Advisory Controls for A-87 Compliance

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ADVISORY CONTROLS FOR A-87 COMPLIANCE

INTRODUCTION

OMB Circular A-87 establishes principles and standards for determining costs for Federal awards carried out through grants, cost reimbursement contracts, and other agreements with State and local governments and federally-recognized Indian tribal governments (governmental units). In addition to providing a uniform approach for determining costs, the principles and standards set out in the Circular are designed to promote effective program delivery, efficiency, and better relationships between governmental units and the Federal Government.

The purpose of this document is to assist agencies in ensuring compliance with A-87 requirements in creating and maintaining Statewide Central Service Cost Allocation Plans, Indirect Cost Rates. This document is intended to address some of the important issues and subject matters that can create challenges for agencies while navigating the A-87 process. In addition, many best practices are presented in this document that may be able to assist agencies in ensuring compliance with A-87.

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I. OVERVIEW

A key component of ensuring compliance with CFR 2, Part 225 Cost Principles for State, Local, and Indian Tribal Governments (previously known as Circular A-87) is to establish and document that federal programs are paying their fair share of the State and Local Government's operating costs in carrying out federal awards. OMB Circular A-87 defines acceptable methods of allocating costs for administrative overhead costs administration and indirect costs. According to the A-87, in order for costs to be allowable, costs must be reasonable, necessary and allocable to federal programs and be consistent with policy and rules applicable to the federal awards and other activities of State and Local governments.

This will allow agencies to more accurately allocate cost and will also eliminate many issues during the creation of contractual/intergovernmental agreements as the cost may be assessed using the indirect cost rate. In order to re-coup overhead (indirect) costs an agency must have a documented indirect cost rate proposal.

A statewide cost allocation plan (SWCAP) is a mechanism by which a state identifies, summarizes, and allocated indirect costs in a logical and systematic manner. A SWCAP is necessary for a state agency to obtain reimbursement from the federal government for the costs of central support services.

Indirect cost rates are a method for fairly and conveniently, while still ensuring sound administrative principle, determining proportions of departmental administration costs each individual program is responsible for. The rate is representative of the ratio between the total indirect costs and benefiting direct costs. The complications come in when excluding and/or reclassifying unallowable costs, and extraordinary or distorting expenditures. When calculating this rate, the indirect costs are the numerator of the equation and the direct costs are the denominator; care should be taken to ensure the indirect costs bear a reasonable relationship to the direct costs.

$$\boxed{\frac{\text{Indirect Costs}}{\text{Direct Costs}}} = \text{Indirect Cost Rate}$$

When this rate is applied, it enables agencies to ensure all programs that benefit from a direct cost also assume their fair share of the indirect costs.

A. Detailed Rate Calculation

In order to ensure the indirect cost rate is calculated accurately, it is important to:

- Ensure all activities carried on by the agency and their costs are properly identified.
- Include ALL activities must be included, regardless of the source of funds used to pay for them.
- Incorporate those costs that are allocated to the agency through the central services cost allocation plan (if applicable).
- Take care to ensure all costs are identified correctly as either indirect or direct costs.
- Eliminate capital expenditures and those costs stipulated as unallowable by OMB Circular or agency legislation from the indirect costs, once all the costs have been classified.

The rate is then computed by dividing the total remaining indirect costs by the direct cost base selected for distribution of the indirect costs.

$$\frac{\text{Total Indirect Costs – Capital Expenditures – Unallowable Costs}}{\text{Direct Cost Base}} = \text{Indirect Cost Rate}$$

Capital Expenditures and unallowable costs should be excluded from the total cost. Above presentation only shows deduction from Indirect Costs implying that unallowable costs and exclusions are included in direct cost base.

Selecting the appropriate cost rate base should result in each federal award[1] bearing a fair share of indirect costs in reasonable relation to the benefits received from those indirect costs. The Modified Total Direct Costs (MTDC) is the most common base used. Agencies may also use the total direct salaries and wages (S&W).

Agencies can use either the Simplified, Multiple, or Special Rate Calculation Method. In order to use the simplified method, all of the agency's major functions must benefit from its indirect cost to approximately the same degree. This will NOT be the case for the majority of agencies. As such, most agencies will use the Multiple Rate Method. This guide will review the simplified and multiple methods.

B. Rate Calculation Methods

SIMPLIFIED METHOD:
The simplified method is calculated by eliminating any costs directly reimbursed through a Federal award given for a specific purpose. All administrative salaries that are funded directly by the grant should be removed as well as any unallowable costs and capital expenditures. Direct costs should be adjusted for any flow-through funds and capital expenditures. Finally, divide the totally allowable indirect costs by the appropriate direct cost base to calculate your Indirect Cost Rate.

