



September 2016

# NIH BIOMEDICAL RESEARCH

## Agencies Involved in the Indirect Cost Rate-Setting Process Need to Improve Controls

# GAO Highlights

Highlights of [GAO-16-616](#), a report to congressional requesters

## Why GAO Did This Study

NIH spent over \$23 billion to support extramural research in 2015, including \$6.3 billion for indirect costs, which are costs not directly attributable to a specific research project or function, such as utilities expenses, for grants and cooperative agreements. NIH relies on designated cognizant agencies to design adequate internal controls over the processes for negotiating indirect cost rates with research organizations. Once set, these rates must be accepted by NIH and all federal awarding agencies.

GAO was asked to review the internal controls for overseeing the validity of indirect cost rates for NIH's research organizations. This report examines the extent to which the three primary cognizant agencies (CAS, NIH-DFAS, and ONR) that set indirect cost rates on NIH's behalf have designed internal controls to mitigate the potential for fraud, waste, and abuse in the indirect cost rate-setting process. GAO reviewed OMB guidance, the FAR, and the cognizant agencies' internal guidance on indirect cost rate negotiation; interviewed staff at the cognizant agencies; and reviewed a nongeneralizable sample of negotiation case files to obtain an understanding of the design of controls.

## What GAO Recommends

GAO is making 12 recommendations to improve controls over their indirect cost rate process. HHS concurred with GAO's 7 recommendations to CAS and NIH-DFAS and described ongoing and planned actions to address them. DOD concurred with 4 recommendations to ONR and partially concurred with 1. GAO continues to believe that action is needed, as discussed in the report.

View [GAO-16-616](#). For more information, contact Beryl H. Davis at (202) 512-2623 or [davisbh@gao.gov](mailto:davisbh@gao.gov).

September 2016

## NIH BIOMEDICAL RESEARCH

### Agencies Involved in the Indirect Cost Rate-Setting Process Need to Improve Controls

## What GAO Found

Research organizations that apply for National Institutes of Health (NIH) funding participate in an indirect cost rate-setting process, which involves submitting a rate proposal; reviewing the proposal and having it audited by a third-party agency at the cognizant agency's request; and finalizing (negotiating) the rate for the organization. The Office of Management and Budget (OMB) and the Department of Health and Human Services (HHS) have designated three primary cognizant agencies to set indirect cost rates for federal financial assistance funded by NIH:

1. HHS's Cost Allocation Services (CAS),
2. NIH's Division of Financial Advisory Services (NIH-DFAS), and
3. the Department of Defense's (DOD) Office of Naval Research (ONR).

These cognizant agencies are responsible for ensuring that negotiated indirect cost rates comply with OMB guidance and the Federal Acquisition Regulation (FAR), as applicable.

GAO found that while the three agencies had designed controls for setting indirect cost rates, deficiencies in the design of some of these controls could result in the waste of federal resources. The deficiencies GAO identified are as follows:

- None of the three agencies has updated its internal guidance to reflect current OMB guidance or changes in agency requirements, such as documentation requirements.
- ONR relies on audits by the Defense Contract Audit Agency to ensure the adequacy and compliance of indirect cost proposals that it processes, but ONR has not included acceptable time frames in its internal guidance for when these audits are to be completed or what steps are to be taken when audits result in qualified opinions or when a prior audit opinion is rescinded.
- All three cognizant agencies' internal guidance lacks detailed instructions to supervisors on their review responsibilities over the indirect cost rate process.
- CAS and ONR have not developed internal guidance addressing differences in negotiating indirect cost rates with certain types of research organizations, such as universities and hospitals.
- ONR and NIH-DFAS have not developed mechanisms to track key milestones for the indirect cost rate-setting process.

If these deficiencies are not addressed, there is an increased risk that these cognizant agencies may not properly and consistently negotiate indirect cost rates and that the rates negotiated may not comply with applicable federal regulations. Thus, there is an increased risk that the indirect cost rates used to reimburse NIH research organizations will include costs that are not allowable, allocable, and reasonable, and may result in wasted federal resources.

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## Abbreviations

CAS	Cost Allocation Services
DCAA	Defense Contract Audit Agency
DOD	Department of Defense
FAR	Federal Acquisition Regulation
HHS	Department of Health and Human Services
NIH	National Institutes of Health
NIH-DFAS	National Institutes of Health's Division of Financial Advisory Services
OMB	Office of Management and Budget
ONR	Office of Naval Research

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September 7, 2016

The Honorable Fred Upton  
Chairman  
Committee on Energy and Commerce  
House of Representatives

The Honorable Tim Murphy  
Chairman  
Subcommittee on Oversight and Investigations  
Committee on Energy and Commerce  
House of Representatives

The federal government plays an important role in contributing to American competitiveness and leadership in science through its sponsorship of research. The Department of Health and Human Services' (HHS) National Institutes of Health (NIH) is the largest public funder of biomedical research in the world, sponsoring extramural research conducted by outside organizations that has led to scientific breakthroughs and new treatments helping people live longer and healthier lives.<sup>1</sup> In fiscal year 2015, NIH spent approximately \$23.5 billion to support extramural research, of which approximately \$22 billion, or 94 percent, was funded using grants and cooperative agreements. NIH reimburses for both direct and indirect costs incurred by the organizations conducting extramural research.<sup>2</sup> Direct costs are specifically attributed to research projects sponsored by NIH grants, whereas indirect costs are not directly attributable to a specific project or function, such as administrative expenses.<sup>3</sup> In fiscal year 2015, reimbursements for indirect

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<sup>1</sup>Extramural research is research supported by NIH primarily through grants, contracts, or cooperative agreements.

<sup>2</sup>NIH funds extramural research, which is research that is not conducted by NIH but by outside organizations—universities, research institutes, for-profit organizations, hospitals, other domestic nonprofit organizations, and foreign organizations—on behalf of NIH.

<sup>3</sup>For purposes of this report, "grant" refers to federal financial assistance that NIH provides to a nonfederal entity pursuant to an award executing a grant agreement, cooperative agreement, or contract, except when we specifically state "grants and cooperative agreement" or "grants and contracts."

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costs represented approximately \$6.3 billion, or 28 percent, of NIH's grant and cooperative agreement award totals.

To be reimbursed for indirect costs, research organizations must properly identify and claim reimbursement for these costs in accordance with applicable federal guidance. The Office of Management and Budget (OMB) guidance<sup>4</sup> and the Federal Acquisition Regulation (FAR)<sup>5</sup> establish the principles for determining the types of indirect costs that are allowed to be claimed and the methods for allocating such costs to federally funded research.<sup>6</sup> Because indirect costs cannot be specifically attributed to a particular research grant, they are allocated via an indirect cost rate that is applied to certain direct costs for each awarded grant. NIH then uses the indirect cost rate to reimburse indirect costs to the organization.

Each research organization that applies for NIH funding participates in an indirect cost rate-setting process, which involves the submission of a rate proposal; reviewing the proposal and having it audited by a third-party agency at the cognizant agency's request; and finalizing (negotiating) the

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<sup>4</sup>For decades, OMB has published guidance to aid grant-making agencies on various subjects, including administration, audit, record keeping, and allowability of costs. OMB Circular Nos. A-21 and A-122, which apply to educational institutions and nonprofit organizations, respectively, established principles for determining applicable costs. In December 2013, OMB consolidated its grants management circulars into a single document, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), 2 C.F.R. pt. 200, 78 Fed. Reg. 78,590 (Dec. 26, 2013). In December 2014, OMB, along with federal grant-making agencies, issued a joint interim final rule implementing OMB's Uniform Guidance for new grants made on or after December 26, 2014. Joint Interim Final Rule on Uniform Guidance, 79 Fed. Reg. 75,871 (Dec. 19, 2014). HHS adopted OMB's final Uniform Guidance with certain amendments, based on existing HHS regulations, to supplement the guidance as needed for the department. HHS's amendments are incorporated into its implementing regulations at 45 C.F.R. pt. 75.

<sup>5</sup>Federal Acquisition Regulation, 48 C.F.R. pt. 31, *Contract Cost Principles and Procedures*, which apply to for-profit organizations.

<sup>6</sup>The guidance applicable to research organizations selected for our review includes OMB Circular No. A-21, *Cost Principles for Education Institutions* (incorporated in 2 C.F.R. pt. 200, subpt. E, and app. III) (2014), and OMB Circular No. A-122, *Cost Principles for Non-Profit Organizations* (incorporated in 2 C.F.R. pt. 200, subpt. E and apps. VII and VIII) (2014).

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rate for the organization.<sup>7</sup> OMB and HHS have designated three primary cognizant agencies to negotiate indirect cost rates for grants funded by NIH: (1) HHS's Cost Allocation Services (CAS), (2) NIH's Division of Financial Advisory Services (NIH-DFAS), and (3) the Department of Defense's (DOD) Office of Naval Research (ONR).<sup>8</sup> The cognizant agencies are responsible for ensuring that the negotiated indirect cost rates comply with OMB guidance and the FAR, as applicable. Once an indirect cost rate has been established for a research organization, any federal agency will apply that rate to all grants awarded to that organization.<sup>9</sup>

You requested that we review the internal controls for overseeing the validity of indirect cost rates for NIH grant recipients. In this report, we discuss the extent to which the three primary cognizant agencies (CAS, NIH-DFAS, and ONR) have designed appropriate internal controls that mitigate the potential for fraud, waste, and abuse in the process for setting indirect cost rates.

To determine the extent to which the three primary cognizant agencies have designed appropriate internal controls to mitigate the potential for fraud, waste, and abuse in the indirect cost rate-setting process, we interviewed staff from each of the three cognizant agencies, NIH, and OMB. We reviewed OMB's guidance, the FAR, *Standards for Internal*

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<sup>7</sup>According to OMB guidance, a cognizant agency is responsible for negotiating, and approving indirect cost rates on behalf of all other federal agencies. A cognizant agency is not necessarily an agency as defined by statute and may be a component of another agency.

<sup>8</sup>Generally, the agency that provides the most funding to a particular research organization has rate-setting cognizance for that organization. OMB guidance assigns responsibility to negotiate rates (1) to either HHS's CAS or DOD's ONR for universities and (2) for research institutes to the cognizant agency with the largest dollar value of grants with an organization, unless different arrangements are agreed to by the agencies concerned. The Secretary of HHS authorized NIH-DFAS to have HHS-wide cognizance of the indirect cost rate negotiation function with for-profit grantees, which are not covered by the OMB guidance on grant cost principles.

<sup>9</sup>Although OMB guidance and the FAR Part 42 require agencies to adhere to the negotiated rate while it is in effect, an agency may apply a different rate, under special circumstances, when required by statute or regulation. OMB Circular A-21, G, 11, B (OMB circular provisions incorporated in the Uniform Guidance at 2 C.F.R. §200.414 (c)), and FAR 42.703-1(a)).

