

BY THE COMPTROLLER GENERAL

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Report To The Congress

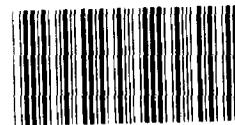
OF THE UNITED STATES

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Federal Cost Principles Are Often Not Applied In Grants And Contracts With State And Local Governments

A decade has passed since the Office of Management and Budget established a circular for uniform cost principles to be applied by all Federal agencies to grants and contracts with State and local governments. Unfortunately, many Federal agencies and grantees do not adhere to these principles. Instead, they continue to apply nonstandard and often inappropriate methods of determining or charging costs to grants and contracts. The Federal Government, therefore, does not always know if costs are properly charged, and many grantees cannot be sure that they are identifying, for possible recovery, costs of operating Federal programs.

To protect the financial interests of all concerned, an agreed-upon set of cost principles must be applied. Therefore, the Office of Management and Budget must revise its circular on this subject for clarity and purpose and must actively press for its use. Federal agencies must improve their day-to-day administration of the circular.



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

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses deficiencies in the implementation of Federal Management Circular 74-4, dealing with cost principles applicable to grants and contracts with State and local governments, and the effects these deficiencies have on inter-governmental relations. We believe application of the cost principles is necessary to protect the financial interests of the Federal Government and State and local governments.

Copies of the report are being sent to the Director, Office of Management and Budget, and to the heads of the departments and agencies concerned.

James A. Stacks
Comptroller General
of the United States



COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

FEDERAL COST PRINCIPLES ARE
OFTEN NOT APPLIED IN GRANTS
AND CONTRACTS WITH STATE
AND LOCAL GOVERNMENTS

D I G E S T

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The Office of Management and Budget should revise its instructions to Federal agencies to emphasize the Federal policy of recognizing total allowable costs incurred by State and local governments to administer and operate Federal grant programs.

The heads of Federal agencies whose programs GAO reviewed need to take action to improve the agencies' day-to-day administration of the cost policies and procedures promulgated by the Office of Management and Budget. These actions are needed to insure the proper application of the cost policies designed to protect the financial interests of all concerned.

These recommendations, and others to follow, are the result of GAO's review of the application of uniform cost principles for Federal grants and contracts with State and local governments established by the Office of Management and Budget nearly 10 years ago.

The Federal Government has provided financial assistance to State and local governments for over a century. This assistance has become enormous, rising from about \$11 billion in 1965, to about \$85 billion estimated for fiscal year 1979. Federal assistance now accounts for an estimated 25 percent of State and local resources.

State and local governments incur costs in operating federally sponsored grant programs. Federal agencies recognize and pay direct program costs; however, often they do not fully recognize and pay the allocated or indirect costs of providing support services necessary to carry out these programs.

COST PRINCIPLES ESTABLISHED

Concerns at both the Federal level and State and local levels led to establishing Federal cost principles. State and local governments were concerned about having to bear the substantially increased indirect costs resulting from the increase in the number and significance of Federal programs. Federal agencies, on the other hand, were concerned that if grantees charged indirect costs individually to each Federal program, the sum of the charges could exceed their total.

To overcome these concerns, the Office of Management and Budget promulgated uniform cost principles applicable to grants and contracts with State and local governments in a management circular issued in 1968.

The principles are similar to those used by defense contractors, universities, and others who deal with the Federal Government on cost reimbursement work. They provide that federally assisted programs should bear their fair share of total allowable costs--both direct and allocated (indirect)--except where prohibited or restricted by law. Grantees seeking reimbursement or recognition of indirect costs are required to identify and allocate the costs to benefiting activities in accordance with generally accepted accounting principles. To do this they must develop cost allocation plans and indirect cost proposals. The circular's principles and procedures are such that both the Federal Government's and State and local government's financial interests are more fully protected because the types and methods of charging costs are agreed upon before Federal assistance is provided.

CIRCULAR PRINCIPLES ARE OFTEN NOT APPLIED

The principles for identifying and allocating indirect support costs are often not applied in grants and contracts with State and local governments. In many instances, grantees are not systematically identifying total costs or using

appropriate methods in charging costs to Federal programs.

Federal and State grant-making officials ^{are} often discourage grantees from identifying and allocating indirect costs to federally assisted programs by

- stating or implying that indirect costs will not be recognized or paid;
- refusing, on one hand, to accept indirect costs developed through the circular-prescribed methods while paying, on the other hand, for such costs developed through nonprescribed methods;
- suggesting the use of arbitrary indirect cost rates (10 percent is typical) that are (1) not documented, (2) inequitable, and (3) generally much lower than rates computed through the prescribed methods; and
- ignoring their responsibilities for assisting grantees.

Some Federal and State grant-making officials point out that they are prevented by statute or administrative regulation from paying any or all indirect costs. Others do not agree that indirect costs applicable to a project should be paid. They argue that (1) limited Federal funds are better used for direct program purposes, (2) grantees have normally absorbed such costs in the past, and (3) grantees do not necessarily incur additional indirect costs when undertaking federally assisted projects. Actions based on attitudes of this nature help explain why many State and local government grantees are not systematically identifying indirect costs applicable to federally assigned programs.

They also help explain why some grantees

- do not determine total program costs, or if they do, bear the indirect cost themselves;
- charge indirect costs to Federal programs without adequate documentation or support; and

--charge Federal programs with arbitrary and unsupported indirect cost rates as well as charging the same costs directly.

Even when not actively discouraged by grant-making officials, some local governments receiving small amounts of Federal assistance do not develop cost allocation plans and indirect cost rates because they believe the benefits do not justify the cost. Also, many small grantees do not believe they have the necessary time or personnel to prepare the seemingly complex indirect cost allocation plans. The cost allocation process, however, does not have to be overly complex and burdensome.

CIRCULAR ADMINISTRATION NEEDS IMPROVEMENT

Office of Management and Budget and Federal agency officials have been hindered in their efforts to administer the circular because of limited staff. Adequate mechanisms have not been established to answer policy questions or to monitor Federal agency and State and local government implementation.

Necessary operating activities have not been adequately performed or monitored to ensure the effective implementation of the circular and the proper use of the circular's products. Instructions for cost allocation plans and indirect cost proposals are too broad and general in nature, the list of cognizant Federal agencies has not been kept accurate nor current, and the role of agency liaison personnel has not been well defined.

Although numerous audit reports have disclosed errors in plans and proposals and unsupported charges to individual grants and contracts, local governments are not required to submit plans and proposals for review and approval before grants are awarded, nor do Federal agencies have the capability or procedures necessary to review a large number of plans and proposals.

Those plans and proposals which are submitted and approved generally are not used by Federal

and State funding agencies in the grant-making process, permitting the opportunity for the recovery of the same cost twice--once in the indirect cost rate and again as a direct charge to the grant. Use of the plans and proposals in the grant-making process would reduce the number of improper charges to Federal grants and contracts. Where such procedures do exist, double reimbursements are reduced.

RECOMMENDATIONS

The Office of Management and Budget, in consultation with interested parties, should consider revising the circular and present policies and practices. This would improve the financial management of Federal grants and contracts awarded to State and local governments. Among other things, such revisions should

- emphasize the Federal policy of recognizing total allowable costs, and clearly state that reimbursing total costs is a separate issue and subject, among other things, to negotiations between the parties;
- clearly indicate to grantees and funding agencies that indirect costs will not be recognized without evidence of plans and proposals;
- prohibit Federal agencies from discouraging total cost determinations by grantees and establish procedures for handling and disposing of grantee complaints of Federal agency noncompliance;
- clearly enunciate whether State agencies and other grantees are required to apply the total cost principles in subgrants;
- establish a procedure to develop a priority listing of grantees--on the basis of the amount of Federal dollars involved, prior experience, and other criteria as appropriate --who submit cost allocation plans for approval before the plans may be used to charge costs to grants; and
- establish a long-range goal for the submission, review, and approval of all cost

allocation plans before grantees are permitted to use them in Federal grants.

To improve the administration and monitoring of the circular, the Office of Management and Budget should

- adopt a more active approach in monitoring agency implementation of the circular and insist on greater adherence to the circular's principles and procedures and
- attempt to increase Federal efforts to provide needed training, instructions, and technical assistance to Federal, State, and local officials.

Federal agencies whose programs were reviewed by GAO should

- ensure that their policies and procedures conform to circular instructions and
- ensure that their agencies are capable of providing necessary training, adequate instruction, and technical assistance.

AGENCY COMMENTS

The Director, Office of Management and Budget, agreed that a fair and consistent method of identifying, accumulating, and allocating costs which can not be readily associated with individual grants and contracts would be valuable to the Federal Government and State and local governments.