MULTIPLE RATE METHOD:
The multiple rate method is used by agencies where the indirect costs benefit the major function to varying degrees. This is the most common rate method used. To calculate the multiple rate method agencies must first classify indirect costs into cost pools (functional cost groupings). Next the appropriate base must be selected for distribution of the indirect costs. Each classified cost pool should then be distributed to the benefitting division. The cost rate is then calculated by relating the total indirect costs allocated each division to that unit's direct cost base.

SPECIAL RATES METHOD:
There may be instances when a single indirect rate is not appropriate; these cases may result in an agency having several rates. This is acceptable, but should be documented.

C. Documentation

To ensure adequate documentation each indirect cost rate proposal should, at a minimum, include the following items:

[1] Federal Awards: Grants, cost reimbursement contracts and other agreements between a State and the Federal Government.

- The rates proposed, including supporting work sheets and other relevant data. This should all be cross-referenced and reconciled to the financial data.
- Allocated central service costs. These may be documented using the summary table that is included in the approved central service cost allocation plan.
- A copy of the financial data upon which the rate is based must be included in all plans.
- An actual amount of direct base costs incurred under federal awards, this should be broken out between salaries and wages and other direct costs. This is important because the cognizant agency[2] will use this breakdown to determine whether to establish the resulting indirect cost rate on the basis of salaries and wages or modified total direct costs. The cognizant agency is not responsible for determining which basis to use.
- An organizational chart for the period in which the proposal applies. The chart should include a functional statement indicating the duties and/or responsibilities of all the units of the agency. Included with the chart should also be a narrative statement that provides adequate detail about the functions performed by each unit. The detail should be sufficient that the cognizant agency, during review, can differentiate levels of benefit provided and received within the organization.

Additional documentation may be required by the federal cognizant agency.

Indirect cost rate proposals will not be approved by the Federal Government unless the rate has been certified by the state agency. All rates, whether submitted to a Federal cognizant agency or maintained on file by the agency, must be certified by the agency using the **Certificate of Indirect Costs**. The certification must be completed, and signed, by an individual at a level no lower then Chief Financial Officer of the agency submitting or covered by the proposal.

II. RECOMMENDED GENERAL CONTROLS REVIEW

Before submission, entities should ensure all submitted cost allocation plan materials are complete, in approved formats, and sufficient supporting documentation is included.

A. Recommended Preliminary Review

The proposal should include:

- The **proposal** itself, including detailed schedules on the composition and allocation of all allocated, billed or indirect cost centers.
- A copy of the Comprehensive Annual Financial Report (CAFR) and, if applicable, any other financial records supporting the amounts included in the proposal.
- A detailed and understandable reconciliation of the costs included in the **proposal** to the CAFR and, if applicable, any official accounting records.
- A signed Certificate of **Cost Allocation Plan** or Certificate of Indirect Costs as required by the Circular.
- An explanation of any significant increases in individual cost centers or rate components (e.g. a proposed central service or significant indirect cost rate component that is more than 10 percent higher than the level negotiated for the prior year).

[2] Cognizant Agency: the Federal agency responsible for reviewing, negotiating, and approving cost allocation plans or indirect cost proposal developed under 2 CFR part 225 on behalf of all Federal agencies. OMB published a listing of all cognizant agencies.

- Any other information that has been specifically requested by the Division of Cost Allocation (DCA) as a condition of prior negotiation agreements.

Review the prior **cost allocation** agreements and entity files to determine the following:

- Any findings/recommendations contained in the most recent OMB A-133 Single Audit report have been considered.
    - o Review any other agreements to ensure agreed upon adjustments have been included in the proposal.
- Prior negotiation adjustments have been reviewed to ensure corrections were included in the current proposal. If the corrections were not made, or conditions were not fulfilled, appropriate adjustments should be made.
- All negotiation conditions have been complied with.
- Fixed rates/amounts were negotiated, and the carry-forward ~~amount in the current proposal agree~~amount in the current proposal agrees with the prior written carry-forward agreement?
- The submission has been compared with prior negotiated agreements, and any aspects of the proposal which appear out-of-line and are not fully explained or discussed in the proposal package have been identified. Make any necessary adjustments or clarifications.
- The **proposal** has been reconciled to the financial statements.
    - o For specific recommended steps, see *Section B, Reconciliation of Proposal to Financial Statements*, below.
- The mathematical computations have been "Test-Checked" to ensure their accuracy.
    - o These verifications and the extent to which the verifications were made should be noted on the proposal.
- A trend analysis of the cost pools allocation bases and, if applicable, indirect cost rates has been performed.
    - o For specific steps, see *Section C, Trend Analysis*, below*.*
- If the **proposal** includes any cost/rate increases beyond those based on historical costs sufficient documentation and explanation has been provided.
    - o See separate sections of this document for a more thorough discussion of projected cost increases.
- Based on the results from the prior review steps, determine the areas of the proposal that appear to require additional information and make appropriate adjustments.