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*Control in the Federal Government*,<sup>10</sup> and *A Framework for Managing Fraud Risk in Federal Programs* to identify controls and objectives required to mitigate the risk for fraud, waste, and abuse in the indirect cost rate-setting process.<sup>11</sup> We then reviewed each cognizant agency's internal control guidance pertaining to the indirect cost rate-setting process to determine whether the guidance was designed to mitigate the potential for fraud, waste, and abuse. These controls are used in negotiating with four types of organizations that received the majority of NIH funding in fiscal year 2014: (1) institutions of higher education (herein-after referred to as universities), (2) research institutes, (3) hospitals, and (4) domestic for-profit organizations.<sup>12</sup>

To further our understanding of the design of internal controls at the three cognizant agencies, we selected a nongeneralizable sample of case files for fiscal year 2014 grants at each agency. Next, we performed walk-throughs of the case files to confirm our understanding of each cognizant agency's design of internal controls over the indirect cost rate-setting process.<sup>13</sup> We limited the scope of our walk-throughs to three types of research organizations: universities, research institutes, and for-profit organizations.<sup>14</sup> We did not test the operational effectiveness of the cognizant agencies' internal guidance and therefore cannot draw

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<sup>10</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999). Beginning in fiscal year 2016, [GAO/AIMD-00-21.3.1](#) is superseded by GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014). Because our audit work applied to fiscal years 2014 and 2015, this report refers to [GAO/AIMD-00-21.3.1](#).

<sup>11</sup>GAO, *A Framework for Managing Fraud Risks in Federal Programs*, [GAO-15-593SP](#) (Washington, D.C.: July 2015).

<sup>12</sup>For purposes of this report, "internal control guidance" (herein referred to as internal guidance) refers to policies and procedures established by the cognizant agencies.

<sup>13</sup>To enhance our understanding of the internal control environment, we performed walk-throughs of each cognizant agency's system of internal controls over the indirect cost rate negotiation process. As part of the walk-throughs, we reviewed case files, interviewed knowledgeable officials, and asked questions regarding the roles of agency staff in the internal control process.

<sup>14</sup>We did not select hospitals for our walk-throughs because CAS, the cognizant agency responsible for hospitals, does not have any internal guidance related to negotiating indirect cost rates for hospitals, as discussed later in this report.



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conclusions about the effectiveness of existing internal controls over the cognizant agencies' indirect cost rate-setting process.


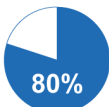
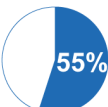

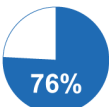



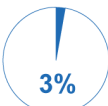







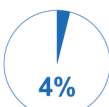
















We conducted this performance audit from March 2015 to September 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Appendix I provides a more detailed discussion of our objective, scope, and methodology.

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## Background

NIH funds extramural research primarily through grants. In 2015, NIH funded approximately 50,000 research projects, totaling over \$22 billion to research organizations, through grants and cooperative agreements for extramural research. Of the six types of organizations conducting extramural research, NIH provided approximately \$17 billion of funding to universities in fiscal year 2015. See figure 1 for a breakout of direct and indirect cost reimbursements received by these research organizations that were funded through grants and cooperative agreements.

**Figure 1: National Institutes of Health-Funded Grants and Cooperative Agreements (Research Projects), Direct Costs, and Indirect Costs by Organization Type in Fiscal Year 2015**

	Organization type	Number of research projects	Percentage of research projects	Direct costs	Percentage of total	Indirect costs	Percentage of total	Total direct and indirect costs	Percentage of total
	Universities	39,908		\$12.3 billion		\$4.8 billion		\$17.1 billion	
	Research institutes	3,220		\$1.4 billion		\$608 million		\$2.0 billion	
	Hospitals	3,636		\$1.3 billion		\$511 million		\$1.8 billion	
	Domestic for-profit	1,834		\$633 million		\$231 million		\$864 million	
	Domestic nonprofit	1,098		\$411 million		\$120 million		\$531 million	
	Foreign	474		\$189 million		\$13 million	0%	\$202 million	
	<b>Total</b>	<b>50,170</b>		<b>\$16.2 billion</b>		<b>\$6.3 billion</b>		<b>\$22.5 billion</b>	

Source: National Institutes of Health Office of Extramural Research. | GAO-16-616

NIH generally reimburses for both direct and indirect costs incurred by the research organizations conducting extramural grant research. Direct costs are specifically attributed to research projects and include, for example, a researcher's salary, equipment cost, and travel. Indirect costs represent an organization's general support expenses that cannot be specifically attributed to a specific research project or function. They

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include, for example, administrative staff salaries, building utilities, and library operations. Because indirect costs cannot be specifically attributed to a particular research project, they are allocated via an indirect cost rate that is applied to certain direct costs for each awarded grant. NIH then uses the negotiated indirect cost rate to reimburse indirect cost expenses to the organization. In fiscal year 2015, indirect costs represented approximately \$6.3 billion (28 percent) of NIH's grants and cooperative agreement award totals.

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### Cognizant Agencies Responsible for Negotiating Indirect Cost Rates

Each research organization that applies for NIH funding develops a proposed indirect cost rate and subsequently negotiates with its designated cognizant agency to set an indirect cost rate used for reimbursement. Because many research organizations perform research for multiple federal agencies, OMB guidance specifies that the designated cognizant agency for a particular research organization is responsible for negotiating and approving indirect cost rate proposals on behalf of all other federal agencies. As noted above, OMB and HHS have designated three primary cognizant agencies to negotiate indirect cost rates for research organizations that receive NIH-funded grants: (1) CAS, (2) NIH-DFAS, and (3) ONR. For fiscal year 2014 NIH-funded grants, CAS negotiated rates for approximately 460 universities, 150 research institutes, and 90 hospitals; NIH-DFAS negotiated rates for approximately 190 for-profit organizations; and ONR negotiated rates for 25 universities and 5 nonprofit organizations.<sup>15</sup> The cognizant agencies are responsible for ensuring that the negotiated indirect cost rates comply with OMB guidance and the FAR, as applicable.

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### Calculation of the Proposed Indirect Cost Rate

A research organization's proposed indirect cost rate is essentially the ratio of its total indirect costs (after adjustments) to its total direct costs related to all of the research organization's grants for a particular time period.<sup>16</sup> To calculate its indirect cost rate, a research organization divides its total claimed indirect costs (e.g., equipment and maintenance)

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<sup>15</sup>According to NIH officials, research institutes are educational organizations other than universities.

<sup>16</sup>Adjustments include the removal of unallowable, unallocable, and unreasonable costs from the claimed indirect cost.

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across the organization by its total direct costs (e.g., researcher's salary and travel), referred to as the distribution base, across all of the research organization's grants. The resulting percentage is the proposed indirect cost rate. This proposed rate is then negotiated with the cognizant agency until they agree upon a negotiated indirect cost rate.

To determine how much of the research organization's indirect costs should be allocated to each research grant, each grant's direct cost amount is multiplied by the negotiated indirect cost rate. In this way, if a particular research grant contributes a higher percentage of the organization's direct costs, it will share in a proportionally higher percentage of the indirect costs as well. See figure 2 for an example calculation of an indirect cost rate and allocation at a hypothetical research organization. This example presumes that the cognizant agency approves the proposed rate as the negotiated rate without further adjustment.<sup>17</sup>

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<sup>17</sup>For simplification purposes, the example shown in fig. 2 is calculated using a total direct cost distribution base and shows only three grant projects. However, research organizations more commonly use one or more modified distribution bases, which exclude certain cost elements, in calculating their proposed indirect cost rates (i.e., direct salaries and wages). Further, it is common for organizations to have other sponsored and institution activities in addition to grant projects.

**Figure 2: Example of an Indirect Cost Rate Calculation for a Hypothetical Organization**

The indirect cost rate is calculated by dividing:

$$\frac{\text{Indirect costs } \$6,300,000}{\text{Direct costs } \$16,700,000} = 38\%$$

For an indirect cost rate of: **38%**

Indirect costs	Total costs	Adjustments for unallowable costs		Total claimed
Maintenance	\$1,000,000	–	\$200,000	= \$800,000
Clerical staff	\$4,000,000	–	\$200,000	= \$3,800,000
Equipment	\$1,000,000	–	\$100,000	= \$900,000
Other indirect costs	\$1,100,000	–	\$300,000	= \$800,000
<b>Total indirect costs</b>	<b>\$7,100,000</b>		<b>\$800,000</b>	<b>\$6,300,000</b>

Direct costs	Grant A	Grant B	Grant C	Total
Salary	\$6,680,000	\$4,000,000	\$2,680,000	\$13,360,000
Travel	\$417,500	\$250,000	\$167,500	\$835,000
Other direct costs	\$1,252,500	\$750,000	\$502,500	\$2,505,000
<b>Total direct costs</b>	<b>\$8,350,000</b>	<b>\$5,000,000</b>	<b>\$3,350,000</b>	<b>\$16,700,000</b>

Indirect costs (38% of each grant's direct costs) are allocated to all three grants.

Total costs	Direct costs	Indirect cost allocation		Total reimbursement
Grant A	\$8,350,000	+	\$3,150,000	= \$11,500,000
Grant B	\$5,000,000	+	\$1,886,228	= \$6,886,228
Grant C	\$3,350,000	+	\$1,263,772	= \$4,613,772
<b>Total</b>	<b>\$16,700,000</b>		<b>\$6,300,000</b>	<b>\$23,000,000</b>

Source: GAO analysis of Office of Management and Budget guidance and Federal Acquisition Regulation. | GAO-16-616

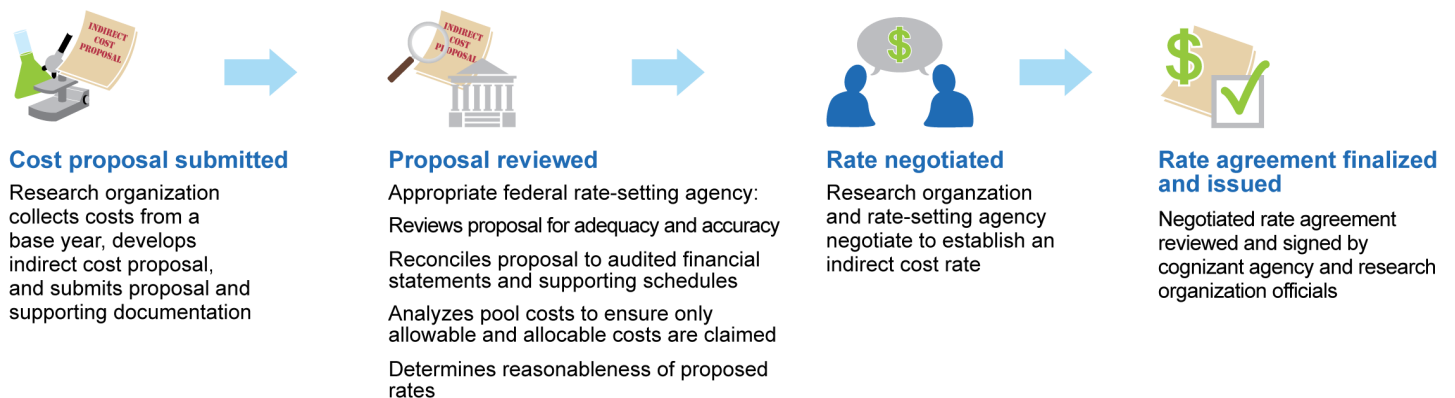
## Indirect Cost Rate-Setting Process

The indirect cost rate-setting process begins when a research organization submits an indirect cost rate proposal with supporting documentation to its cognizant agency based on a combination of historical and estimated costs. Examples of supporting documentation include proposals, audited financial statements, Single Audit reports,<sup>18</sup>