The Director recognizes that the circular has not yet been fully implemented, particularly with respect to indirect costs and cost allocation plans, but he believes that implementation problems are more severe at the local level than at the State level. He agreed that some revisions of the circular may be needed and plans to meet periodically with agency liaison officials and seek advice on changes to the circular from a broad range of other interested parties.

The Office of Management and Budget agreed that more can be done to assure agency implementation of the circular and intends to "beef up" its efforts in this regard. It has already updated the listing of agency assignments for negotiating cost allocation plans. The Director believed, however, that the report does not give adequate recognition to past and current efforts of the Office and of other organizations in providing training, instruction, and technical assistance. Although the Office of Management and Budget has made significant efforts, the errors observed in preparing and using cost allocation plans suggest that additional efforts are needed. The Director felt that while more training might be useful, the Office is now doing as much as it is reasonable to expect.



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I Letter dated May 15, 1978, from the
Director, Office of Management and
Budget

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ABBREVIATIONS

- ✓ OMB Office of Management and Budget
- ✓ HEW Department of Health, Education, and
Welfare *AGC 00022*
- GSA General Services Administration
- ✓ LEAA Law Enforcement Assistance Administration *AGC 00187*
- CETA Comprehensive Employment and Training Act
- EPA Environmental Protection Agency
- DOT Department of Transportation
- ✓ HUD Department of Housing and Urban Development
AGC 00023

~~✓ DOC AGC 00009~~

CHAPTER 1

INTRODUCTION

For over a century, the Federal Government has provided financial assistance to State and local governments to accomplish national priorities. Financial assistance has increased dramatically from about \$11 billion in 1965 to about \$85 billion estimated for fiscal year 1979. Federal assistance now accounts for an estimated 25 percent of State and local resources. Since 1968, costs charged to Federal programs have had to comply with Office of Management and Budget (OMB) Circular A-87: Cost Principles Applicable to Grants and Contracts With State and Local Governments. 1/

HISTORICAL PERSPECTIVE

The total allowable costs of any grant or contract are those directly related to its performance plus an allocated share of indirect or overhead costs. No universal rule exists for classifying costs as direct or indirect. Generally speaking, however, a direct cost is one which usually can be readily identified with and assigned to a cost objective (grant, contract, organizational unit, etc.). Indirect costs for such things as administration, purchasing, accounting, budgeting, and space often benefit more than one cost objective and generally are not readily assignable directly to a grant or contract. 2/ In these cases, the indirect or joint costs should be assigned to cost objectives in reasonable and equitable proportions relative to benefits received, a cause and effect relationship, or some other reasonable or logical basis.

State and local governments' costs to carry out Federal programs often exceed the amount of Federal assistance received. When the amount of Federal assistance was comparatively small, State and local governments did not identify and allocate indirect costs to federally assisted programs. As the number and significance of Federal programs increased, State and local governments' involvement and their costs to administer the programs also increased, and several States and localities began to identify and allocate indirect costs. As

1/ The General Services Administration replaced OMB Circular A-87 with Federal Management Circular 74-4 dated July 18, 1974. No substantive changes were made.

2/ References to grants from this point should be read as grants and contracts.

a result, some Federal agencies allowed State and local governments to use Federal funds to pay part or all identified costs while other Federal agencies did not.

In the early 1960s, States expressed concern about the lack of uniformity among Federal agencies in allowing costs under Federal programs. Federal agencies, on the other hand, were often concerned that grantees were recovering more costs than incurred. In 1964, OMB, together with the Departments of Health, Education, and Welfare (HEW) and Labor and the National Association of State Budget Officers, studied Federal practices in allowing costs. The study, conducted in six States, showed that many differences and inconsistencies existed in the types of costs which could be charged.

As a result of the study, OMB issued Circular A-87 in May 1968. OMB has administered the circular since then, except for a period between May 1973 and December 1975 when the function and staff were assigned to the General Services Administration (GSA).

WHAT THE CIRCULAR DID AND DID NOT DO

The purposes of the circular were to provide a uniform approach to determining total allowable costs of Federal programs at the State and local government levels and to promote financial accountability and better relationships between grantees and their Federal counterparts. The circular established principles and standards to be applied by all Federal agencies for determining costs applicable to grants, including subgrants, with State and local governments.

The principles in the circular are similar to those used in defense contracting, university grants, and other transactions which are cost-reimbursement in nature. The principles were designed to provide that federally assisted programs bear their fair share of costs recognized under the principles, except where restricted or prohibited by law. To many State and local governments, this meant increased Federal reimbursement under grant programs. Some Federal agencies, however, saw the circular as leading to grantee systems for identifying and allocating total costs but not necessarily guaranteeing additional reimbursement. These different viewpoints remain a source of conflict and friction.

OMB anticipated that application of the circular's principles would reduce audit exceptions. The circular required that allocated or joint costs charged to Federal programs be supported by a plan of allocation. The circular

was to simplify intergovernmental relations by requiring a State or local government to justify allowability and allocability of its costs once a year to one Federal agency.

The circular did not supersede cost limitations imposed by law, provide new funds to Federal agencies for costs not previously allowed by them, or dictate the extent of Federal funding in a particular program.

GUIDELINES FOR IMPLEMENTING THE CIRCULAR

HEW, in consultation with other Federal agencies, is responsible for developing and issuing instructions to State and local governments for preparing cost allocation plans. HEW issued guidelines for State governments in 1969 and for local governments in 1970. In 1976 HEW consolidated the two guides into a single guideline for use by State and local governments. The procedures in the guideline apply to grants awarded by all Federal agencies and were approved by OMB.

The HEW guide states that charging of joint or common costs against Federal grants requires the prior preparation of cost allocation plans. The purposes of a cost allocation plan are to (1) account for 100 percent of each joint cost, (2) identify and eliminate costs which are not allowable on Federal programs, and (3) distribute allowable costs on rational bases to government departments, programs, or activities.

Two types of cost allocation plans are generally prepared. One, commonly called a governmentwide cost allocation plan, (1) distributes the costs of central services, such as accounting, data processing, space, and budgeting, to the grantee's operating departments and agencies which benefit from the costs or (2) shows how these costs may be directly charged to a Federal grant. Generally, only one plan is prepared for each State and local government. Plan preparation is not necessarily a complicated task. It involves three basic, logical, sequential steps: (1) identify the services to be claimed and their costs, (2) determine bases for allocating costs to appropriate departments, and (3) compute the amounts to be allocated.

The second plan, commonly called an indirect cost proposal, is prepared for each operating department of a State and local government seeking reimbursement for indirect costs under its Federal assistance programs. Each department's indirect cost proposal would include the central service costs allocated to it by the governmentwide cost

allocation plan and the department's own indirect or joint costs. Examples of department joint costs would be supervisory and clerical staff and other costs which benefit several programs or activities of the department. In the indirect cost proposal, all identified joint costs generally are converted to an indirect cost rate (percentage) to be applied to Federal grants.

The HEW guidelines offer several methods for preparing indirect cost proposals. Local government grantees can choose a fairly simple method which identifies only central service costs or can choose more involved methods which identify and allocate a greater amount of overhead-type costs.

The circular provides for the designation of a single Federal agency (cognizant agency) to act for all agencies in negotiating, approving, and auditing the cost allocation plans and proposals of a particular State or local government. HEW, in collaboration with other Federal agencies, is responsible for State governmentwide cost allocation plans. The Federal agency with the predominant financial interest is responsible for indirect cost proposals of State departments and for local governmentwide cost allocation plans and proposals.

Cost allocation plans and proposals of State governments must be prepared and submitted annually to Federal agencies for negotiation and approval. Cost allocation plans and proposals of local governments are to be prepared annually but retained by the local government unless the cognizant Federal agency requests their submittal. According to Labor and HEW officials, large local government grantees were required to submit plans and proposals as a matter of practice.

CHAPTER 2

PRECIRCULAR CONDITIONS CONTINUE TO BE WIDESPREAD

Many State departments and local governments are not preparing plans to identify and allocate their joint costs to Federal programs. Federal and State agencies often discourage and even prohibit grantees from doing so. Also, grantor agencies allow many grantees to charge joint costs to Federal programs through methods which do not meet the circular's requirements.

Plans and proposals which are developed are often prepared and used improperly by grantees. Many errors in cost allocation plans and indirect cost proposals can be traced to a lack of understanding of the cost allocation process and a lack of technical assistance by grantor agencies.