B. Recommended Reconciliation of Proposal to Financial Statements

In order to ensure completeness and accuracy as well as compliance the costs included in the cost allocation plan or indirect cost rate proposal should ultimately be reconciled to the Comprehensive Annual Financial Report (CAFR) or other official accounting records. The reconciliation process will generally require the use of accounting records such as appropriation statements or similar budget and expenditure documents. These documents are the official accounting records of the entity and should be the source of the expense information contained in the CAFR. The information in these statements should provide the necessary information to determine that costs have been properly categorized as allowable or unallowable.

- Reconcile the proposal to the CAFR and, if applicable, other official accounting records.
    - o Total costs for each agency should be reconciled first to the Statement of Expenditures or similar document. These documents are the source of the expenditure information included in the CAFR. In many cases the amount reported in the CAFR will be the sum of a number of appropriation accounts and

may include reclassifications or other adjustments. A careful examination of these accounts may be necessary to ensure that all appropriate costs have been included in the proposal. This will also enable the identification of any unallowable or unallocable costs.

- Once it is confirmed that the costs included in the proposal agree with the CAFR/financial statements, adjustments for unallowable or additional costs should be examined for appropriateness.
    - Refer to the Circular, Appendix B, for a discussion of allowable and unallowable costs. Additional costs not recorded on the books of account, such as depreciation or amortization expenses, should be reviewed to ensure adequate support is provided. Additional information regarding the reconciliation and verification of costs included in the proposal is contained in other sections of this document dealing with specific types of rate/cost allocation proposals.

C. Recommended Trend Analysis

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

- Complete a detailed trend analysis of the cost pools, allocation bases, and indirect cost rates as appropriate. It is recommended that the analysis compare costs for a minimum of three years.
    - There are a variety of areas in which a trend analysis may be useful. For cost allocation plans, both the costs being allocated and the bases used to allocate the costs should be considered. This will allow the determination of not only cost centers with significant increases, but also important shifts in the allocation of those costs among various benefiting agencies. For indirect cost rate proposals, it is useful to analyze changes in both the indirect cost base and the indirect cost pool. Finally, the trend analysis will identify new cost centers included in the proposal.
    - Additional guidance on trend analysis as it relates to specific types of proposals is contained in later sections of this document.
- Evaluate the justification for any significant changes or additions.
    - If the justifications are not included, they should be added.

D. Recommended File Documentation

The back-up files should contain sufficient documentation to support the state-wide cost allocation plan or indirect cost rate. It is recommended that the files include, but not necessarily be limited to: worksheets and schedules developed during the review; correspondence with the cognizant agency and the responses; documentation of telephone conversations or of meetings; file notes; and any other pertinent information.

The files should clearly document:

- The adjustments made to the proposal from previously approved proposals, the reasons for the adjustments and supporting computations.
- How the costs/rates were computed and previously negotiated.
- How cost avoidances, if any, were computed.
    - Cost avoidance must be calculated according to DCA policy.

- The required certifications.

Useful Reference Materials

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

III. RECOMMENDED STATEWIDE COST ALLOCATION PLAN REVIEW

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

A. Recommended Preliminary Review

Ensure that all the required supporting documentation is included with the plan. The documentation required to support the plan may vary depending on the circumstances involved in the negotiation. The items listed here are recommended to constitute the minimum documentation necessary to provide support for the plan.

- A certification signed by the authorized state official as required by the Circular.
- The state's official financial statements.
- An organization chart that shows the state-wide organizations rendering services, all the state departments/agencies receiving the services, and all the departments/agencies not receiving the services.
- Exhibit A in an electronic spreadsheet file.
    - See *Section E*, below.

It is recommended that the plan, at a minimum, contains the following items (also, see *Section C Internal Service Funds* below for additional requirements for Section II Internal Service Funds):

- The nature of the service provided and their relevance to Federal grants and contracts.
- The items of expense included in the central service costs.
- The methods used in distributing the costs.
- Listings of both state departments/agencies rendering the services and those receiving the services.
- A summary schedule showing the allocation of each service to the specific benefited agencies.

Determine whether all central services (allocated and billed) are accounted for by Sections I and II of the plan.

- To assure that duplicate charges do not occur, the plan should account for all central service costs, including those which are billed to the user departments/agencies and institutions (e.g. state hospitals or universities).