<sup>18</sup>31 U.S.C. §§ 7501-7507. The Single Audit Act, as amended, requires all nonfederal entities that expend a certain amount of federal awards, including grants and other assistance, in a fiscal year to have a single or program-specific audit conducted by an independent auditor.

and certification of indirect cost rates for universities and for-profit organizations.<sup>19</sup> CAS and NIH-DFAS review proposals whereas ONR generally sends proposals to the Defense Contract Audit Agency (DCAA) to be audited. When reviewing a proposal, the cognizant agency is to verify the mathematical accuracy of the rates proposed, confirm unallowable costs have been excluded, reconcile the cost proposal to the audited financial statements, and determine the reasonableness of the proposed costs. After the proposal has been reviewed or audited, the cognizant agency and the research organization negotiate and come to an agreement on the rate. The negotiated rate is then documented in a formal indirect cost rate agreement to be applied to all grants going forward. Generally, the negotiated rate is set for a 1-to-4-year time frame. This process is illustrated in figure 3.

**Figure 3: Indirect Cost Rate-Setting Process**



Source: GAO analysis of the cognizant agencies' guidance. | GAO-16-616

<sup>19</sup>Universities and for-profit organizations are generally required to submit a certification of indirect cost rates which confirms that the proposal includes only allowable costs in accordance with federal requirements. The certification must be signed on behalf of the research organization by an individual at a level no lower than vice president or chief financial officer. An indirect cost proposal shall not be accepted and no agreement shall be made to establish final indirect cost rates unless the proposed costs have first been certified by the research organization (OMB Circular No. A-21, K (OMB circular provisions incorporated in the Uniform Guidance at 2 C.F.R. pt. 200. subpt. F); and FAR subpt. 31.110, *Contract Cost Principles and Procedures*).

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## Indirect Cost Rate Guidance and Regulations

The cognizant agencies are required to negotiate the indirect cost rates in accordance with applicable federal guidance and regulations. OMB Circular No. A-21 (*Cost Principles for Educational Institutions*); OMB Circular No. A-122 (*Cost Principles for Non-Profit Organizations*); OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance); and FAR Part 31 (*Contract Cost Principles and Procedures*, applicable to for-profit organizations) establish the principles for defining, calculating, and negotiating indirect cost rates for applicable grants. Specifically, the guidance and regulations describe

- classification and types of allowable indirect costs;<sup>20</sup>
- methods of allocating such costs;
- reasonableness of claimed costs;
- exclusions and descriptions of unallowable cost elements, such as alcohol and bad debts; and
- guidelines for establishing indirect cost rates.

GAO's *A Framework for Managing Fraud Risks in Federal Programs* identifies leading practices to aid program managers in managing fraud risks. For example, *A Framework for Managing Fraud Risks in Federal Programs* states that management should design and implement data analytics as a control activity to prevent and detect fraud. Further, *Standards for Internal Control in the Federal Government* provides the overall framework for establishing and maintaining internal control across the federal government and for identifying and addressing major performance and management challenges and areas at greatest risk of

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<sup>20</sup>A cost is allowable if it is reasonable, is allocable to the agreement, is treated consistently with generally accepted accounting principles appropriate to the circumstances, and conforms to principles prescribed by the federal government and the sponsoring agreement. A cost may be considered reasonable if the nature of the goods or services acquired or applied, and the dollar amount involved, reflect the action that a prudent person would have taken under the circumstances. A cost is allocable to a particular cost objective (e.g., a specific function, project, sponsored agreement, or department) if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received or other equitable relationship (OMB Circular No. A-21, C and OMB Circular No. A-122, A (OMB circular provisions incorporated in the Uniform Guidance at 2 C.F.R. § 200.403-405), and FAR subpt. 31.201, *Contracts with Commercial Organizations*).

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fraud, waste, abuse, and mismanagement.<sup>21</sup> *Standards for Internal Control in the Federal Government* states that internal controls comprise the plans, methods, and procedures used to meet missions, goals, and objectives. Management is responsible for developing detailed internal guidance and practices to fit the agency's operations and ensuring that they are integral to operations.

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## Recent Reviews of the Cognizant Agencies' Indirect Cost Rate-Setting Processes

GAO and ONR's internal review team have each issued one report in recent years with recommendations related to the indirect cost rate-setting processes for the cognizant agencies.<sup>22</sup> GAO reviewed DOD's processes and procedures related to indirect costs for research and made one recommendation. During its review, GAO found a wide variation in indirect cost rates at universities receiving DOD funding because of inconsistencies in the rate-setting and reimbursement processes. The report concluded that with inconsistencies in rate-setting and reimbursement processes and weakness in oversight methods, DOD lacks assurance that it is reimbursing indirect costs appropriately. GAO's recommendation directed the Secretary of Defense to assess the current level of audit coverage for monitoring DOD's indirect cost reimbursement for universities and determine what level is sufficient and whether to expand use of closeout and other audits to oversee compliance. ONR's

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<sup>21</sup>[GAO/AIMD-00-21.3.1](#).

<sup>22</sup>GAO, *University Research: Policies for the Reimbursement of Indirect Costs Need to Be Updated*, [GAO-10-937](#) (Washington, D.C.: Sept. 8, 2010), and Department of the Navy's Procurement Performance Management Assessment Program, *Final Report of the Indirect Cost Branch* (January 2014). Two additional GAO reports evaluated indirect costs, but the recommendations in those reports did not directly relate to the cognizant agencies. In one report, GAO found that indirect costs were growing at a faster rate than direct costs and identified factors that suggested indirect costs could increase more quickly in the future. Over the long term, this could lead to a reduction in the number of research grants that could be funded by NIH. See GAO, *Biomedical Research: NIH Should Assess the Impact of Growth in Indirect Costs on Its Mission*, [GAO-13-760](#) (Washington, D.C.: Sept. 24, 2013). In a second report, GAO found that programs at HHS collect administrative cost information but that differences in cost caps and definitions create challenges. The challenges include that comparisons across different types of grant programs should be made with caution and that any use of information on administrative costs needs to recognize these concerns, particularly when comparing programs with different types of objectives, projects, or services. See GAO, *Grants Management: Programs at HHS and HUD Collect Administrative Cost Information but Differences in Cost Caps and Definitions Create Challenges*, [GAO-15-118](#) (Washington, D.C.: Dec. 12, 2014).



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internal review office assessed the effectiveness of its Indirect Cost Branch's processes. While the overall rating was satisfactory, ONR's review office made one recommendation related to the performance standards and procurement processes and one recommendation to complete a staffing analysis. ONR implemented GAO's recommendation, but ONR's two internal review recommendations remain unimplemented.

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## The Three Cognizant Agencies Have Not Adequately Designed Controls over the Indirect Cost Rate-Setting Process

Under OMB guidance, the cognizant agencies are responsible for reviewing, negotiating, and approving indirect cost rate proposals on behalf of all other federal agencies. Consequently, NIH relies on the cognizant agencies to design adequate internal controls over their processes for negotiating indirect cost rates with research organizations that support the various types of NIH extramural research programs. Since NIH reimburses the indirect costs for NIH grants based on the negotiated rates, the controls that the cognizant agencies have designed are essential to help protect NIH funds against fraud, waste, and abuse in the indirect cost rate-setting process.

Based on our review of OMB guidance and the FAR, we identified controls that are key to preventing fraud, waste, and abuse in the indirect cost rate-setting process. These controls included steps for the negotiator to (1) determine the allowability, allocability, and reasonableness of proposed indirect costs and assess a research organization's methods for allocating such costs to federally funded research grants; (2) determine the composition of the distribution base; and (3) maintain sufficient documentation to support the negotiation and calculation of the indirect cost rates.<sup>23</sup>

Our review determined that while the three cognizant agencies had designed some controls for setting indirect cost rates, deficiencies in the design of these controls could result in the waste of federal resources. The deficiencies we identified are as follows:

- internal guidance at all three cognizant agencies was not updated to reflect current OMB guidance or changes in agency requirements,

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<sup>23</sup>Indirect costs claimed should be allocated individually to the related grants using an equitable distribution base, such as direct salaries and wages.

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such as documentation requirements or formalizing agency internal guidance;

- ONR's internal guidance lacked adequate review procedures over DCAA's advisory audit function when a DCAA audit was significantly delayed or resulted in a qualified opinion or when DCAA rescinded a previously issued opinion;<sup>24</sup>
- internal guidance at all three cognizant agencies lacked detailed instructions to supervisors on their review responsibilities over the indirect cost rate process;
- CAS and ONR had not developed internal guidance addressing differences in negotiating indirect cost rates with certain types of research organizations; and
- ONR and NIH-DFAS had not developed mechanisms to track key milestones for the indirect cost rate-setting process.

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### The Three Cognizant Agencies Did Not Update Internal Guidance for Changes in Regulations or Agency Requirements

*Standards for Internal Control in the Federal Government* states that management should develop internal guidance to help ensure that management directives are carried out and effective and efficient control activities are implemented to accomplish the agency's objectives. The standards also state that information should be recorded and communicated to staff within a time frame that enables the staff to carry out their responsibilities. We found that CAS and ONR had not updated their internal guidance to reflect a majority of the federal regulations issued as the Uniform Guidance, which became effective for grants awarded on or after December 26, 2014.<sup>25</sup> Working with the Council on Financial Assistance Reform, OMB consolidated its grants management circulars into the Uniform Guidance to streamline its guidance, promote consistency among grantees, and reduce administrative burden on

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<sup>24</sup>DCAA's Integrity and Quality Assurance Directorate quality review found that one of DCAA's audits was not performed in accordance with generally accepted government auditing standards. As a result, DCAA rescinded its audit opinion, meaning that its opinion is no longer valid.

<sup>25</sup>See Joint Interim Final Rule on Uniform Guidance, 79 Fed. Reg. 75871 (Dec. 19, 2014); 45 C.F.R. Part 75.