As a result, a major purpose of the circular--to systematically determine total costs of Federal programs at the State and local government levels--is not being achieved, and the financial interests of grantor and grantee are not fully protected. Much work lies ahead for all levels of government to make the circular's objective an operating reality.

COST ALLOCATION PLANS AND PROPOSALS ARE NOT PREPARED

Cost allocation plans and indirect cost proposals are integral parts of the circular, but many governments do not prepare them. Therefore, the following financial safeguards afforded by the plans and proposals are not being fully realized:

- Accounting for 100 percent of each joint cost.
- Identifying and eliminating costs which are not allowable under Federal programs.
- Distributing allowable costs to government departments, programs, or activities on rational bases.

We surveyed State and local governments to see if they were preparing the plans and proposals. All States prepared governmentwide cost allocation plans to distribute central support joint costs to State departments and agencies. However, our poll of 3 States showed that 22 of 67 departments and agencies had not prepared indirect cost proposals. We

polled 165 counties and cities with populations exceeding 50,000 in 8 States and found that 106 did not prepare governmentwide cost allocation plans or indirect cost proposals. Of the 59 which did prepare plans, we did not determine the number of indirect cost proposals prepared.

The results of our poll are shown in the following table.

<u>Government</u>	<u>Prepared plans</u>	<u>Did not prepare plans</u>	<u>Total</u>
<u>State agencies</u>			
Pennsylvania	13	3	16
Missouri	6	8	14
California	<u>26</u>	<u>11</u>	<u>37</u>
Total	<u>45</u>	<u>22</u>	<u>67</u>
Local governments:			
Cities:			
Pennsylvania	6	7	13
Missouri	4	3	7
California	7	16	23
New England States (note a)	<u>2</u>	<u>34</u>	<u>36</u>
	<u>19</u>	<u>60</u>	<u>79</u>
Counties:			
Pennsylvania	4	37	41
Missouri	2	9	11
California	<u>34</u>	<u>0</u>	<u>34</u>
	<u>40</u>	<u>46</u>	<u>86</u>
Total	<u>59</u>	<u>106</u>	<u>165</u>
Total State and local governments	104 ===	128 ===	232 ===

a/Includes Connecticut, Massachusetts, Rhode Island, New Hampshire, and Maine.

Close to two-thirds of the local governments we polled did not prepare cost allocation plans and proposals. In our poll, California was the only State where all counties prepared plans and proposals.

Following are the major reasons given by State and local

government officials for not preparing cost allocation plans and indirect cost proposals:

- Federal funds are limited and many officials did not believe they would get additional funds by preparing plans and proposals.
- Federal agencies restricted the amount of joint costs, generally overhead costs, that could be claimed.
- Federal agencies allowed grantees to claim joint costs directly without preparing cost allocation plans and proposals.
- Local governments did not believe they had an adequate accounting system or the technical ability, funds, and staff to prepare the plans and proposals.
- Officials were not familiar with the circular.

Our review work at the Federal, State, and local levels substantiated the reasons given by the grantee officials.

BARRIERS TO PREPARING COST ALLOCATION PLANS AND PROPOSALS

Although Federal grant-making agencies have adopted the circular's provisions as part of their regulations, many Federal and State funding agencies indirectly discourage grantees from preparing cost allocation plans to accumulate total costs of Federal programs. Funding agency officials often cite statutory and regulatory restrictions which deny or limit reimbursements for joint costs or argue that Federal funds are limited and should be used for program purposes. Funding agencies' positions on reimbursements, however, inadvertently hinder the development of total costs of Federal programs--a major purpose of the circular.

Statutory and regulatory restrictions

Several Federal programs limit by statute and regulation the amount of Federal reimbursement for joint costs, such as administrative and other overhead costs. For example, the Comprehensive Employment and Training Act (CETA), 29 U.S.C. 801 et. seq. (1975) requires, for public employment programs, that not less than 85 percent of the appropriated funds shall be expended for public service jobs. A Labor Department official interprets this provision to mean that no more than 15 percent can be used for administrative costs for operating the program.

Legislation for the State and Community Highway Safety Program (23 U.S.C. 402) requires that the State transportation agencies be suitably equipped and organized to participate in the program. Federal officials, in interpreting this provision, had proposed to establish regulations disallowing payment for the operating costs of all State transportation agencies. Their rationale was that Federal funds should not be used to reimburse States for something that was already required to exist. After significant opposition by grantees, Department of Transportation (DOT) officials decided not to issue these regulations. If such restrictions had been implemented, grantees probably would not have developed total costs because they could not have been reimbursed for administrative and overhead expenses.

Subgrantees have complained that State funding agencies administering Federal programs are not adhering to the circular's provisions. Confusion abounds at the State and local government level on the circular's applicability to subgrants and subcontracts because of conflicting and inconsistent Federal agency interpretations.

Officials of several Federal agencies, such as HEW, Labor, and the Law Enforcement Assistance Administration (LEAA), contend that they cannot dictate the cost reimbursement policies of States when the States administer and participate in the financing of programs which are subgranted to other governmental units. But the agencies have not made it clear to the States whether they are required to adhere to the "total cost" principle of the circular in the subgrants. Lacking such clarity, some States have not allowed local governments to develop total program costs; that is, they do not allow indirect costs to be included in subgrant applications.

In contrast, a Department of Agriculture official has told States that local governments are entitled to charge indirect cost rates on subgrants and recover joint costs based on those rates. A Department of Interior official told us States are required to reimburse local governments for their indirect costs.

OMB has not issued a clear policy applying the principles of the circular to subgrants. On one hand, the circular states that:

"These principles will be applied by all Federal agencies in determining costs incurred by State and local governments under Federal grants and cost reimbursement type contracts (including

subgrants and subcontracts) * * *." (Under-scoring provided.)

On the other hand, in practice, OMB has only encouraged State agencies administering Federal funds to observe the principles of the circular. It has not required that States apply the circular when subgranting Federal funds to local governments.

We have held that Federal regulations can be applied to subgrantees. In our decision of July 2, 1974 (B-167015), we stated that:

"It is clear that a grantee receiving Federal funds takes such funds subject to any statutory or regulatory restriction which may be imposed by the Federal Government."

Therefore, Federal agencies can require, in their grant agreement with State agencies, the application of Circular A-87's total cost principle on subgrants.

Statutory and regulatory restrictions do not prevent grantees or subgrantees from developing total costs; they only limit or prevent payment of some costs. But by limiting payment for costs, the major incentive for grantees to develop total cost is removed. And, as discussed later, many grantees claim reimbursement anyway for some of their joint costs through various and nonuniform methods which provide no assurance that the costs are proper or supported.

Funding agencies' restrictive practices

Many Federal and State funding agency officials argue that Federal funds are better used for direct program purposes than for joint costs of administration and overhead. They employ several different practices which discourage grantees and subgrantees from identifying total costs. These practices include (1) not recognizing joint costs and (2) limiting the maximum amounts or types of joint costs that will be paid or allowed for meeting the matching requirements of grants.

According to an LEAA headquarters official, grantees may charge joint costs to LEAA grants if the grantees have approved indirect cost rates. However, Kansas City and San Francisco LEAA regional officials told us that they discourage such claims. According to a Kansas City LEAA official, the region stresses to grantees that funds are limited and that none of the State planning agencies in the region charge central service costs to LEAA grants.

Several State planning agencies which administer LEAA subgrants, in turn, generally discourage or disallow joint costs on the subgrants. For example, a Missouri State planning agency's operating handbook, prior to June 1, 1975, permitted subgrantees to recover joint costs by submitting an indirect cost proposal to a Federal agency and having it audited, negotiated, and approved. However, the handbook also included a section which stated that this was a cumbersome, time-consuming process and not feasible unless many grants were involved and costs could not be directly charged. After June 1, 1975, the section on recovery of joint costs was deleted. According to an agency official, this section was eliminated to discourage joint cost claims.

Connecticut State LEAA planning agency officials said that if local grantees apply for joint costs as a line item, the agency deletes the item and returns the application for resubmission.

These are not isolated examples. In a June 1974 memorandum, the National Conference of State Criminal Justice Planning Administrators reported that of 36 State planning agencies surveyed, half did not allow joint costs as a budget element, and only 5 allowed charging joint costs in accordance with a federally approved cost allocation plan.

HEW's overall policy is to pay joint costs. At the regional level, however, practices differ. For example, HEW Region VI conducted a study in 1973 of the methods used by the various HEW agencies within the region to pay joint costs. The study was initiated, in part, because of complaints and inquiries from the grantee community. HEW found that four of its agencies--Public Health Service, Social and Rehabilitation Service, Office of Education, and Office of Human Development--handled joint costs in several different ways. They paid either at the indirect cost rate, at a lower rate, or not at all.

