(B) and DR 5–102 (1979), comment, pages 212–221, and D.C. Bar Legal Ethics Committee, Op. 44 (1978) and Op.125 (1983).

Commenters also pointed out that under the Circulars and interpretations of them, costs of counsel may be charged against an award for services associated with protests or appeals within the administrative agency process up to and including any decision by the head of the agency. Litigation inst the granting agency, however, is chargeable against the award. The poration has concluded that it should rely upon the precedent of general federal grant law, incorporated by reference in § 1630.4(g), and permit programs to use in-house staff or retained counsel, and charge their costs to LSC funds, for all stages of negotiations and proceedings which are within the internal administrative structure of the Corporation. Thus, programs can charge LSC funds for costs of counsel and expenses in all proceedings brought by the Corporation to suspend, terminate, or deny refunding. This approach was adopted because it addressed many of the concerns raised by programs about the more restrictive requirement and was generally consistent with the approach used by other federal agencies in dealing with grantees. Under current practice, the Corporation has not exercised its prior approval authority for contracts entered into by programs with attorneys for such representation. Corporate practice will not be modified to insist upon prior approval pursuant to § 1630.5(b)(3) for such contracts except through formal issuance of an instruction pursuant to section 1008(e) of the Act.

Although cost of counsel in these situations will not be subject to prior approval, it will, like any other cost, be subject to later audit. The Project Advisory Group, for instance, recognized in its June 20, 1986 memorandum to the Board that "LSC retains full ability to review costs incurred in retaining counsel in disputes with LSC after the fact. Sections 1630.4 and 1630.5(a) still apply to all funds which did not receive prior approval."

Section 1630.6 Effect of absence of prior approval.

Under § 1630.6, the Corporation cannot claim lack of prior approval where it fails to act on time. The principal criticism of this section was that it contained no separate criteria for prior approval. In response to comments, language has been inserted in § 1630.5(b) as discussed above.

Several commenters were concerned about the time intervals provided for in this section, particularly where a quick response would be needed to avoid harm or loss. The Corporation intends to make every reasonable effort to respond promptly to all program requests for approval, especially if the program presents information which indicates that a quick response is necessary. For example, if a program would incur substantial harm from a delayed response to a request for approval of a consultant contract, the Corporation will attempt to respond in a timely manner so that the loss or harm can be avoided. While the Corporation must make a written request for additional information within 45 days after receipt, it will endeavor to request such additional information as soon as possible, both orally and in writing.

Section 1630.8 Recovery of disallowed costs.

Under § 1630.8, disallowed funds are recovered from future checks or by direct payment or otherwise. Comments criticized the version of this provision that was published in the **Federal Register** because it could be construed to prevent a program from seeking equitable or other relief from recovery of a disallowed cost where it chooses to appeal to the President under § 1630.7(c). The final rule has eliminated the problem by moving the relevant provisions of former § 1630.8 into § 1630.7. Other comments raised concern about the policy of recovering income derived from a disallowed cost. Generally, we believe that derivative income will not occur in most disallowed costs cases. Where such income can be identified and traced, however, we think it should be recovered so that there is no monetary incentive to spend funds on unallowable items.

Comments have also questioned our authority to recover income derived from disallowed expenditures. No basis has been given for this contention. It is a basic principle of statutory construction that express authority to administer a program carries with it implied authority to do what is necessary to implement the express authority. SUTHERLAND, STATUTORY CONSTRUCTION, Section 55.04 (4th ed. 1973) and cases cited thereat; *Chevron, U.S.A., Inc.* v. *National Resources Defense Council, Inc.*, 104 S. Ct 2778 (1984).

Section 1630.9 Other remedies; effect on other parts.

This section provides that the Corporation will require necessary steps by recipients to correct deficiencies. In addition, action pursuant to Parts 1606, 1623, and 1625 may be required. Referrals may also be made to law enforcement agencies and bar associations, as appropriate. This section also provides that recovery of a questioned cost is not to be construed as a termination or a denial of refunding under Parts 1606 or 1625.

Some commenters have stated that any recovery of a questioned cost is subject to section 1011 of the Act and an appropriate proceeding thereunder. They cited *East Arkansas Legal*

Services v. *LSC*, 742 F.2d 1472 (D.C. Cir. 1984) but did not explain in detail application of its reasoning to proceedings under this Part. *East Arkansas Legal Services* v. *L.S.C., supra.* involved reduction of a recipient's grant to offset part of a fund balance carried over from a prior year. The circuit court concluded that reduction was subject to a Section 1011 proceeding. Because of the vastly different considerations at issue here, we do not think that Congress intended to require section 1011 proceedings for the recovery of misspent funds or that the language of the cited case governs the concerns here addressed or precludes the Corporation from adopting the interpretation of Section 1011 set forth in this section.