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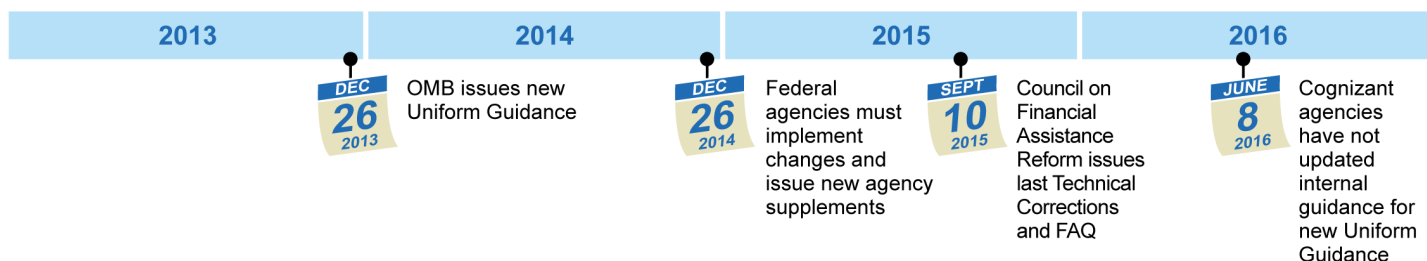
nonfederal entities.<sup>26</sup> New requirements include, for example, (1) the option for research organizations that currently have a negotiated rate to apply for a onetime extension of that rate for a period of up to 4 more years, (2) the option for research organizations that have never negotiated an indirect cost rate to use a de minimis indirect cost rate of 10 percent in lieu of negotiating an indirect cost rate with the cognizant agency, and (3) additional provisions for administrative costs to be counted as direct costs when allocable to a specific grant.

CAS officials stated that they issued a memo in July 2015 to the negotiators providing guidance covering one of the new Uniform Guidance requirements which allows for a one-time rate extension. However, they have not updated their internal guidance to reflect other new applicable requirements from the Uniform Guidance. According to officials at CAS and ONR, they were waiting for OMB to finalize the corresponding technical corrections and frequently asked questions and thus had not updated their internal guidance to reflect the changes in the Uniform Guidance as of June 2016. Further, CAS officials stated that in addition to waiting for technical corrections and frequently asked questions to be finalized, they were also waiting for HHS's Office of Grants Policy, Oversight and Evaluation to update the HHS Grants Policy Statement to reflect the changes in the Uniform Guidance. The Grants Policy Statement covers indirect cost policy for HHS grants and has not been updated since 2007. However, OMB officials stated that in meetings held in 2015 with the cognizant agencies, they requested that the cognizant agencies update their internal guidance to reflect the requirements of the Uniform Guidance. Figure 4 displays a timeline of key milestones during the implementation process of the Uniform Guidance.

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<sup>26</sup>The Council on Financial Assistance Reform is an interagency group of executive branch officials that coordinates financial assistance. Council activities include providing recommendations to OMB on policies and actions necessary to effectively deliver, oversee, and report on grants and cooperative agreements, as well as sharing with executive departments and agencies best practices and innovative ideas for transforming the delivery of this assistance.

**Figure 4: Office of Management and Budget's (OMB) Uniform Grants Reform Timeline**



Source: GAO analysis. | GAO-16-616

Note: OMB consolidated its grants management circulars into a single document, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), 2 C.F.R. pt. 200, 78 Fed. Reg. 78,590 (Dec. 26, 2013). In December 2014, OMB, along with federal grant-making agencies, issued a joint interim final rule implementing OMB's Uniform Guidance for new grants made on or after December 26, 2014. Joint Interim Final Rule on Uniform Guidance, 79 Fed. Reg. 75,871 (Dec. 19, 2014).

If they do not incorporate the new Uniform Guidance and its applicable regulatory requirements in their internal guidance, CAS and ONR risk not properly and consistently negotiating indirect cost rates—potentially leading to waste of government resources. CAS and ONR as well as research organizations stand to benefit from incorporating elements of the Uniform Guidance, such as ONR extending negotiated rates for up to 4 years and both allowing the use of a de minimis indirect cost rate of 10 percent. These two options reduce administrative burden to both parties, making the process more efficient and potentially reducing the waste of government resources. Also, while OMB guidance has allowed for charging salaries of administrative and clerical staff as a direct cost when appropriate and when certain conditions in the guidance are met, the Uniform Guidance has clarified the existing conditions and added new requirements describing when administrative costs can be charged as direct. For example, a new requirement states that costs must now be explicitly included in the budget or have the prior written approval of the federal awarding agency before they can be charged as direct costs. Without updated internal guidance to reflect those provisions, CAS and ONR may incorrectly negotiate this element as direct in cases where it does not meet the conditions outlined in federal guidance.

Further, we found that the cognizant agencies changed certain agency requirements, such as documentation requirements, when reviewing indirect cost rate proposals, but did not update their internal guidance to reflect such changes. For example:

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- Individual CAS field offices have established checklists, which provide procedural steps for the negotiators to follow and acknowledge completion of during their review of the research organization's indirect cost proposal. These checklists include steps such as reconciling the proposal to the audited financial statements, confirming that the rates are mathematically accurate, verifying the consistency of the distribution base with prior years, and confirming that unallowable expenses have been removed from the indirect costs claimed. We found that although CAS considers use of these checklists to be a control over the negotiation process, CAS has not updated its internal guidance to require negotiators to use a checklist or established a standardized checklist for all offices to use when negotiating indirect cost rates.

Our walk-throughs of CAS case files determined that field offices have developed their own checklists based on their interpretations of negotiation requirements found in CAS's internal guidance, and that these interpretations were not always consistent. Although these checklists contained similar review steps that the negotiators were to perform, we found differences in instructions for performing trend analyses and reviewing the indirect and direct costs claimed for allowable and unallowable costs, which are two key controls for minimizing the potential for fraud, waste, and abuse. Without a standardized checklist and agency-wide internal guidance instructing negotiators to use the standardized checklist during negotiation, management cannot reasonably assure that negotiators and supervisors are consistently and fairly negotiating indirect cost rates across all CAS field offices. According to CAS officials, they are in the process of finalizing review checklists for nonprofit organizations, which include research institutes and universities using the simplified proposal method and they expect the checklists to be implemented by the end of the fiscal year 2016.

- For NIH-DFAS, we were unable to determine when primary guidance was last updated because NIH-DFAS did not have formalized internal guidance with official dates and signatures. Its internal guidance lacked key characteristics—such as a policy number, purpose of the policy, effective date, and approving official—that are normally included in formal policies and procedures. NIH-DFAS officials acknowledged that their internal guidance did not contain the key characteristics of internal control. These officials stated that in June 2014, NIH's Administrative and Program Resources Office finalized the standard operating procedures for developing formalized internal guidance, and in October 2015, NIH-DFAS hired an outside contractor

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to formalize NIH-DFAS's internal guidance, which the officials anticipate will be completed by December 2016.

*Standards for Internal Control in the Federal Government* requires management to ensure that internal guidance and practices are integral to their operations.<sup>27</sup> We found that these deficiencies occurred because the cognizant agencies had not designed monitoring controls to ensure that internal guidance had been reviewed and updated to reflect changes in federal regulations and internal procedures. According to CAS officials, they have not designed monitoring controls to establish time frames for periodic review and assign related roles and responsibilities because (1) they update internal guidance as needed and (2) staff already know their roles and responsibilities. According to ONR officials, in May 2014, ONR issued a policy that requires staff to review and update their internal guidance annually. However, ONR's internal guidance was last reviewed and updated in January 2011, so the Uniform Guidance and its applicable regulatory requirements have not been incorporated. Without established controls for reviewing and updating internal guidance, including setting time frames and assigning roles and responsibilities, there is an increased risk that management will not hold staff accountable. The officials acknowledged that their current internal guidance needed to be updated to reflect changes to applicable federal guidance, regulations, or agency procedural changes, such as formalizing internal guidance. By not ensuring that their internal guidance reflects current regulations and procedures, the agencies increase their risk that their indirect cost rate-setting processes may not be properly and consistently carried out by the negotiators, which in turn increases the risk that rates negotiated will not be in accordance with federal guidance and regulations, thus increasing the potential for fraud, waste, and abuse of federal resources.

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<sup>27</sup> [GAO/AIMD-00-21.3.1](#).

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## ONR Did Not Design Adequate Review Procedures over the DCAA Advisory Audit Function

Unless other arrangements have been made, ONR negotiators request a DCAA advisory audit on all indirect cost rate proposals and rely on DCAA to issue an opinion on the adequacy and compliance of a research organization's indirect cost proposal prior to negotiating the indirect cost rate.<sup>28</sup> *Standards for Internal Control in the Federal Government* states that controls should be designed to help ensure that management's directives are carried out in order to accomplish the agency's control objectives.<sup>29</sup> While ONR's internal guidance requires taking into account DCAA results and comments, it does not specify review procedures to take when DCAA (1) is unable to complete its advisory audit within a reasonable time frame, (2) issues a qualified opinion, or (3) rescinds one of its previously issued audit opinions.

- To negotiate indirect cost rates timely, ONR's internal guidance requires its negotiators to provide DCAA with 45 days to complete its advisory audit report on behalf of ONR, unless arrangements have been made for a due date beyond 45 days (e.g., DCAA requests an extension). In a March 2015 report to Congress, DCAA officials stated that depending on the type of audit, the average elapsed time to complete an audit ranges from 95 to 1,006 days.<sup>30</sup> This high number is the result of a growing backlog of DCAA audits. In light of this backlog, ONR officials told us that their current procedure is to routinely give DCAA additional time to complete its initial audit report of a research organization's cost proposals. For example, in our walk-through of ONR case files, we found that ONR initially granted as many as 363 days—about a year—for DCAA to complete its audit, well beyond the 45 days period in ONR's internal guidance. In many cases, DCAA requested and received an extension to complete its audit of a research organization's cost proposal. Our walk-throughs identified instances in which ONR granted up to 139 days on top of what was initially given to DCAA to complete its audit. ONR's internal guidance does not reflect this change in procedure of routinely granting DCAA more than 45 days to prepare an advisory audit report,

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<sup>28</sup>Other arrangements include obtaining an audit from a non-DOD federal agency or use of the independent auditor's report, pursuant to OMB Circular No. A-133, otherwise known as a Single Audit.

<sup>29</sup>[GAO/AIMD-00-21.3.1](#).

<sup>30</sup>Defense Contract Audit Agency, *Report to Congress on FY 2014 Activities* (Fort Belvoir, Va.: Mar. 25, 2015).