State grantees for the HEW Aging Program restricted joint cost recoveries by subgrantees. HEW officials acknowledged that States were inconsistent in their treatment of subgrantees. Examples of such inconsistent treatment follow:

--The Missouri State Aging Agency generally allowed joint costs as part of subgrantees' contributions but did not encourage them to claim reimbursement for the costs.

--The California State Aging Agency allowed subgrantees to claim up to 8 percent for joint costs. The

remainder of the joint costs could be used as part of the subgrantees' matching contributions.

--The Arizona State Aging Agency did not allow joint cost reimbursement because resources were so scarce.

Labor's policy on its programs is to pay for joint costs to the extent that financing is available and program efforts are not reduced. Kansas City regional officials said they have not encouraged joint cost claims on CETA programs because they do not want to subsidize grantees. The officials said they knew of no grantees currently claiming such costs through an indirect cost rate.

State agencies administering the CETA program have differing practices for allowing joint costs of subgrantees. For example:

--A Connecticut agency does not allow joint costs. Officials said the statutory limitations on administrative costs make the circular not applicable.

--A Missouri agency pays joint costs only to large subgrantees which have negotiated indirect cost rates.

Labor also restricts joint costs on other programs. For example, Boston regional officials said that although some departmental joint costs of State Employment Security Agencies were allowable, the region has always disallowed costs of services provided by State central service agencies.

Other Federal agencies and intermediary funding agencies either restrict or discourage claims for joint costs. For example:

--A Pennsylvania State Agency which administers the Department of Housing and Urban Development (HUD) comprehensive planning assistance program said its policy was to pay joint costs if requested but it tries to discourage the claims.

--Philadelphia regional officials of the Environmental Protection Agency (EPA) discourage grantees from requesting joint costs on air pollution programs because of limited funds.

--Denver regional officials of the Bureau of Outdoor Recreation said they do not restrict joint costs on grants but do allow State intermediary funding agencies to be restrictive on subgrants.

--Action agency officials in Philadelphia said the agency's policy was to comply with the circular. However, the agency's directive on project costs of the Retired Senior Volunteer program states the low cost characteristics of the program do not accommodate indirect costs.

JOINT COSTS ARE CHARGED WITHOUT MEETING CIRCULAR REQUIREMENTS

Many grantees charge joint costs to Federal programs without plans of allocation. These charges are not adequately supported, may not benefit the programs, or may exceed costs incurred. Because these costs are generally not questioned by grantor officials, grantees see no need to identify and allocate them according to the circular's procedures.

The circular precludes charging joint costs not supported by a plan of allocation. The allocation plan requirement was instituted because Federal programs in the past were individually charged with costs which benefited several activities and in many cases, Federal agency audits disclosed that no support existed for the joint costs claimed. Therefore, Federal officials were concerned that grantees were recovering more than 100 percent of the costs incurred by claiming the same costs under more than one grant.

The cost allocation plan mechanism, if properly used, overcomes this problem. The plan systematically accounts for 100 percent of each joint cost; identifies for elimination those costs which are not allowable under Federal programs; and distributes allowable costs to government departments, programs, or activities on a rational basis.

We reviewed four local governments and four State government agencies which had not prepared plans of allocation in accordance with the circular's requirements, but which had charged joint costs to Federal programs, often with approval of Federal and State funding agencies. While each grantee usually employed some allocation method to distribute the joint costs, the methods did not include information necessary to ensure that all costs were identified, equitably allocated, proper, and beneficial to the Federal programs. In some cases, costs were clearly inappropriate.

For example, one Massachusetts city included joint costs for data processing, payroll preparation, purchasing activities, and financial operations as part of a 15-percent fringe benefit rate charged to its Federal programs. Audits covering fiscal years 1971 through 1975 disclosed that inclusion

of these joint costs resulted in overcharges of \$190,930 on Department of Labor contracts alone. We identified overcharges of \$106,900 on all Federal programs in the city for fiscal years 1975 and 1976.

City officials told Labor Department officials that the fringe benefit rate was justified and documented. City officials gave us one sheet of documentation listing the joint costs and the fringe benefits. The documentation did not (1) show 100-percent accounting of the joint costs, (2) exclude unallowable costs, or (3) show how the costs benefited Federal programs. Furthermore, the base used for allocating the joint costs was a salary and wage base which was inappropriate for allocating any of the joint costs. When questioned on the fringe benefit rate, city auditors told us that the rate was arbitrary but fair. In response to our inquiry, in 1976 Labor regional officials requested the city to refund overcharges identified in Labor audits.

In another example, a California State agency charged \$135,542 in joint costs over a 5-year period to two Federal programs without documentation to support the costs. The joint costs were for computer, accounting, personnel, legal, and supervision services. A Federal audit found that the charges " * * * were based on accounting data which did not identify and distribute costs properly * * * ." Because a plan of allocation was not prepared, the Federal auditor concluded that no assurance existed that costs claimed and paid represented the costs incurred and that the charges may have resulted in overstatements of costs to the Federal programs.

A California city which had 63 federally assisted projects in a 4-year period did not prepare cost allocation plans. The city charged joint costs to 11 of the 28 projects we reviewed. Unallowable costs were included in these charges.

One grantee charged a HUD planning grant by multiplying hours recorded as worked on the grant by fixed hourly rates of \$15 for professional staff and \$6.42 for nonprofessional staff. We were told the fixed rates included salaries, fringe benefits, rent, and utilities. We were unable, however, to determine how the rates were computed and the grantee could provide no support for them. Officials of the State agency administering the grant did not attempt to determine how the grantee was arriving at the costs claimed in the expenditure reports.

Federal and State audits of grant expenditures continually reveal that grantees are charging joint costs without employing adequate cost allocation techniques. Federal and State officials confirm that this frequently occurs.

Grantees also charge Federal programs with arbitrary indirect cost rates as a means of recovering joint costs. Arbitrary rates may bear no relationship to actual costs; therefore, their use is precluded by the circular.

While our review disclosed that some other Federal and State funding agencies permitted grantees to apply arbitrary indirect cost rates to grants, LEAA is the primary Federal agency permitting its use. LEAA permits the use of a 10-percent rate applied to a salary and wage base or a 5-percent rate applied to a total direct cost base. LEAA officials prefer these rates because they (1) are simple to apply and (2) usually result in a lower joint cost amount than would otherwise be paid. Most grantees find arbitrary rates appealing because the rates are not questioned and because a portion of overhead costs are recovered.

Because there is no universal rule for classifying costs as either direct or indirect, the costs specifically represented by an arbitrary rate are not easily agreed upon. LEAA states that the rate is for the costs of "accounting services, legal services, building occupancy and maintenance, etc." LEAA's statement is too general and can result in it paying the same cost twice--once in the rate and once as a direct charge. For example, a California city claimed reimbursement for space cost directly on several LEAA grants and also charged a 10-percent indirect cost rate which already provided for space charges. State regional criminal justice officials acknowledged they inadvertently overlooked the direct charges for space when approving the grants.

Conversely, the use of arbitrary rates can understate total program costs and result in underreimbursement. For instance, any LEAA grantee or subgrantee using the 10-percent arbitrary rate in lieu of a higher circular-developed rate is potentially underreimbursed. Examples involving other funding agencies can be cited. A city in New York developed a 46.35-percent indirect cost rate for DOT programs, but the State funding agency only allowed the use of an arbitrary 10-percent rate.

In 1969 we reported that use of a uniform indirect cost rate for higher educational and other nonprofit institutions was not a realistic or equitable method of determining

indirect costs. We noted that educational institutions differ widely in how they are organized and how they treat costs. Some institutions charge costs directly that other institutions charge indirectly, and the inconsistent handling of costs obviously affects the total of indirect costs. Therefore, applying a uniform indirect cost rate to institutions would be arbitrary and inequitable.

Because State and local governments, like educational institutions, are organized differently, indirect costs are not handled alike. Therefore, allowing uniform rates to be used in grants and contracts with State and local governments would likewise be arbitrary and inequitable.

PLANS AND PROPOSALS ARE IMPROPERLY PREPARED AND USED

Those plans and proposals prepared by State and local governments to identify and allocate joint costs are often developed and used improperly. Many plan and proposal errors can be traced to (1) a lack of understanding of the cost allocation process, (2) inadequate technical assistance provided by most Federal agencies, and (3) inadequate comparison of grant applications with allocation plans and proposals.