Section 1630.12 Non-public funds.

This section provides that if an activity is in violation of section 1010(c) of the Act, which forbids recipients from doing anything prohibited by the Act, the cost of the activity cannot be charged to nonpublic funds. It also provides that the Corporation will take from Corporation funds an amount not to exceed the amount disallowed. Congress has prohibited certain uses of non-public funds and empowered the Corporation to enforce this prohibition; for small violations, a proportionate and reasonable monetary penalty is preferable to termination or denial of refunding.

Many comments criticized various aspects of the way former versions of Part 1630 handled non-public funds. Many comments asserted that the Corporation has no authority to deduct from Corporation funds an amount equal to the disallowance. They contended that our implementation of section 1010(c) of the Act was limited to Part 1610 of the Corporation's regulations. Many commenters noted that it did not seem clear in several sections of the regulation (1630.4(b); 1630.5(c); 1630.5(e)) whether the same criteria were used for Corporation and non-public funds.

In response to the comments, the Board decided to treat non-public funds in a separate new § 1630.12. Conforming changes were made to §§ 1630.4, 1630.5, and 1630.6 to eliminate any confusion.

List of Subjects in 45 CFR Part 1630

Accounting, Government contracts, Grant programs, Legal services, Questioned costs.

For the reasons set out in the preamble, a new Part 1630 is added to 45 CFR, Chapter XVI, as follows:

PART 1630—COSTS STANDARDS AND PROCEDURES

Sec.

Authority: 42 U.S.C. 2996e, 2996f, 2996g, 2996h(c)(1), and 2996i(c).

§ 1630.1 Purpose.

This part is intended to provide uniform standards for allowability of costs and to provide a comprehensive, fair, timely, and flexible process for the resolution of questioned costs incurred by recipients of the Corporation. The Corporation has considered the standardized policies developed over years of federal experience with assistance to nonprofit organizations, and has adopted, or adapted, many of these policies where appropriate for the funding of legal services for eligible clients.

§ 1630.2 Definitions.

(a) A "questioned cost" is a charge or proposed charge to a recipient's Corporation funds which could be determined to be ineligible.

(b) An "allowed cost" is a cost that, after investigation, the Corporation has determined to be eligible for payment from a recipient's Corporation funds.

(c) A "disallowed cost" is a cost which has been determined to be ineligible for payment from a recipient's Corporation funds and includes any income the recipient may have derived from activities supported by that cost, including proceeds from the sale of assets and interest.

(d) "Recipient" as used in this part means any grantee or contractor receiving funds from the Corporation under sections 1006(a)(1) or 1006(a)(3) of the Act.

§ 1630.3 Burden of proof.

(a) The recipient shall at all times have the burden of proof under this Part.

(b) If a recipient defends a questioned cost on the basis that the funds used were not subject to the restriction cited by the Corporation, the recipient has the burden of proving that the funds actually expended were not in fact subject to that restriction.

§ 1630.4 Standards governing allowability of costs under Corporation grants or contracts.

(a) *General criteria.* Expenditures by a recipient are allowable under the recipient's grant or contract only if the recipient can demonstrate that the cost was:

(1) Actually incurred during the effective term of the grant or contract (unless allowed by Part 1628) and the recipient was liable for payment;

(2) Reasonable and necessary for the provision of legal services for eligible clients or for the accomplishment of another function specified in the grant or contract application as approved by the Corporation;

(3) Allocable to such function(s);

(4) In compliance with the Act, applicable appropriation acts, Corporation rules, regulations, guidelines, and instructions, the Corporation Audit and Accounting Guide for Recipients and Auditors, and the terms and conditions of the grant or contract;

(5) Consistent with policies and procedures that apply uniformly to both Corporation-financed and other activities of the recipient;

(6) Accorded consistent treatment;

(7) Determined in accordance with generally accepted accounting principles;

(8) Not included as a cost or used to meet cost sharing or matching requirements of any other federally financed program, unless the agency whose funds are being matched determines in writing that Corporation funds may be used for federal matching purposes; and

(9) *Adequately and* contemporaneously documented and the Corporation was given access during normal business hours to the documentation as filed in the recipient's normal business records.

(b) *Reasonable costs.* A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. If a cost is disallowed solely on the ground that it is excessive, only the amount that is larger than reasonable shall be disallowed. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with recipients, or separate divisions thereof, which receive the preponderance of their support from grants or contracts with the Corporation

or federal agencies, rather than through the sale of goods and services in free markets. In determining the reasonableness of a given cost, consideration shall be given to:

(1) Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the recipient or the performance of the grant or contract;

(2) The restraints or requirements imposed by such factors as generally accepted sound business practices, arms-length bargaining, federal and state laws and regulations, and the terms and conditions of the grant or contract;

(3) Whether the individuals concerned acted with prudence under the circumstances, considering their responsibilities to the recipient, its clients and employees, the public at large, the Corporation, and the federal government; and

(4) Significant deviations from the established practices of the recipient which may unjustifiably increase the grant or contract costs.