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and it does not include parameters defining a reasonable period for the initial extensions beyond the 45 days. In addition, ONR's internal guidance does not provide procedures for negotiators to perform the necessary audit steps if DCAA does not complete its audit within the required time frames or a reasonable and accepted extended period. By not including in its internal guidance reasonable and acceptable audit completion time frames and procedures for ONR negotiators who perform audit steps when DCAA does not complete an audit, management cannot reasonably assure that indirect cost rate negotiations will be accurate and completed in a timely manner.<sup>31</sup>

- Furthermore, we found that although ONR's internal guidance requires negotiators to review DCAA's audit results, it does not contain procedures for the negotiators to perform supplemental review steps when DCAA's audit results contain qualified opinions or when DCAA rescinds one of its previously issued audit opinions. DCAA issues a qualified opinion when it is unable to perform detailed transaction testing on the incurred costs that are often used as the research organization's basis of estimate or when it does not have enough time to complete an audit. Our walk-throughs identified several instances of DCAA audit reports with qualified opinions (in which DCAA was not able to perform detailed transaction testing on incurred costs used as a basis of estimate) and one instance in which DCAA rescinded an audit opinion (when DCAA's Integrity and Quality Assurance Directorate review found that DCAA's audit was not performed in accordance with generally accepted government auditing standards). In those cases, ONR's guidance does not require the negotiator to perform any supplemental procedures to validate costs. Without internal guidance regarding supplemental procedures to be taken when DCAA issues a qualified opinion or rescinds one of its previously issued audit opinions, ONR cannot reasonably assure that its negotiators take consistent and appropriate steps, potentially increasing the risk that ONR's negotiated indirect cost rates could include reimbursement for unallowable, unallocable, and unreasonable costs.

We found that these deficiencies occurred because ONR had not designed sufficient review procedures for those situations when DCAA

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<sup>31</sup>According to ONR officials, if a proposal has not been received or has expired, the prior negotiated rate is used for reimbursement.



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(1) is unable to complete its advisory audit within a reasonable time frame, (2) issues a qualified opinion, or (3) rescinds one of its previously issued audit opinions. According to ONR officials, they believe that the procedures listed in their internal guidance will allow negotiators to validate costs prior to negotiating an indirect cost rate. However, by not including in its internal guidance reasonable and acceptable audit completion time frames and supplemental procedures to be taken to review cost proposals when DCAA cannot perform its audits in a timely manner, issues a qualified opinion, or rescinds one of its previously issued audit opinions, there is an increased risk that the negotiated indirect cost rate may not comply with applicable regulations, thus increasing the risk of fraud, waste, and abuse of federal resources.

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### Cognizant Agencies' Internal Guidance Lacks Detailed Procedures on Supervisory Review over the Indirect Cost Rate-Setting Process

Although the cognizant agencies' internal guidance describes broad procedures for supervisory review, such as requiring that the supervisors review and approve workpapers and applicable rates, these documents do not include detailed procedures for supervisors to monitor the negotiators' processes. Supervisory review is a type of internal control that provides reasonable assurance that the negotiator followed agency procedures for negotiating indirect cost rates and reduces the risk of inaccuracy and potential for waste of government resources. *Standards for Internal Control in the Federal Government* states that management should design internal controls to reasonably assure that ongoing monitoring occurs in the course of normal operations, which includes supervisory activities.<sup>32</sup>

We found that none of the three cognizant agencies' internal guidance include adequate detailed procedures that would allow supervisors to confirm that the negotiators have adequately performed and documented key controls identified in their internal guidance, such as performing cost trend analyses, executing reconciliations, analyzing adjustments for unallowable costs, verifying the accuracy of the distribution base, evaluating any future significant changes, and comparing the proposal to the disclosed cost accounting practices in the approved Disclosure Statement.<sup>33</sup> These controls are meant to provide reasonable assurance

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<sup>32</sup>[GAO/AIMD-00-21.3.1](#).

<sup>33</sup>A Disclosure Statement documents the research organization's cost accounting practices.

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that only allowable, allocable, and reasonable indirect costs have been proposed and that appropriate distribution bases were selected for allocating such costs to federally funded grants. However, the cognizant agencies' internal guidance did not specifically require supervisors to reasonably assure that negotiators perform those steps. In fact, as illustrated by the examples below, our walk-throughs of case files for the three cognizant agencies found a few instances in which supervisors approved rates that were set by negotiators who did not perform one or more of the controls required by the cognizant agencies' internal guidance.

- As a tool used to assess risk, CAS's internal guidance requires negotiators to complete a detailed trend analysis of nonprofit and long form research organizations' indirect cost rates and distribution bases for the last 3 years, including the proposal year.<sup>34</sup> According to CAS's internal guidance, a trend analysis provides the negotiator with an insight into the areas of the proposal needing a more detailed review. During our walk-through of CAS case files, we found that the negotiators did not always review the indirect cost rates and the distribution bases for the last 3 years, including the proposal year, when preparing a trend analysis. Additionally, CAS's internal guidance requires the negotiator to compare the accounting policies delineated in the research organization's Disclosure Statement to the indirect cost proposal to ensure consistency in the proposal's preparation. However, during our walk-through of CAS case files, we found that when the supervisors reviewed supporting documentation, they did not confirm that the negotiators had performed this comparison.
- OMB guidance states that each institution must describe the process it uses to ensure that federal funds are not used to subsidize industry and foreign government programs.<sup>35</sup> To meet this requirement, ONR's submission requirements checklist states that institutions must complete and submit several certifications and assurances, including a Statement of Assurance attesting that federal funds are not used to

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<sup>34</sup>Universities receiving over \$10 million in federal support are required to submit a "long form" facilities and administrative proposal. Under the long form method, the universities determine multiple rates, such as organization research, instruction, and other sponsored activities, and use a modified total direct cost as a distribution base.

<sup>35</sup>OMB Circular A-21, G, 1, A (incorporated in the Uniform Guidance at 2 C.F.R. pt. 200, app. III).

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subsidize industry and foreign government programs, which cites the OMB guidance. During our walkthrough of ONR's case files, we found one instance in which a university did not submit the required Statement of Assurance. The ONR supervisor did not confirm that all required certifications and assurances were included in the grantee's proposal during his review of the supporting documentation.

- At NIH-DFAS, we found one instance in which the negotiator had not reconciled the indirect cost information contained in the cost proposal to the audited financial statements, which is a control that helps verify that actual costs incurred were used as a basis in the proposal. The NIH-DFAS supervisor did not verify that the negotiator had reconciled the cost information.

Agency officials at the three cognizant agencies stated that they believe the procedures listed in their internal guidance are sufficient for supervisors to perform detailed review of the negotiators' work. However, without adequate documented supervisory review procedures, there is an increased risk that supervisors could approve rates that were not properly executed by the negotiators, as demonstrated in the examples above.

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## Two Cognizant Agencies' Internal Guidance Does Not Address Differences in Negotiating with All Types of Research Organizations

Internal guidance links an agency's objectives to its day-to-day operations, providing a framework for employees to clearly understand their roles and responsibilities when carrying out agency objectives. *Standards for Internal Controls in the Federal Government* states that management should develop internal guidance to help ensure that management directives are carried out, and that effective and efficient control activities are implemented to accomplish the agency's objectives. Standards also state that information should be recorded and communicated to staff within a time frame that enables the staff to carry out their responsibilities.<sup>36</sup> However, we found that CAS and ONR lack internal guidance for negotiating indirect cost rates with certain types of research organizations.

- CAS has not developed internal guidance that describes procedures required for negotiating indirect cost rates for hospitals, which represented \$511 million in indirect cost reimbursements in fiscal year 2015. Currently, CAS uses a policy that the Department of Health,

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<sup>36</sup> [GAO/AIMD-00-21.3.1](#).

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Education, and Welfare (now HHS) published in 1974 (policy OASC-3) for establishing indirect cost and patient care rates with hospitals for grants and contracts.<sup>37</sup> An HHS Office of Inspector General memorandum from 1993 recommended that the hospital cost principles be modernized and strengthened, as OASC-3 does not always provide clear guidance for determining what types of costs should be allowed and how costs should be allocated.<sup>38</sup> However, HHS has not updated OASC-3, and CAS continues to rely on this policy for negotiating indirect cost rates with hospitals. According to CAS officials, they have not created internal guidance for hospitals because CAS's national specialist—who was responsible for creating and updating internal guidance—resigned and they have not filled the vacancy. Without up-to-date and clear guidance for negotiating indirect cost rates for hospitals, there is an increased risk that negotiators will allow unallowable costs claimed by hospitals.

- Additionally, CAS does not have internal guidance related to the types of distribution bases allowed for small universities using the simplified method (also known as the short form) for preparing facilities and administrative cost rate proposals.<sup>39</sup> According to CAS officials, they consider the internal guidance for the long form to be sufficient and have instructed negotiators to use the long form best practice manual for all university proposals. However, under the simplified method, universities are given greater flexibility in choosing between two different types of distribution bases, whereas the long form proposal requires universities to submit proposals using only a modified total direct cost base. Further, OMB guidance restricts the use of the simplified method when it produces results that appear inequitable to

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<sup>37</sup>Department of Health, Education, and Welfare, Office of the Secretary, *Cost Principles and Procedures for Establishing Indirect Cost and Patient Care Rates for Grants and Contracts with the Department of Health, Education, and Welfare*, OASC-3 (1974).

<sup>38</sup>Department of Health and Human Services, Office of Inspector General, *Department of Health and Human Services Hospital Cost Principles for Federally Sponsored Research Activities*, memorandum from Bryan B. Mitchell, Principal Deputy Inspector General (May 17, 1993).

<sup>39</sup>For universities receiving less than \$10 million in federal support annually, OMB Circular No. A-21, (H) (OMB circular provisions incorporated in the Uniform Guidance at 2 C.F.R. pt. 200, app. III, (D)) permits using the “simplified method” for preparing the facilities and administrative cost rate proposal. Under the simplified method, the university determines one rate applicable to all grants and may elect to use salaries and wages or modified total direct costs as a distribution base.

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the federal government. Therefore, without internal guidance for proposals using the simplified method, there is an increased risk that indirect costs will not be fairly distributed to grants. For example, a distribution base that is understated will result in an inflated indirect cost rate.

- Although OMB has issued separate guidance specific to universities and nonprofits, ONR's only internal guidance on negotiating indirect cost rates applies to both types of research organizations and does not address certain key differences in OMB guidance applicable to each type of research organization. Specifically, the distribution bases allowed for calculating indirect cost rates differ for universities (short and long form) and for nonprofits.<sup>40</sup> For example, under the OMB guidance, universities may use only two different types of distribution bases, whereas nonprofit organizations are given greater flexibility as they are instructed to select a distribution base best suited for assigning the indirect costs to the project. However, ONR's internal guidance applicable to both types of research organizations does not distinguish between the different provisions of OMB guidance. After we identified this issue, ONR officials acknowledged that the internal guidance needs to be updated to distinguish procedures between the different provisions of OMB guidance and reported that they are in the process of making the necessary revisions. ONR officials stated that they anticipate that the draft internal guidance will be updated and ready for final management review in June 2016. To reduce the risk that the negotiators could use an inappropriate distribution base, resulting in a rate calculation that is not in compliance with federal guidance, it is important that ONR implement and issue the internal guidance timely. However, ONR has not established a time frame for issuance of the final internal guidance.