Preparation errors

We examined the cost allocation plans and proposals of five local governments and three State agencies. Each plan and proposal was deficient in one or more respects. The deficiencies were

- inclusion of unallowable costs,
- no provisions for adjusting estimated costs to actual,
- incorrectly computed adjustments,
- overstated or understated joint costs,
- inappropriate or incomplete cost allocation bases, and
- inadequate documentation.

Although we did not always determine the dollar effect of the errors, not correcting the deficiencies could result in Federal agencies overpaying some grantees and underpaying others.

We found instances where indirect cost rates were overstated. For example, a Pennsylvania county's plan and

and cost proposals did not include fringe benefit costs in the base (understating the base) for computing indirect cost rates even though EPA and the county had reached prior agreement to do so.

The EPA reviewer did not pick up the error, which resulted in the approval of an indirect cost rate higher than the data would justify. Advised of the error, the EPA reviewer stated that if costs were incurred as proposed, the county would have been able to overbill approximately \$100,000.

A Connecticut city did not include over \$450,000 in Federal and State grants and \$326,000 in general government expenses in the direct cost base for computing an indirect cost rate, thereby understating the base and overstating the indirect cost rate. Correcting this deficiency would cut the indirect cost rate in half.

A California county did not correctly compute cost adjustments of prior years in successive cost proposals. Our recomputation resulted in a 1975 rate of 21.91 percent rather than 28.52 percent and a 1976 rate of 26.72 percent rather than 34.06 percent.

Improperly prepared cost allocation plans, on the other hand, can adversely affect the grantee's recovery of legitimate joint costs. Correcting obvious deficiencies in a Missouri city's 1975 cost plan would have nearly doubled the indirect cost rate.

Some grantee officials who prepared cost allocation plans said they did not understand the cost allocation process and received little assistance from Federal agencies. Errors in plans and proposals are therefore made. Guidance that was provided was often general in nature. Because of limited staff, Federal officials normally do not get deeply involved unless the plans are submitted for review. Because local government plans and proposals are not required to be submitted for review, many errors go undetected.

Federal and State officials said that HEW guidelines are too broad and general in nature. One State official said the revised and consolidated HEW guidelines were a considerable improvement but still left out significant points and were difficult to apply because State operations differed from the descriptions in the guidelines. One Federal official said there should be a first-grade approach--a "How-to-do-it" manual is needed.

Attempting to deal with this problem, GSA and OMB officials conducted a series of seminars on the circular. In a 1-year period, 9 seminars involving 2,400 participants including Federal, State, and local government officials were held. Several State and local officials who attended the seminars said the presentations were useful for getting an overview of the circular but did not qualify them to prepare a cost allocation plan.

For example, an official of a Missouri city, who had prepared cost allocation plans annually since 1972, used several different formats and methods to distribute costs over the years. None of the plans was adequate. The official said although she had attended several training seminars, she did not understand them. A California city official said he prepared the city's first cost allocation plan on the basis of his experience and attendance at a seminar. Another official, who told us he did not understand the purpose or procedure, prepared subsequent plans for the same city on the basis of the format of the first plan. The city's various plans contained numerous errors.

HEW's guidelines lack discussion of important points critical to the proper preparation of plans and proposals. For example, the guidelines do not specifically state that Federal grants must be included in the base on which the indirect cost rate is calculated. Also, the circular classifies the costs of general government as unallowable and HEW guidelines state that these joint costs must be eliminated. Except for a footnote to one sample format, the guidelines do not clearly state that general government costs must be included in the base on which the indirect cost rate is calculated. Omitting Federal grants and general government costs from the base overstates the indirect cost rate. These errors occur frequently, indicating that the circular needs clarification.

Application errors

Our review at five local governments which prepared cost allocation plans and proposals showed that grantees did not always use the plans and proposals in a proper manner. Grantees (1) applied indirect cost rates to grants which did not benefit from costs included in the rates, (2) applied indirect cost rates to bases different from those on which the rates were computed, and (3) charged joint costs directly to grants even though they were also included in the indirect cost rates. For example:

--A Missouri city claimed \$65,920 as the city's share of an LEAA grant in fiscal year 1975. The amount was

computed by applying an indirect cost rate to a contractor's cost on the project. The city had no records to show that any services were provided to the contractor. The city's internal auditor and officials at the LEAA regional office and the State grantor agency said the rate should not have been applied to the contract.

--A California county overclaimed \$140,642 on a 1975 welfare grant because it charged joint costs directly to the grant that were also included in computing the indirect cost rate.

--A Missouri city applied its indirect cost rate to the total cost of a HUD grant even though the rate was calculated on a salaries and wage base. It also charged salaries of five employees directly to the grant even though these salaries were already included in the indirect cost rate.

Two reasons for these errors may be that grantee officials did not understand how to use indirect cost rates developed through plans and proposals and did not adequately compare grant applications with plans and proposals.

CHAPTER 3

IMPROVEMENTS NEEDED IN ADMINISTERING THE CIRCULAR

The administrative system needed to bring about widespread observance of the circular's principles has not been established at the Federal level. A small staff at OMB has responsibility for monitoring the circular along with other duties. Although Federal grant-making agencies have incorporated provisions of the circular in their regulations and have a stated policy of following circular requirements, most have not established effective mechanisms to insure its proper application. Among Federal agencies, the staff resources to administer the circular may be insufficient, and the top-level management support needed to offset the inherent reluctance of program officials to accept the circular's objectives has not developed. These conditions have contributed to a situation in which grantees are not treated uniformly and problems involving allowable costs are not resolved in a timely fashion.

AGENCIES NEED TO ESTABLISH SYSTEMS ASSURING THE CIRCULAR'S IMPLEMENTATION

Under OMB's leadership, Federal agencies are responsible for assuring that the circular's principles are observed in administering their programs. Each major Federal agency administering domestic grant programs had a liaison officer to oversee circular implementation and to serve as the focal point for contact with OMB. Many of the liaison officers, however, have not been involved in establishing or making sure that their agencies' mechanisms or written procedures at the headquarters or regional levels implement the circular uniformly.

This occurred because (1) the role of liaison officers was not well defined, (2) the officers spend little time on circular matters because of other duties, and (3) a number of officers lacked authority and responsibility to resolve issues associated with the circular.

Of the nine liaison officers we interviewed, only HEW and Labor officers had responsibility and authority for formulating agencywide cost determination policies and procedures for implementing the circular. The other officers had little or no involvement in developing agencies' cost policies and procedures. Two officers were unsure of their authority and responsibilities while others said that their authority was limited in practice by regional administrators, program officials, and organizational problems.

Many liaison officers did not actively monitor their agencies' compliance with the circular. They did not normally follow up with subordinate headquarters units or require feedback on the circular's implementation. Grantee complaints were not systematically compiled, analyzed, and disposed of to ensure the circular's uniform implementation. Most liaison officers said that they were either not responsible for monitoring compliance or that monitoring was not necessary.

Many liaison officers did not monitor their agencies' regional activities. Except for HEW headquarters and one HEW and one HUD region, neither the liaison officers nor regional officials conducted any surveys or studies to determine how the circular was implemented. HUD's liaison officer had a more fundamental problem. He did not know, at the time of our review, which staff was designated by HUD's regional administrators to conduct reviews of cost allocation plans. HUD's Philadelphia regional staff, on the other hand, could not locate anyone in HUD headquarters who was responsible for the circular or who could assist them in reviewing a city's cost allocation plan.

The agencies' passive approach to monitoring compliance, that is, relying on grantee complaints, is not sufficient to ensure the adequate implementation of the circular. A number of grantees told us that they were reluctant to complain about the failure of agencies to comply with the circular because the grantees were funded, in part, by the same agencies.

LOCAL GOVERNMENT PLANS AND PROPOSALS NOT SUBJECTED TO REVIEW

Few local government cost allocation plans and indirect cost proposals are reviewed by cognizant Federal agencies because the circular does not require submission of these plans and proposals, and many local governments do not prepare them. Local governments have not been required to submit plans and proposals because of concerns about the ability of Federal agencies to handle the resultant workload. The evidence indicates, however, that Federal agencies should review plans and proposals before their use on Federal grants.

The types of errors we found in local governments' cost allocation plans and proposals were not unique. The cognizant agencies and the California State Controller did 72 audits of State and local plans and proposals. After reviewing these audits, we noted that similar problems frequently occurred. The major findings were as follows:

	Number of audits and audit findings					Total
	HEW	HUD (note a)	EPA	Interior	California State Controller	
Total audits	32	14	19	1	6	72
Findings						
Unallowable costs included	24	4	6	1	8	43
Inappropriate or incomplete allocation base	29	2	9	0	10	50
Inconsistent/improper treatment of costs	11	1	2	0	1	15
Incorrect or no adjustment for prior plans	7	0	0	0	1	8
Duplicate costs	5	1	1	1	6	14
Over- or understated indirect costs	5	1	3	1	5	15

Note a/In many cases HUD audit reports did not detail the problems. The auditors made changes and approved the plans as revised.