(c) *Allocable costs.* (1) A cost is allocable to a particular cost objective, such as a grant, project, service, or other activity, in accordance with the relative benefits received. A cost is allocable to a Corporation grant or contract if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

(i) Is incurred specifically for the grant or contract;

(ii) Benefits both the grant or contract and other work and can be distributed in reasonable proportion to the benefits received; or

(iii) Is necessary to the overall operation of the recipient, although a direct relationship to any particular cost objective cannot be shown.

(2) Any cost allocable to a particular grant or contract or other cost objective under these principles may not be shifted to other Corporation grants or contracts to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms or conditions of the grant or contract.

(d) *Applicable credits.* (1) A recipient must deduct all applicable credits, as defined in paragraph (2) below, from the costs it charges to a grant or contract from the Corporation.

(2) The term "applicable credits" refers to those receipts or reductions of expenditures which operate to offset or reduce expense items that are allocable to grants or contracts as direct or indirect costs. Typical examples of such transactions are purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds, and adjustments of overpayments or erroneous charges. To the extent that such credits accruing to or received by the recipient relate to allowable costs they shall be credited to the grant or contract either as a cost reduction or cash refund, as appropriate.

(e) *Program income.* Program income represents gross income earned by the recipient from Corporation-supported activities, and includes, but is not limited to, income from service fees (including attorneys' fees and costs), sales of commodities and property, and interest earned on grant or contract advances or other funds.

(f) *Advance understandings.* (1) Under any given grant or contract the reasonableness and allocability of certain items of costs may be difficult to determine. This is particularly true in connection with recipients that receive a preponderance of their support from the Corporation. In order to avoid subsequent disallowance or dispute based on unreasonableness or nonallocability, it is often desirable to seek a written agreement with the Office of Monitoring, Audit, and Compliance in advance of incurring special or unusual costs. The absence of an advance agreement on any element of cost will not, in itself, affect the reasonableness or allocability of that element. Acceptance of the annual budget as part of the renewal of funding does not constitute an "advance understanding" or "approval", unless the cost or expenditure is identified and specifications of the purpose, amount, and all other information necessary to evaluate the necessity and reasonableness of the cost are included and explicit approval of the specific transaction is included with approval of the grant application.

(2) Because there is significant potential for disagreement regarding the reasonableness, necessity, or allowability of costs allocable to the following activities, recipients are encouraged to seek advance understandings regarding—

(i) Conduct of or attendance at meetings (attended primarily by employees of other LSC recipients or a purpose of which is to encourage political activity), conferences, symposia, or training projects by participants, trainees, trainers, or employees;

(ii) Maintenance or occupancy of a branch office if a primary use of that office is to support legislative advocacy, formal rulemaking, or lobbying.

(g) *Guidance.* The Circulars of the Office of Management and Budget shall provide guidance for all allowable cost questions arising under this part when relevant policies or criteria therein are not inconsistent with the provisions of the Act, applicable appropriations acts, this part, the Audit and Accounting Guide for Recipients and Auditors, and Corporation rules, regulations, guidelines, and instructions.

§ 1630.5 Costs specifically unallowable under Corporation grants and contracts.

(a) No cost allocable to an activity that violates the Act, other provisions of law, Corporation rules, regulations, guidelines, instructions, or the terms of a recipient's grant or contract agreement may be charged to Corporation funds.

(b) Without prior approval of the Corporation (which approval shall not be withheld unless the Corporation determines that the cost would be inconsistent with the standards and policies of this part and which shall be valid for no more than one year), no cost allocable to any of the following may be charged to Corporation funds:

(1) The cost of a lease or purchase of equipment, furniture, books or similar personal property if the single item or combined purchase price is in excess of $10,000. In the case of a lease, the purchase price is determined by the prevailing market rate for purchase of the property leased, not by the lease price. "Combined purchase price" means the total cost of all the components of a system, such as a computer or telephone system, in which the components are planned as integral parts of the system or lease process. The addition of books to an existing library purchased during a prior audit year, of new printers to an existing computer system purchased during a prior audit year, or of new furniture to office furniture purchased during a prior audit year would not require prior approval unless the additions had a combined purchase price in excess of $10,000. When purchases or leases are made for more than one office, the "combined purchase price" includes the cost of all new system components for all offices affected;

(2) Purchases of real property;

(3) Consultant contracts in excess of $5,000 or consultant fees in excess of $261 per eight-hour day or $35 per hour except that (i) the retention of expert witnesses or other consultants or attorneys secured on behalf of eligible clients shall not be considered consultant services, and (ii) audit services shall not be considered as consultant services, but other services that may be provided by a recipient's auditor, such as the preparation of interim financial reports or tax reports, shall be considered consultant services

and shall require approval if the fees exceed the limits established by this subparagraph.