Without up-to-date internal guidance for all types of research organizations, the cognizant agencies cannot clearly delineate negotiators' roles and responsibilities during the indirect cost rate negotiation process. Further, by not developing adequate internal guidance for all types of research organizations, cognizant agencies are at an increased risk that the negotiated indirect cost rates could include

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<sup>40</sup>Similar to OMB guidance, the Uniform Guidance also differentiates the cost principles for calculating indirect cost rates for universities (short and long form) and nonprofits.

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reimbursement for unallowable, unallocable, and unreasonable costs, potentially resulting in wasted federal resources.

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## Two of the Cognizant Agencies Do Not Have Mechanisms to Track Milestones for Indirect Cost Rate Data

In order for each cognizant agency to achieve its objectives and comply with federal guidance and regulations, it is essential for management to have the capability to generate and review reports on indirect cost rate data. *Standards for Internal Control in the Federal Government* states that relevant information should be recorded and communicated with management and others within the entity who need it. This information should be in an understandable format, and provided within a time frame that enables employees to carry out their internal control responsibilities.

We found that only one of the three cognizant agencies generates reports for management to view data associated with all phases of the indirect cost rate-setting process. Specifically, CAS's system generates reports that management and the negotiators can use to determine when proposals are due; when signed rate agreements, proposals, or extensions to proposals are overdue; and other rate agreement information. In contrast, NIH-DFAS and ONR officials reported that they do not have systems capable of generating these types of reports. ONR officials stated that they do maintain a spreadsheet in Microsoft Excel for universities and nonprofit organizations, which tracks information such as whether rate agreements have been signed and whether a proposal is awaiting an audit or management review. However, the Excel spreadsheet does not identify when rate proposals are past due, when the DCAA advisory audit reports are due, or the dates when the negotiators followed up for past due proposals or DCAA advisory audit reports.

Without the ability to produce reports enabling the cognizant agencies to track all phases of the indirect cost rate-setting process, cognizant agencies cannot reasonably assure compliance with federal guidance and regulations and accomplishment of agency objectives. For example, in accordance with federal guidance and regulation, a research organization must submit its indirect cost rate proposal to the cognizant agency within 6 months after the close of the fiscal year.<sup>41</sup> However, we

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<sup>41</sup>OMB Circular No. A-21, *Cost Principles for Education Institutions* (incorporated in 2 C.F.R. pt. 200) (2014), and FAR pt. 42.705-1.

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found one instance in which an ONR research organization had not submitted its final indirect cost rate proposal, which was due in December 2014. As of January 2016 (13 months overdue), the organization had still not provided the final indirect cost rate proposal to ONR. In June 2016, upon further inquiry by us, ONR officials stated that the research organization did not submit a rate proposal because it had gone out of business.

When indirect cost rate proposals are not submitted in a timely manner, the cognizant agencies are also unable to close out grants and can incur additional costs to the government, leading to potential waste.<sup>42</sup> Effective management reporting tools are therefore critical for enabling management to make better decisions and meet agency objectives and goals for effective and efficient use of resources.

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## Conclusions

Grants are an important form of federal financial assistance that NIH uses to carry out its mission as the nation's leading sponsor of biomedical research. NIH reimbursed \$6.3 billion in indirect costs in fiscal year 2015, representing over a quarter of the total amount that NIH awarded through grants and cooperative agreements. Because the designated cognizant agencies negotiate the indirect cost rates on behalf of all federal agencies, including NIH, it is critical that the cognizant agencies adequately design internal controls to reasonably assure that their indirect cost rate negotiation process run efficiently and effectively and reduce the risk that federal resources may be subject to fraud, waste, and abuse.

Although the three cognizant agencies had established controls for the indirect cost rate-setting process, we identified deficiencies in the design of some of these controls. Until the three cognizant agencies update their internal guidance to reflect current regulations and agency procedures and include instructions to supervisors about their review responsibilities, there is an increased risk that taxpayer funds will not be adequately

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<sup>42</sup>GAO, *Grants Management: Actions Needed to Address Persistent Grant Closeout Timeliness and Undisbursed Balance Issues*, [GAO-16-362](#) (Washington, D.C.: Apr. 14, 2016), found approximately \$994 million in funding remained in expired grant accounts in HHS's Payment Management System, at the end of fiscal year 2015. Agency officials told GAO that closeout delays can occur for a number of reasons, including grantee failure to submit final financial and performance reports and agency failure to review, process, and reconcile grantees' final reporting in a timely manner.

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protected. In addition, ONR lacks needed guidance to address delayed audits, audits that have qualified opinions, and audits where previously issued opinions are rescinded. Also, both CAS and ONR lack internal guidance to address differences in negotiating for all research organization types. Finally, ONR and NIH-DFAS are missing mechanisms to track key milestones for indirect cost rate-setting information. If these deficiencies are not addressed, there is an increased risk that the cognizant agencies may not properly and consistently negotiate indirect cost rates and that the rates negotiated may not comply with applicable federal regulations. Thus, there is an increased risk that the indirect cost rates used to reimburse NIH research organizations will include costs that are not allowable, allocable, and reasonable and may result in wasted federal resources.

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## Recommendations for Executive Action

To improve the design of internal controls over the indirect cost rate-setting process, we recommend that the Director of CAS take the following four actions:

- establish internal controls to periodically review and update internal guidance when changes are made to applicable regulations to reasonably assure the guidance reflects current requirements;
- develop a standardized checklist and document procedures in its internal guidance instructing negotiators to use the checklist during negotiation;
- develop detailed internal guidance for the completion and documentation of supervisory review of the indirect cost rate negotiation process to provide reasonable assurance that key control activities have been performed by the negotiators; and
- develop internal guidance for negotiating indirect cost rates with all types of research organizations, including hospitals, as well as universities using the simplified method.

As NIH-DFAS begins formalizing its internal guidance, we recommend that the Director of NIH-DFAS take the following three actions:

- update internal guidance to include key characteristics, such as policy number, purpose of the policy, effective date, and approving official, that are normally included in formal policy and procedures;
- develop detailed procedures for the completion and documentation of supervisory review of the indirect cost rate negotiation process to



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provide reasonable assurance that key control activities have been performed by the negotiator; and

- establish a mechanism for tracking key milestones in the indirect cost rate-setting process, such as when indirect cost rate proposals are due.

To improve the design of internal controls over the indirect cost rate-setting process, we recommend that the Director of ONR take the following five actions:

- implement the May 2014 policy requiring an annual review of guidance so that internal guidance is updated when changes are made to applicable regulations and procedures to reasonably assure that the guidance reflects current requirements;
- include in its internal guidance acceptable DCAA audit completion time frames and identify supplemental procedures to be performed by negotiators if DCAA cannot perform its audits timely or if DCAA issues a qualified opinion or rescinds one of its previously issued audit opinions, to reasonably assure that the indirect cost rate proposal has been adequately reviewed and the negotiated rate complies with applicable regulations;
- develop detailed procedures for the completion and documentation of supervisory review of the indirect cost rate negotiation process to provide reasonable assurance that required certifications and assurances are obtained and follow-up with the research organization is documented;
- finalize and issue internal guidance for negotiating indirect cost rates with universities and nonprofit organizations, including establishing a time frame for issuance of the internal guidance, to help ensure that the procedures are implemented in a timely manner; and
- update ONR's existing process for tracking key milestones in the indirect cost rate-setting process to include information such as when indirect cost rate proposals are overdue and when DCAA's audit reports are due.

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## Agency Comments and Our Evaluation

We provided a draft of this report to HHS, DOD, and OMB for their review and comment. In written comments, reprinted in appendixes II and III, HHS concurred with our recommendations and provided information on actions planned or under way to address them and DOD concurred with four of our five recommendations and partially concurred with one. Our report did not include recommendations to OMB, and the OMB Liaison to

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GAO responded in an e-mail that OMB did not have any formal comments on the report. HHS, DOD, and OMB each provided technical comments, which we incorporated as appropriate.

In response to the recommendations directed toward CAS, HHS said that by December 31, 2016, CAS will establish a written procedure requiring periodic reviews and updates of internal guidance whenever changes are made to applicable regulations, update and complete standardized checklists for each type of indirect cost review and instruct the staff to use the checklists, establish and implement standardized procedures for supervisory review of workpapers and rate agreements, and update internal guidance for negotiating indirect cost rates with universities using the simplified method. HHS also stated that CAS would develop internal guidance for negotiating with hospitals as soon as possible.

In response to the recommendations directed toward NIH-DFAS, HHS said that by December 31, 2016, NIH-DFAS will update internal guidance to include key characteristics that are normally included in formal policies and procedures and develop detailed procedures for completing and documenting supervisory review of indirect cost rate negotiations. HHS also stated that NIH-DFAS will establish a mechanism for tracking key milestones in the indirect cost rate-setting process. HHS said that NIH-DFAS is currently looking into the feasibility of incorporating key milestones into two major initiatives, and if it is unable to do so, NIH-DFAS will develop an alternative tracking system by March 31, 2017.

HHS's CAS and NIH-DFAS actions, if implemented effectively, would address our recommendations.

In response to the recommendations directed toward ONR, DOD concurred with four of our five recommendations. For the four recommendations that it concurred with, DOD stated that ONR will comply with its requirement for an annual review of its internal guidance and update its internal guidance to provide more realistic DCAA audit report dates, including general procedures for negotiators to perform in the case of untimely audits and qualified or rescinded opinions. Additionally, DOD said that ONR will update its internal guidance for negotiating indirect cost rates with universities and nonprofit organizations by December 31, 2016, and will update its existing processes for tracking key milestones to include information such as due dates for rate proposals and DCAA audit reports. If implemented effectively, these actions would address the four recommendations.

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In response to the recommendation to develop supervisory review procedures, DOD partially concurred. First, DOD disagreed that a certification declaring that federal funds were not used to subsidize industry and foreign government programs is required. DOD cited 2 C.F.R. pt. 200, appendix. III (formerly located in OMB Circular A-21, 2 C.F.R. pt. 220, app. A prior to December 2014), which states that each institution must describe the process it uses to ensure that federal funds are not used to subsidize industry and foreign government programs, and stated that a certification is only one way to accomplish this. While we agree there may be different ways to meet this requirement, ONR's submission requirements checklist states that institutions must complete and submit several certifications and assurances, including a Statement of Assurance attesting that federal funds are not used to subsidize industry and foreign government programs. The Statement of Assurance specifically cites the C.F.R. provision. Consequently, ONR has chosen to use the Statement of Assurance to meet the C.F.R. provision, and we found no other documentation that would otherwise meet the requirement. We revised the body of the report to avoid suggesting that OMB requires a certification and to specifically cite the Statement of Assurance, and similarly revised the recommendation for clarification, but our overall finding stands. Therefore, we continue to believe that ONR needs to develop supervisory review procedures to reasonably assure that these Statements of Assurance are obtained.