In 28 of the above reports, auditors questioned \$71.4 million of improperly allocated charges. Improper charges applicable to Federal grants were not shown separately in the audit reports because the plans and proposals distributed costs to Federal and non-Federal activities, and the mix of such activities was not readily determinable. The amount of improper charges to Federal grants, however, can be significant as indicated in chapter 2.

Initial reviews are much more important than subsequent reviews. Follow-on reviews of cost allocation plans disclosed significantly fewer deficiencies in subsequent plans. For example, in 1972 HEW questioned \$169,827 on a statewide cost allocation plan but did not question any costs in a second review. In 1972 EPA questioned \$4.8 million allocated in a citywide cost allocation plan but only questioned \$73,000 the following year. Therefore, we believe Federal review efforts should be concentrated on those plans and proposals which have not been reviewed.

Federal agencies have not established the capability and procedures necessary to review a large number of cost allocation plans. Sixteen Federal agencies are designated to review and audit cost allocation plans and proposals of State governments and agencies, and five of these Federal agencies are designated to review and audit plans and proposals of local governments with over 50,000 population, as shown below.

<u>Federal agency</u>	<u>State governments and agencies</u>	<u>Local governments</u>	<u>Total</u>
HEW	342	706	1,048
EPA	45	139	184
HUD	61	89	150
Department of Labor	95	32	127
Department of the Interior	102	-	102
Department of Defense	89	-	89
DOT	71	-	71
Department of Agriculture	70	-	70
National Foundation on the Arts and Humanities	52	-	52
Community Services Administration	32	-	32
Department of Justice	22	1	23
Department of Commerce	21	-	21
Equal Employment Opportunity Commission	5	-	5
Veterans Administration	3	-	3
LEAA	2	-	2
National Science Foundation	1	-	1
Total	<u>1,013</u>	<u>967</u>	<u>1,980</u>

We could not readily determine the number of staff assigned to this function by Federal agencies. Some agencies, such as HEW and Labor, employ specially trained reviewers.

HEW supplements its reviewers with internal auditors, as needed. Other agencies, such as Interior, use internal auditors on an as-needed basis. In one region, HUD had two employees to review plans and proposals on a part-time basis while in two other regions, HUD used internal auditors to review plans.

HEW is responsible for substantially more cost allocation plans than other Federal agencies. In addition to the plans of the State and local governments shown in the table, HEW is responsible for all school districts, many special districts, and numerous nonprofit agencies and educational institutions. HEW employs 51 reviewers to handle this work, but they did not devote full time because of other duties. Due to the large number of plans, HEW directs its effort to the plans that are required to be reviewed and to grantees with large Federal programs.

EPA has only one person to review plans and proposals for the grantees for which it is cognizant. Labor has seven persons assigned to the review function, but they do not devote full time because of other duties.

The number of plans and proposals requiring review would increase substantially if all grantees prepared them. To accomplish such reviews, Federal agencies may have to (1) re-direct existing staff resources, (2) add additional staff, (3) rely on state reviews, or (4) contract out the reviews. Adequately conducted reviews or preaudits of plans and proposals would reduce the number of improper charges to Federal grants and contracts; improve relations among Federal, State, and local government officials; and permit expanded postaudit coverage of individual Federal grants and contracts.

NONUSE OF PLANS AND PROPOSALS BY FEDERAL AGENCIES

Recovery of the same cost through an indirect cost rate and as a direct charge to the grant occurs frequently because adequate procedures do not exist in many funding agencies for comparing costs included in grant applications with cost included in cost allocation plans and individual cost proposals. When plans are not required to be submitted, Federal and State funding agencies cannot do a proper review of grant application costs to detect and disallow the claiming of the same costs twice. Opportunities for detecting and correcting many erroneous charges to individual grants before their incurrence are being lost because of nonuse of the circular's products.

Federal and State grant-making officials generally told us that budgets and reimbursement claims are not reviewed in

the depth necessary to disclose such errors as we found in our review. Officials of HUD, EPA, the Interior, Labor, and the National Highway Traffic Safety Administration relied on the audit function to validate costs after the fact. Reviews by program officials of grant applications and expenditures claims are designed to make sure funds are spent on eligible program activities and that total dollar amounts appear reasonable when compared to expected program results. When grants are administered by the State, Federal officials said they do very little fiscal review. They said State officials are provided handbooks for grant administration and accounting and are expected to follow them.

Although most program administrators depend on audits to disclose deficiencies in grant programs, we found that programs were not being audited on a systematic or timely basis. Because of limited audit staffs, Federal and State program and audit officials told us they attempt to apply audit resources to programs with the largest amount of dollars. According to one official, his agency is unable to audit some grants until well after the grant has ended, and he questions whether overpayments could be recovered.

During our review we noted several examples where coordination between Federal officials who review cost allocation plans and Federal program officials prevented or disclosed double reimbursements and inconsistent treatment of costs. For example, a Labor plan reviewer, when comparing a proposed grant budget and the indirect cost proposal of a State department, found some directly charged administrative salaries that were also in the indirect cost rate. The reviewer instructed the Labor program official to eliminate the direct charges from the grant budget.

An HEW auditor contacted the HEW plan reviewer about \$4.3 million in costs allocated to a city's hospital from the city's cost allocation plan. The hospital was claiming these costs in the fiscal year 1973 Medicare Program. Because the reviewer knew of the city's practice of directly billing many joint costs that were already included in the plan, he was able to prevent the double reimbursement of the Federal share of this amount.

As a general proposition, however, Federal agencies lack procedures for comparing proposed grant budgets with approved plans and proposals. One reason such procedures do not exist is that sufficient information on approved plans and proposals is generally not available to program and grant management personnel.

When plans and proposals are approved, the Federal agency and grantee enter into a negotiation agreement which is forwarded to HEW for distribution to all Federal agencies requesting them. The agreements give Federal awarding agencies the authority to accept claims for indirect and central service costs. The indirect cost negotiation agreement summarizes the proposal and contains information on the indirect cost rate. The cost allocation plan negotiation agreement contains information on those central service costs distributed to the user departments and those central service costs directly billed to the user departments.

Neither type of agreement, however, provides the detailed information needed by Federal program and grant management personnel to detect erroneous or duplicative indirect charges to Federal grants and contracts. Copies of the cost allocation plans and proposals would be needed to do this. As an alternative, program personnel could adopt Labor's practice of forwarding proposed grant budgets to the agency's indirect cost negotiator who, with copies of the grantee's plan and proposals, could review the grant budgets for erroneous indirect cost charges.

Federal agencies are taking steps to reduce double reimbursement. HEW and Labor have held workshops on indirect costs for their grants management and contract officers. Also, HEW and Labor have asked their regional cost allocation plan negotiation personnel to help grant and contract officers by including as much specific information as possible on the negotiation agreements of central service and department costs that are permitted to be charged directly to grants and costs that are to be recovered through the indirect cost rate.

While the efforts are positive and needed, we believe reviews of grant budgets themselves are also needed.

**OMB SHOULD BE MORE ACTIVE IN MONITORING
IMPLEMENTATION OF THE CIRCULAR**

OMB relies on Federal agencies to implement the circular but has not developed a systematic approach to determine the extent to which the circular is being applied to Federal programs. OMB had neither formally reviewed the use of the circular nor required the agencies to report on their implementation practices. A more active OMB posture would promote wider use of the circular and help protect the financial interests of the Federal Government and State and local government grantees.

The circular's administration rests with a small staff which, because of other duties, has little time to devote to

the circular. Therefore, OMB dealt with circular problems on an exception basis. Under this approach, OMB generally was aware of only those problems brought to its attention by grantees or Federal agencies. It was not aware of the extent of the circular's nonuse as discussed in chapter 2.

When OMB responded to agency problems, it did not systematically notify other parties which could be affected by its interpretations or policy decisions. For example, in 1974, HEW asked if cost allocation plans could include depreciation or use charges on the grantee's contribution to buildings or equipment funded in part through Federal grants. OMB told HEW that depreciation or use charges were not allowable if the grants required the grantee to share in the costs. According to HEW officials, they understood that OMB would issue a formal policy statement on the matter.