§ 1630.6 Effect of absence of prior approval.

The Corporation may not assert the absence of its approval as a basis for disallowance of a cost if it has not provided written notice to a recipient that it objects to a proposed cost expenditure involving Corporation funds, or to a proposed action that could result in a cost expenditure that the recipient will charge to Corporation funds, within sixty (60) days of receipt by the Office of Monitoring, Audit, and Compliance of a request for such approval, or within thirty (30) days of the receipt by that Office of all requested information about the proposal. The Corporation must make written request for additional information within forty five (45) days of the receipt by the Office of Monitoring, Audit, and Compliance of the request for approval. This section does not apply to requests for approval made prior to the effective date of this regulation. If the request for prior approval is denied, the Corporation will provide the recipient with an explanation and statement of the grounds for denial.

§ 1630.7 Review and appeal process.

(a) When it questions a cost incurred by a recipient, the Corporation shall give written notice to the recipient and the Chairperson of its governing body stating the dollar amount of the cost and the factual and legal basis for questioning it. Such notice must be provided no more than six (6) years after the recipient incurred the cost or expended the funds.

(b) The recipient may respond with written evidence and argument to show that the cost was allowable, that the Corporation, for equitable, practical, or other reasons, should not recover all, or part of the amount, or that the recovery should be made in installments. If the recipient fails to respond within thirty (30) days of its receipt of notice, the cost shall be disallowed.

(c) Within forty-five (45) days of receiving the recipient's written response to the notice of questioned cost, the Corporation shall issue a determination that the cost has been allowed or disallowed and advise the recipient of the method and schedule for collection of any disallowed costs.

(d) Within thirty (30) days after it receives a determination from the Corporation that a questioned cost has been disallowed, a recipient may send a written request for review to the President of the Corporation, stating its reasons in detail.

(e) Within thirty (30) days after receipt of the written request for review, the President shall either adopt, modify, or reverse the determination. The decision shall be based on the written record, consisting of the notice, the recipient's response, the Corporation's determination, the recipient's request for review, and any response and analysis sent to the President by Corporate staff. The decision of the President, or his or her designee, shall become final upon receipt by the recipient of written notice of the decision. The Corporation shall send a copy of the staff's response and analysis to the recipient at the time it sends the President's decision.

(f) If the President has had prior involvement in the consideration of the issue, another executive employee who has had no prior involvement shall be designated to hear and decide the request for review.

§ 1630.8 Recovery of disallowed costs.

After completion of all action under § 1630.7, the Corporation shall recover, in the form of a reduction in future grant checks or direct payment or otherwise, an amount not to exceed the total disallowed cost and any additional income derived from activities supported or assets purchased by means of the disallowed cost.

§ 1630.9 Other remedies; effect on other parts.

(a) In all cases in which a cost has been disallowed by the Corporation, the Corporation shall require that the recipient take the action needed to prevent recurrence of the activity that gave rise to such disallowed cost. In cases of serious financial mismanagement, fraud, or defalcation of funds, the Corporation may take appropriate action pursuant to Parts 1606, 1623, and 1625 of its regulations and shall make such referrals and recommendations as the circumstances warrant.

(b) Recovery of questioned costs by any means under this part is not to be construed to affect permanently the annualized funding level of the recipient, or to constitute a termination of financial assistance under Part 1606, a suspension of funding under Part 1623, or a denial of refunding under Part 1625.

§ 1630.10 Responsibility of subgrantees and subcontractors.

When disallowed costs arise from expenditures incurred under a subgrant or subcontract of Corporation funds, the recipient and the subrecipient or subcontractor will be held jointly and severally responsible for the actions of the subrecipient or subcontractor, as provided in 45 CFR Part 1627, and will be subject to all remedies available under this Part.

§ 1630.11 Time.

(a) *Computation.* Time limits specified in this Part shall be computed in accordance with Rules 6(a) and 6(e) of the Federal Rules of Civil Procedure.

(b) *Enlargement.* The President of the Corporation may, on written request for good cause shown, grant an enlargement of time and shall so notify the recipient in writing.

§ 1630.12 Non-public funds.

(a) No cost allocable to an activity that violates section 1010(c) of the Act or Part 1610 of these regulations may be charged to non-public funds.

(b) The Corporation shall, pursuant to this part, collect from the recipient's Corporation funds an amount not to exceed the amount of non-public funds allocated to such violation and any additional income derived therefrom.

Dated: August 6, 1986.

John H. Bayly, Jr.,

General Counsel.

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