Further, DOD did not agree that ONR lacks procedures to ensure supervisors confirm that negotiators adequately performed and documented key controls. DOD noted that both the primary and secondary supervisors are required to review and approve the Business Clearance Memorandum, which records steps performed by the negotiator. While we agree that the Business Clearance Memorandum documents steps performed by the negotiator, these steps are documented at a high level and do not include detailed procedures for supervisors to follow to reasonably assure that the negotiator has performed and documented all key control activities, such as obtaining all required certifications and assurances. DOD agreed in its response that ONR's Business Clearance Memorandum can be improved and stated that ONR will update it to require the negotiator to cross-reference the review steps to the proposal to facilitate the supervisor's review process. However, it is not clear whether the planned Business Clearance Memorandum revisions will include providing detailed procedures for supervisory review as we recommended.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 21 days from the report date. At that time, we will send copies to the Secretaries of Health and Human Services and Defense and the Director of the Office of Management and Budget. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-2623 or [davisbh@gao.gov](mailto:davisbh@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who make key contributions to this report are listed in appendix IV.

A handwritten signature in cursive script that reads "Beryl H. Davis".

Beryl H. Davis  
Director  
Financial Management and Assurance

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# Appendix I: Objective, Scope, and Methodology





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The objective of this review was to determine the extent to which the cognizant agencies have designed internal controls to mitigate fraud, waste, and abuse in the indirect cost rate-setting process for National Institutes of Health (NIH) grants. Generally, the agency that provides the most funding to a particular research organization has rate-setting cognizance for that organization. However, the Office of Management and Budget (OMB) and the Department of Health and Human Services (HHS) have designated three primary cognizant agencies to negotiate indirect cost rates for grants funded by NIH: (1) HHS's Cost Allocation Services (CAS), (2) NIH's Division of Financial Advisory Services (NIH-DFAS), and (3) the Department of Defense's (DOD) Office of Naval Research (ONR). Specifically, OMB guidance (OMB Circular No. A-21, *Cost Principles for Educational Institutions*, whose provisions have been incorporated in OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance)) specifically assigns responsibility for negotiating rates for universities to either HHS's CAS or DOD's ONR. OMB guidance (OMB Circular No. A-122, *Cost Principles for Non-Profit Organizations*, whose provisions have been incorporated in the Uniform Guidance) assigns responsibility for negotiating rates for research institutes to the cognizant agency with the largest dollar value of grants with an organization, unless different arrangements are agreed to by the agencies concerned. HHS Acquisition Regulations Part 342, *Contract Administration*, assigns the responsibility for negotiating indirect cost rates for hospitals to HHS's CAS. Furthermore, the Secretary of HHS authorized NIH-DFAS to have HHS-wide cognizance of the indirect cost rate negotiation function with for-profit grantees, which are not covered by the OMB circulars on grant cost principles. Therefore, we focused our review on the three primary cognizant agencies: (1) CAS, (2) NIH-DFAS, and (3) ONR.

To determine the extent to which the three primary cognizant agencies have adequately designed internal controls to mitigate the potential for fraud, waste, and abuse in the indirect cost rate-setting process, we interviewed staff from each of the three cognizant agencies, NIH, and OMB. We also reviewed OMB's guidance and federal regulations (in place during 2014) related to the negotiation of indirect cost rates for the four types of research organizations that received the majority of NIH funding in fiscal year 2014: (1) universities, (2) research institutes, (3) hospitals, and (4) domestic for-profit organizations. Further, we confirmed with the cognizant agencies that the OMB guidance and federal regulations that we reviewed were applicable and were used by them during the indirect cost rate-setting process. See figure 5 for a summary of the cognizant agencies designated to negotiate indirect cost

rates for the four types of research organizations reviewed and corresponding federal guidance and regulations.

Figure 5: Federal Guidance or Regulations Cognizant Agencies Used to Set Indirect Cost Rates

Research organization reviewed and applicable fiscal year 2014 federal guidance or regulation				
Cognizant agency	 Universities	 Research institutes	 Hospitals	 Domestic for-profit organizations
Department of Health and Human Services - Cost Allocation Services	Office of Management and Budget (OMB) Circular No. A-21	OMB Circular No. A-122	Appendix E of 45 Code of Federal Regulations, Part 74	
National Institutes of Health - Division of Financial Advisory Services				Federal Acquisition Regulation (FAR) Part 31
Department of Defense - Office of Naval Research	OMB Circular No. A-21	OMB Circular No. A-122		

Source: GAO analysis of OMB guidance and FAR regulations. | GAO-16-616

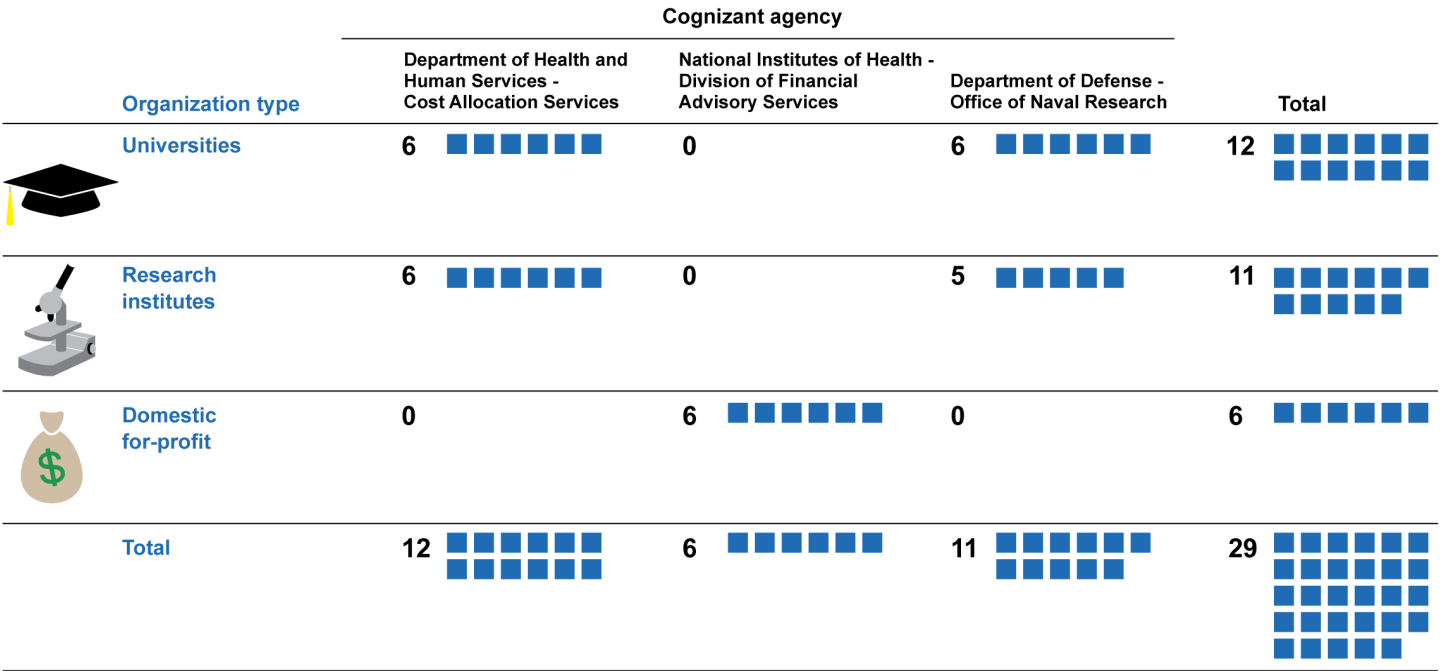
Note: OMB consolidated its grants management circulars into a single document, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), 2 C.F.R. pt. 200, 78 Fed. Reg. 78,590 (Dec. 26, 2013). In December 2014, OMB, along with federal grant-making agencies, issued a joint interim final rule implementing OMB’s Uniform Guidance for new grants made on or after December 26, 2014. Joint Interim Final Rule on Uniform Guidance, 79 Fed. Reg. 75,871 (Dec. 19, 2014).

We determined the design of controls to identify the risks for fraud, waste, and abuse in the indirect cost rate-setting process. Using OMB guidance and federal regulations described above, we identified the key control activities needed by the cognizant agencies to mitigate those risks. We compared the control activities from the federal guidance and regulations to each cognizant agency’s respective internal control guidance in place during 2014, and determined if the cognizant agency’s internal control guidance was consistent with control activities identified by the federal guidance and regulations for mitigating the risk of fraud, waste, and abuse. Additionally, we evaluated whether the cognizant agencies’ internal guidance included key characteristics—such as policy number, purpose of the policy, effective date, and approving official—that are normally included in formal policies and procedures. We identified these key characteristics by interviewing HHS management in the Division of Grants and the Office of Grants and Acquisition Policy and Accountability, and reviewing examples of published guidance from HHS, NIH, and OMB websites. We reviewed the cognizant agencies’ policies and procedures

for these key characteristics and determined, through the inclusion of the characteristics, whether the policies would be considered formal.

We obtained NIH grant funding data for extramural research for fiscal year 2014 and performed procedures to determine whether the data were reliable enough for our purposes. Specifically, we interviewed knowledgeable agency officials about the quality control procedures the agency had in place when collecting and creating the data and tested the data for unusual items. Based on the results of these procedures, we determined that the data were reliable enough for our purposes. To further our understanding of the design of internal controls at the three cognizant agencies, we selected a nongeneralizable sample of negotiation case files and performed walk-throughs for each type of research organization selected for our review. To select the nongeneralizable sample, we took the total population of grants funded for fiscal year 2014 and stratified the population by funding dollars (i.e., high, medium, and low) for each type of research organization and each cognizant agency. Finally, we selected six case files from each of the populations (see fig. 6).

Figure 6: Nongeneralizable Sample Selected for Each Cognizant Agency



 Represents one case file

Source: GAO analysis of population of National Institutes of Health-funded research organizations. | GAO-16-616

Note: We selected six case files from each of the populations except for the Office of Naval Research (ONR), as ONR negotiated rates for only five National Institutes of Health-funded research institutes in fiscal year 2014.