OMB, however, has no formal process to distribute such decisions to all agencies. According to an EPA official, in 1976 he was unaware of the OMB decision and had been allowing a use charge on the grantee's share of the cost. In addition, he did not agree with the OMB decision and felt there were good arguments against such a determination. Also, he questioned whether the letter to HEW constituted a policy or merely an opinion since the circular does not contain the policy and since the letter was not distributed to all cognizant agencies as a policy.

In another example, HEW, in 1973, requested guidance from OMB on how State and local governments should handle general revenue sharing funds in cost allocation plans. OMB decided that such funds were to be considered as State and local funds rather than Federal funds. Other agencies were not notified of the decision.

OMB has experienced delays in making needed decisions, and it sometimes has not issued instructions on matters having governmentwide implications. When CETA was passed, a Labor officer wanted the indirect cost rates of local governments renegotiated because the use of the existing rates on the large influx of CETA funds could result in overreimbursements. Because of the governmentwide implications, the Labor officials asked OMB to advise other Federal agencies who were cognizant for the cost allocation plans and proposals of many of the local governments to renegotiate the rates. OMB, instead of advising other agencies, told Labor to do it.

Oregon asked HEW in November 1976 for permission to charge interest to Federal grants and contracts. Because the circular does not allow interest cost, HEW asked OMB for guidance. Additional requests from State and county

governments on the subject prompted HEW again to ask OMB to reassess the interest cost policy. HEW officials said OMB had not responded. In January 1979 an OMB official was working with organizations representing State and local governments to resolve the question of cost allowability.

OMB delegated to HEW responsibility for issuing guidelines for implementing the circular; distributing cost allocation plans and indirect cost proposal agreements; maintaining a listing of the plans, proposals, and agreements; and maintaining a list of cognizant agencies. While OMB endorsed the guidelines, it did not closely monitor HEW's operating responsibilities to ensure the effective implementation of the circular and the meaningful use of the circular's products.

HEW issued guidelines for State governments in 1969 and for local governments in 1970. The local guidelines were applicable to all Federal programs, but according to HEW, the State guidelines applied only to State agencies (about 340) for which HEW was cognizant. Any of the other 671 State agencies seeking guidance were to follow the guidelines of other cognizant agencies. HEW reissued one set of guidelines in 1976 for application to all Federal programs, regardless of cognizant responsibility. But for a 7-year period, OMB did not require other cognizant agencies to use the HEW guidelines for State agencies, and we found the other cognizant agencies did not prepare their own guidelines.

The circular provided that one agency would be designated as cognizant to act for all agencies in negotiating, approving, and auditing cost allocation plans and proposals of specific grantees. HEW published a list of cognizant agencies in October 1970. Responsibility for State agencies and local governments was generally assigned to that Federal agency which had the greatest dollar involvement with a given locality or State department. Local governments included in the list were limited to the cities or counties with populations over 50,000.

OMB and other Federal agencies referred grantees to the list of cognizant agencies, but according to a Federal official, copies were in short supply. HEW publications referred grantees to the Government Printing Office for copies. A Printing Office official said the list has been out of print since 1973.

HEW did not update the list until 1975 even though Federal agency cognizance by the greatest dollar involvement criterion had changed in many instances during the intervening years. HEW officials said the updated list together with certain related questions were provided to OMB and their

guidance was requested. OMB did not respond. Finally, after about a year, HEW told OMB that it would no longer be responsible for maintaining the list.

The draft 1975 list sometimes did not adequately list or cross reference agency assignments and in some instances did not agree with the understanding of Federal officials. For example:

--The list did not correctly show all departments of the Missouri State government. Two State departments included on the list were abolished on July 1, 1974, and 5 newly established departments which prepare cost allocation plans were not listed.

--An EPA auditor said EPA was responsible for Wichita, Kansas, and Omaha, Nebraska. The 1975 list assigned the 2 cities to HUD, which has audited both cities' cost allocation plans.

--A 1976 listing prepared by Labor headquarters showed the agency was responsible for Wichita, Kansas; Lincoln, Nebraska; Jackson County, Missouri; and St. Louis County, Missouri. The draft 1975 list showed HUD was responsible for the 2 cities and HEW for the 2 counties.

Federal agencies work with OMB to adjust agency assignments, but because the list was not regularly updated to reflect the changes, grantees wasted time searching out the assigned cognizant Federal agency to determine if cost allocation plans should be submitted or to discuss problems they may have. In December 1978, we were advised by OMB officials that they were publishing a list and intended to keep it as current as possible.

Sometimes conflicts arise between the cognizant Federal agency and another Federal agency regarding approved cost allocation plans. OMB, however, has not always acted promptly to resolve the conflicts. For example, HEW, the cognizant agency, negotiated an indirect cost rate effective July 3, 1974, with the Atlanta Regional Commission. LEAA questioned whether its programs benefited fully from the rate and requested the Commission to supply documentation for the rate. The Commission responded that all questions should be directed to the cognizant agency as required by the circular. LEAA did not agree and continued to ask for information.

In September 1974, the Atlanta Regional Commission asked OMB to assist in bringing the two Federal agencies together to resolve the issues. Meanwhile, HEW and LEAA began discussions

in October 1974. LEAA proposed a special rate for its programs, but HEW did not agree a special rate was necessary. The disagreement continued, and in January 1975, the Commission again asked OMB to help resolve the problem. In June 1975, HEW asked for OMB's assistance. OMB responded a month later, urging the agencies to discuss their differences. Finally, in January 1976, LEAA agreed to an audit which HEW completed in April 1976 and which confirmed the originally negotiated rate.

OMB's inaction contributed to continuation of this conflict for 1-1/2 years. But perhaps more importantly, the cognizant agency concept tends to be undermined if OMB does not vigorously solve disputes over cognizant agencies' determination.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

A decade has passed since OMB established uniform cost principles for Federal grants and contracts with State and local governments. In formulating the governmentwide principles, it was recognized that the total allowable costs incurred by State and local governments in administering Federal programs should be identified. This identification, in accordance with the principles of OMB's circular and HEW's guidelines, was expected to obtain efficiency and better relationships between State and local grantees and the Federal Government.

These objectives have not been met to the extent possible. Too many grants and contracts are awarded by Federal agencies and by State agencies using Federal funds without applying the circular's safeguards. As a result, the Federal Government is not always assured of being charged properly, and grantees do not identify, for possible recovery, the costs of operating Federal programs. Many inappropriate charges are made to Federal programs, total grantees' costs of administering programs are often not identified, and grantees and the Federal Government frequently haggle over the circular.

The potential value of the circular to all parties is significant--the agreed-upon use of a method that fairly and consistently identifies, accumulates, and allocates costs which can not readily be associated with individual grants and contracts but which are necessary for the administration of the grants and contracts. However, too many grantees are not systematically identifying, accumulating, or allocating costs for various reasons:

--Some Federal and State funding agencies employ practices which discourage and sometimes prohibit total cost determinations by grantees. Some funding agency officials evidently believe that grantees do not incur additional costs to administer grants or believe that limited Federal funds are better used for direct program purposes. Although the identification of total costs does not necessarily mean that the costs will be fully reimbursed, if they are not identified the prospects for reimbursement are reduced.

- Some Federal and State funding agencies allow grantees to use arbitrary indirect cost rates that may have no relationship to actual rates.
- Some Federal and State funding agencies allow grantees to charge indirect costs to grants without a plan of allocation. The funding agencies rely on post audits to detect erroneous charges.
- Sufficient Federal guidance does not exist on how to prepare plans of allocation.
- Some grantees want to avoid the hassle with funding agencies that may result from attempting to use the circular.
- Clarity does not exist on whether State funding agencies must observe the total cost principles of the circular in subgrants of Federal funds to local governments.

The administrative system needed to bring about widespread observance of the circular's principles has not been established at the Federal level. A small staff at OMB has responsibility for monitoring the circular along with other duties. Among Federal grant-making agencies, the staff resources to administer the circular may be insufficient, and the top-level management support clearly needed to offset the inherent reluctance of program officials to accept the circular's objectives has not developed.