We excluded hospitals from our walk-through sample because CAS had not established internal guidance for hospitals. We performed walk-throughs of the selected research organizations’ negotiation files to confirm our understanding of each cognizant agency’s internal control over the indirect cost rate negotiation process. In our walk-throughs, we reviewed documentation contained in the negotiation files, such as indirect cost rate proposals, rate agreements, trend analysis, and audited financial statements. We did not test the operational effectiveness of the cognizant agencies’ internal control guidance and therefore cannot draw conclusions about the effectiveness of internal controls over the cognizant agencies’ indirect cost rate-setting processes.

We conducted this performance audit from March 2015 to September 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to



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obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

# Appendix II: Comments from the Department of Health and Human Services



DEPARTMENT OF HEALTH & HUMAN SERVICES

OFFICE OF THE SECRETARY

Assistant Secretary for Legislation  
Washington, DC 20201

AUG 03 2016

Beryl Davis  
Director, Financial Management Assurance  
U.S. Government Accountability Office  
441 G Street NW  
Washington, DC 20548

Dear Ms. Davis:

Attached are comments on the U.S. Government Accountability Office's (GAO) report entitled, *"NIH Biomedical Research: Agencies Involved in Indirect Cost Rate Setting Process Need to Improve Controls"* (GAO-16-616).

The Department appreciates the opportunity to review this report prior to publication.

Sincerely,

A handwritten signature in black ink that reads "Jim R. Esquea".

Jim R. Esquea  
Assistant Secretary for Legislation

Attachment

**GENERAL COMMENTS OF THE DEPARTMENT OF HEALTH AND HUMAN  
SERVICES (HHS) ON THE GOVERNMENT ACCOUNTABILITY OFFICE'S DRAFT  
REPORT ENTITLED: NIH BIOMEDICAL RESEARCH: AGENCIES INVOLVED IN  
INDIRECT COST RATE SETTING PROCESS NEED TO IMPROVE CONTROLS  
(GAO-16-616)**

The U.S. Department of Health and Human Services (HHS) appreciates the opportunity from the Government Accountability Office (GAO) to review and comment on this draft report.

**GAO Recommendation**

The Director of HHS's Cost Allocation Services (CAS) should establish internal controls to periodically review and update internal guidance when changes are made to applicable regulations to reasonably assure the guidance reflects current requirements.

**HHS Response**

HHS concurs. CAS will establish a written procedure requiring periodic reviews and updates of internal guidance whenever changes are made to applicable regulations. This action will be completed by December 31, 2016. The internal guidance will reflect new federal regulations, grant policy, and other policies having an impact on the review and negotiation of indirect cost rates applicable to colleges and universities, non-profit organizations (including research institutes), and hospitals.

**GAO Recommendation**

The Director of CAS should develop a standardized checklist and document procedures in its internal guidance instructing negotiators to use the checklist during negotiation.

**HHS Response**

HHS concurs. Due to differing requirements for different types of non-federal entities, CAS will update and complete standardized checklists for each type of review. Checklists for the following types of reviews: (1) non-profit organizations' indirect cost rates (including research institutes); (2) fringe benefit rates reviews, and (3) reviews of F&A rates for universities using the simplified method will be completed by December 31, 2016 and the Directors will instruct the staff in writing to use the checklists.

**GAO Recommendation**

The Director of CAS should develop detailed internal guidance for the completion and documentation of supervisory review of the indirect cost rate negotiation process to provide reasonable assurance that key control activities have been performed by the negotiators.

**HHS Response**

HHS concurs. CAS will establish a document outlining standardized review procedures for supervisory review of workpapers and rate agreements. CAS will develop and implement a supervisory review checklist that will outline steps to be performed by the supervisors for the review and approval of workpapers and rate agreements. The CAS Directors will issue a formal document and checklist to all supervisors by December 31, 2016.

**GAO Recommendation**

The Director of CAS should Develop internal guidance for negotiating indirect cost rates with all types of research organizations, including hospitals, as well as universities using the simplified method.

**HHS Response**

HHS concurs. CAS will update internal guidance for negotiating indirect cost rates with universities using the simplified method by December 31, 2016. This guidance will include an example under the two types of direct costs bases, a salary and wage base and a modified total direct cost base. CAS will develop internal guidance for reviews of hospitals as soon as possible.

**GAO Recommendation**

The National Institute of Health's (NIH) Division of Financial Advisory Services (DFAS) should update internal guidance to include key characteristics, such as policy number, purpose of the policy, effective date, and approving official that are normally included in formal policy and procedures.

**HHS Response**

HHS concurs. DFAS will update internal guidance to include key characteristics that are normally included in formal policy and procedures. DFAS is in the process of developing internal guidance that addresses all of these key characteristics. DFAS plans to finalize these procedures by December 31, 2016.

**GAO Recommendation**

DFAS should develop detailed procedures for the completion and documentation of supervisory review of the indirect cost rate negotiation process to provide reasonable assurance that key control activities have been performed by the negotiator.

**HHS Response**

HHS concurs. DFAS will develop detailed procedures for the completion and documentation of supervisory review of the indirect cost rate negotiation process. DFAS is developing internal guidance that addresses the supervisory review of the indirect cost negotiation process. DFAS plans to finalize these procedures by December 31, 2016.

**GAO Recommendation**

DFAS should establish a mechanism for tracking key milestones in the indirect cost rate-setting process, such as when indirect cost proposals are due.

**HHS Response**

HHS concurs. DFAS will establish a mechanism for tracking key milestones in the indirect cost rate-setting process. DFAS has major initiatives currently underway that include moving from paper submissions to electronic submissions of indirect cost proposals and developing a replacement to its Commercial Rate Agreement Distribution Services (C-RADS) website. DFAS is looking into the feasibility of incorporating key milestones into these two major initiatives. If unable to incorporate tracking of key milestones into these initiatives, DFAS will develop an alternative tracking system with the goal of having it in place by March 31, 2017.

# Appendix III: Comments from the Department of Defense



RESEARCH  
AND ENGINEERING

## ASSISTANT SECRETARY OF DEFENSE

3030 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3030

AUG 18 2016

Ms. Beryl H. Davis  
Director, Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, NW  
Washington DC 20548

Dear Ms. Davis,

This is the Department of Defense (DoD) response to the GAO Draft Report GAO-16-616, "NIH BIOMEDICAL RESEARCH: Agencies Involved in Indirect Cost Rate Setting Process Need to Improve Controls," dated July 5, 2016 (GAO Code 197246).

The Department is providing official written comments for inclusion in the report.

Sincerely,

A handwritten signature in blue ink, appearing to read "S. Welby", is positioned above the printed name of the Assistant Secretary of Defense.

Stephen P. Welby

Enclosure:  
As stated

**DoD comments to GAO's recommendations to DoD in draft report**

To improve the design of internal controls over the indirect cost rate-setting process, the GAO recommends that the Director of ONR take the following five actions:

- **GAO Recommendation #1:** Implement the May 2014 policy requiring an annual review of guidance so that internal guidance is updated when changes are made to applicable regulations and procedures to reasonably assure the guidance reflects current requirements;

**DoD RESPONSE:** Concur. ONR will comply with its May 2014 policy requirement requiring annual review of ONR Instruction 7580.1C ONR Policy on the Negotiation of Indirect Costs

- **GAO Recommendation #2:** Include in its internal guidance acceptable DCAA audit completion timeframes and identify supplemental procedures to be performed by negotiators if DCAA cannot perform its audits timely or if DCAA issues a qualified opinion or rescinds one of its previously issued audit opinions, to reasonably assure that the indirect cost rate proposal has been adequately reviewed and the negotiated rate complies with applicable regulations;

**DoD RESPONSE:** Concur. ONR's internal guidance will be updated to provide more realistic audit report due dates and will include general procedures to be performed by negotiators in the case of untimely audits, qualified opinions, or rescinded opinions.

- **GAO Recommendation #3:** Develop detailed procedures for the completion and documentation of supervisory review of the indirect cost rate negotiation process to provide reasonable assurance that required certifications are obtained and follow-up with the research organization is documented;

**DoD RESPONSE:** Partially concur. This recommendation is based on a walkthrough of ONR case files about which GAO states:

*"At ONR, we found one instance in which a university did not submit and sign an OMB required certification declaring federal funds were not used to subsidize industry and foreign government programs. The ONR supervisor did not confirm all required certifications were included in the grantee's proposal during his review of the supporting documentation."*

DoD does not agree that a certification is required. 2 CFR 200 requires *"At the time a F&A cost proposal is submitted to a cognizant Federal agency, each institution must describe the process it uses to ensure that Federal funds are not used to subsidize industry and foreign government programs."*<sup>1</sup>. A certification may be one way to accomplish this, but it is an overstatement to say one is required.

<sup>1</sup> 2 CFR 200 Appendix III paragraph C.1.(3) and prior to December 2014 see 2 CFR 220 Appendix A paragraph G.1.a.(3)

ONR does not agree that its internal guidance lacks procedures to ensure supervisors confirm that negotiators adequately performed and document key controls. ONR business clearance memorandums for negotiation of university and nonprofit rates both include a section for Pre-Negotiation Compliances and Information (Section II), which requires the negotiator to affirm that the institution's proposal complies with 2 CFR 200, Appendix III paragraph C.1.(3). The affirmation typically consists of a general reference to the proposal. ONR policy currently requires both the primary and secondary supervisor to review and approved all business clearance memorandums for negotiation of indirect rates. Therefore, ONR supervisors are already using a detailed format embedded in its business clearance memorandums to ensure negotiators have adequately performed and documented key controls.

DoD does agree that the ONR business clearance memorandum templates can be improved and therefore, ONR will update Section II of its business clearance memorandums for negotiation of rates to require a specific cross reference to the proposal which will facilitate the supervisor's review process for ensuring that the proposal has met this requirement.

- **GAO Recommendation #4:** Finalize and issue internal guidance for negotiating indirect cost rates with universities and nonprofit organizations, including establishing a timeframe for issuance of the internal guidance to help ensure that the procedures are implemented in a timely manner; and

**DoD RESPONSE:** Concur. ONR is currently updating its internal guidance. Initial estimates to finalize revised guidance was 30 June 2016, however workload priorities in June 2016 necessitates a revised date of 31 October 2016 to finalize drafting and 31 December 2016 for issuance.

- **GAO Recommendation #5:** Update ONR's existing process for tracking key milestones in the indirect cost rate-setting process, to include information such as when indirect cost rate proposals are overdue and when DCAA's audit reports are due.

**DoD RESPONSE:** Concur. ONR is updating its existing processes to include information related to due dates for rate proposals and DCAA audit reports.

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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

Beryl H. Davis, (202) 512-2623 or [davisbh@gao.gov](mailto:davisbh@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Kim McGatlin (Assistant Director), Rathi Bose, Francine DelVecchio, Wilfred Holloway, Alec Hulbert, Diana Lee, Sophie Geyer, Jason Kelly, Kevin McAloon, and Kailey Seibert made key contributions to this report.



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