The preparation of cost allocation plans for identifying, accumulating, and allocating all joint costs and the review and approval of the plans before their use would promote the circular's objectives of efficiency and better relations between grantees and grantor funding agencies. Widespread use of the plans and proposals by funding agencies in the grant-making process would promote needed financial safeguards for both grantee and grantor. }

RECOMMENDATIONS TO THE DIRECTOR, OMB

To improve the financial management of Federal grants awarded to State and local governments, we recommend that OMB, in consultation with interested parties, consider needed revisions to the cost principles circular and related policies and procedures. In our opinion, the revisions should:

- Emphasize the Federal policy of recognizing total allowable costs, and clearly state that reimbursement of total costs is a separate question which is subject, among other things, to negotiations between the parties.
- Define joint costs and clearly indicate that such costs will not be recognized or reimbursed under Federal programs without evidence of plans of allocation. This could be accomplished by:
 - Requiring grantees to certify where joint costs are claimed, that a plan of allocation has been prepared.
 - Prohibit Federal agencies from discouraging total cost determinations by grantees and establish procedures for handling and disposing of grantee complaints of Federal agency noncompliance.
 - Clearly enunciate whether State agencies and other grantees are required to apply the total cost principles in subgrants.
 - Establish a procedure to develop a priority listing of grantees, on the basis of the amount of Federal dollars involved, prior experience, and other criteria as appropriate; who must submit cost allocation plans for approval before these plans may be used to charge costs to grants.
 - Establish, as a long-range goal, a process which would require the submittal, reviewal, and approval of all cost allocation plan and proposals before grantees are permitted to use them in Federal grants.
 - Prohibit the use of arbitrary indirect cost rates in Federal grants.
 - Establish a process for periodic consultation with Federal agency liaison officials to identify issues that may need attention.

To improve the administration and monitoring of the circular, we recommend that OMB:

- Adopt a more active approach in monitoring the circular's administration to assure that its policy

interpretations and decisions are communicated to and uniformly adopted by Federal agencies in a timely manner.

- Define the duties of Federal agency liaison officers responsible for the circular, and use the officers to help monitor its administration.
- Make a concerted attempt to increase Federal efforts to provide needed training, instructions, and technical assistance.
- Establish or oversee the establishment of a system to collect and distribute plans to appropriate Federal, State, and local officials to facilitate use of cost allocation plans in the grant-making process.

RECOMMENDATIONS TO FEDERAL AGENCIES

While OMB has the central role in developing and promulgating policy and procedures for Federal cost principles, the individual Federal agencies are responsible for their daily administration. To improve the administration of the circular, we recommend that the heads of the 10 Federal agencies whose programs we reviewed (see p. 35) take action to assure that: *should*

- ✓ --Their regulations and procedures are consistent with the circular.
- ✓ --The practices of their agencies are consistent with their own regulations and policies and OMB requirements.
- ✓ --Their agencies have the capacity and are providing necessary training, instructions, and technical assistance to (1) State and local government grantees in preparing and using cost allocation plans, (2) Federal and State agency personnel in reviewing and approving cost allocation plans, and (3) Federal and State funding personnel in using cost allocation plans in awarding grants and contracts.

AGENCY COMMENTS

OMB, in commenting on our report (see app. I), agreed that by providing a method that fairly and consistently identifies, accumulates, and allocates costs which can not be readily associated with individual grants and contracts, the circular has significant potential value to both the Federal Government and State and local governments.

OMB recognized that the circular has not yet been fully implemented, particularly with respect to indirect costs and cost allocation plans, but it believes that problems in implementing the circular are more severe at the local level than at the State level. OMB noted that all States have received approval of statewide cost allocation plans and that most State agencies have received similar approvals. Our study confirmed that cost allocation plans are generally prepared by State governments, but we found that some States, as well as local governments, do not use the plans they have prepared and that errors in the preparation and use of the plans occur at both the State and local levels.

OMB agreed that some revisions of the circular may be needed, and plans to seek advice on changes to the circular from a broad range of interested parties.

OMB agreed that more can be done to assure agency implementation of the circular and intends to increase its efforts in this regard. OMB believed, however, that our report did not give adequate recognition to past and current efforts of OMB and others in providing training, instruction, and technical assistance. Although OMB has made significant efforts, the errors we observed in the preparation and use of cost allocation plans suggest that additional efforts are needed. OMB felt that while more training might be useful, it is now doing as much as is reasonable to expect.

CHAPTER 5

SCOPE OF REVIEW

To determine the intent of the circular and circumstances leading to its issuance, we interviewed Federal officials involved in drafting and implementing the circular and reviewed documentation at OMB and at other Federal agencies in Washington, D.C.

To determine how well the Federal agencies had implemented the circular, we reviewed selected program legislation to determine the statutory prohibitions on cost allowability and also reviewed regulations, guidelines, and procedures for implementing the circular. We interviewed officials at the Washington, D.C., headquarters of ~~HEW, HUD,~~ ~~Commerce, the Interior, Justice, Agriculture, Labor, DOT, EPA,~~ and ~~Action.~~ We also reviewed regional office procedures for implementing the circular and for reviewing and auditing costs incurred on selected programs and interviewed officials in the agencies' Atlanta, Boston, Philadelphia, Kansas City, Denver, and San Francisco regional offices.

To determine the adequacy of the circular for grantee purposes and the extent of implementation, we visited State grantees in Missouri, Connecticut, Pennsylvania, and California and local governments, including Springfield, Jefferson City, and St. Louis, Missouri; Lake County, Stockton, and San Jose, California; New Britain, Connecticut; Worcester, Massachusetts; Bucks County, Pennsylvania; Dade County, Florida; and Buffalo, New York. We also obtained additional supporting information through a telephone survey of 165 local governments in Missouri, California, Pennsylvania, Massachusetts, New Hampshire, Rhode Island, Maine, and Connecticut.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

May 15, 1978

Honorable Elmer B. Staats
Comptroller General of the United States
General Accounting Office
Washington, D.C. 20548

Dear Mr. Staats:

This is in reply to the draft report, "Federal Cost Principles Are Often Not Applied In Grants And Contracts With State And Local Governments."

We greatly appreciated the willingness of your staff to meet with us on the draft report, and to participate in our meetings on it with agency officials and with representatives of State and local governments. These meetings proved very useful in gaining better insight into the problems disclosed in the GAO study, and were an effective way for us to obtain comments and suggestions from other affected parties before preparing our response.

As the draft report indicates, Circular 74-4 was developed to provide a uniform set of cost accounting principles that would apply to all grants and contracts with State and local governments. It replaced many different--and often conflicting--sets of cost accounting rules that agencies were then using in individual programs. We agree with the observation in the draft report that, "the potential value of the circular to all parties is significant--the agreed-upon use of a method that fairly and consistently identifies, accumulates, and allocates costs which can not readily be associated with individual grants and contracts but which are necessary for the administration of grants and contracts."

We recognize, however, that full implementation of the uniform cost accounting principles has not yet been achieved. It appears from the draft report that accounting for direct costs in accordance with the provisions of Circular 74-4 is not creating any particular problem. But the draft report does cite problems with indirect costs,

particularly with respect to preparing, negotiating, and approving indirect cost allocation plans. Although the draft report does not distinguish between State implementation and local implementation, we believe that problems at the State level are less severe. We understand, for example, that all States have submitted, and received approval of, State-wide cost allocation plans, and that almost all of the nearly 500 State agencies have done likewise. We also understand that most Councils of Government which depend heavily on Federal funding have successfully implemented the Circular's provisions.

[See GAO note, p. 38.]

we plan to seek advice on changes to the Circular from the broadest range of interested parties--Congress, Federal agencies, State and local governments, public interest groups, and the public at large. We would hope to work with your staff on any such revision, and get the benefit of their advice and counsel.

The draft report further recommends that OMB adopt an aggressive program for reviewing agency implementation, and assure that training, instruction, and technical assistance are provided to Federal, State, and local officials who work with indirect cost allocation plans. We agree that more can be done to assure agency implementation, and we intend to beef up our efforts in this regard. However, with respect to training, instruction, and technical assistance, we believe the draft report does not give sufficient recognition to the extensive work that is already being done. Our staff have organized and conducted training efforts, and have cooperated with numerous training agencies and organizations that regularly put on programs dealing with Circular 74-4. Some time back--in cooperation with

GAO, other Federal agencies, Federal Regional Councils, and public interest groups--we held a nationwide series of grant management workshops. These workshops, which included detailed instruction on indirect cost allocation plans, involved all ten Federal regions and reached almost 2,500 Federal, State, and local officials. Regular programs put on each year by the Civil Service Commission and the Interagency Auditor Training Center, with OMB participation, reach hundreds more. The Department of Health, Education, and Welfare and the Labor Department regularly conduct similar programs, both in Washington and in the field. In addition, our staff each year participates in numerous workshops and seminars sponsored by State and local groups. And we understand that private organizations and universities conduct programs of their own. It may be that still more training would be useful, but we believe OMB is now doing as much as it is reasonable to expect.

We appreciate the opportunity to comment on the draft report.

Sincerely,



James T. McIntyre, Jr.
Director

GAO note: Deleted comments refer to material contained in the draft report which has not been included in the final report.

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