Review negotiation agreements, cost allocation plans, correspondence, and supporting documents applicable to prior years to determine:

- Whether the state has complied with the terms and conditions of the prior negotiation related to the development of future cost allocation plans.
    - In prior negotiations, advance agreements may have been established for future negotiations to preclude disputes or problems or to help ensure equitable cost determinations in the future. Examples of such agreements include those involving the performance of special studies or refinements in allocation bases, the treatment of certain types of costs, or changes in the state's accounting system.
- Whether the "carry-forward" amount was correctly computed and included as part of the plan (if central service costs were approved on a "fixed" basis in prior years).
    - If a central service is excluded from the proposed cost allocation plan used to fix the amounts for a given fiscal year, the State may not subsequently claim a carryforward adjustment for the omitted central service.
- What adjustments were made in the prior year's negotiation.

Review the organization chart and the amount of Federal grant/contract costs incurred by each organization receiving the central services to determine the services which should be most thoroughly documented because of their ultimate impact on grant/contract costs.

Complete a trend analysis of the cost pools and allocation bases.

- The recommended analysis of the allocation bases, is to select high Federal subvention agencies to determine if the percentage of costs allocated to these agencies has changed. It is important to account for any significant increases.

Obtain a copy of the most recent OMB A-133 Single Audit report. Review any audit findings and ensure any that affect the current plan have been taken into consideration.

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

B. Recommended Review of Section I Costs

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

REVIEW OF COSTS

- If any new allocated central service costs were added, ensure there is adequate justification for including the item as a Section I cost.
  - See ASMB C-10, Question 4-2 for the carry-forward treatment of costs for new central services.
- Ensure the costs included in the plan appear to be allowable, reasonable and allocable to Federal awards.
  - For definitions of cost allowability, reasonableness and allocability, refer to the Circular, Appendix A, paragraph C, 1 - 3.
  - Unless specifically unallowable, central services benefit Federal programs if they benefit the program directly or if they are necessary for the overall operations of departments/agencies performing the programs.
- Ensure the central services costs in the plan exclude unallowable costs in accordance with Appendix B of the Circular. Some examples of unallowable costs are as follows [3]:
  - Alcoholic beverages (3)
  - Bad debts (5)
  - Contingencies (9)
  - Donations (12.a)
  - Entertainment (14)
  - Equipment and other capital expenditures (15)
  - Fines and penalties (16)
  - Fundraising (17.a)
  - General government expenses (19)
  - Investment management (17.b)
  - Legal expenses for prosecution of claims against the Federal government (10.b)
  - Lobbying (24 & 28.d)

Review the following costs to ensure they have been treated properly in the cost allocation plan:

- Depreciation or use allowances[4]:
  - The value of the assets for depreciation/use allowances purposes was properly established.

[3] The numbers next to each item refer to the section number in Appendix B of the Circular which prescribes the handling of these costs. These are examples, and are not intended to be a comprehensive list of all unallowable costs

[4] The value for depreciation/use allowances purposes is acquisition cost. This cost should reflect the actual amount recorded in the records of the state or, if cost records do not exist, an estimate of the acquisition cost, which is usually based on an independent and professional appraisal. Where such appraisals are used, care should be exercised to ensure that the amount used reflects the cost at the time of purchase and not replacement cost at the time of the appraisal. Where depreciation or use allowances are material in amount, the negotiator should determine that the valuation bases are proper and, if the amounts are based on appraisals, that such appraisals were performed by independent and professional appraisers or by other reliable methods (e.g. insurance valuations).

- The cost of land and the portion of assets that are federally financed or financed with matching contributions have been eliminated from the computation.
- A combination of the depreciation and use allowance methods have not been used for a single class of fixed assets
- If depreciation is proposed, ensure that the depreciable lives that have been established are reasonable.
  - In the absence of historical usage patterns, guidance in this area can be found in the Circular, Appendix B, section 11.d or IRS depreciation guidelines.
- The depreciation methods used result in an equitable allocation of costs to the time periods in which the assets are used.
  - Depreciation methods other than the straight-line method should not be utilized unless the circumstances fully justify their use (i.e., when it can be demonstrated that assets are being consumed faster in the earlier years than in the latter years of their useful lives).
- The charges for use allowances or depreciation are adequately supported by property records. The aggregate amount of the use allowances and depreciation applicable to the asset (including any imputed depreciation applicable to periods prior to charging of use allowances as well as depreciation after the conversion) may not exceed the total cost of the asset.
  - When the depreciation method is followed, depreciation records indicating the amount of depreciation taken each period should also be maintained. If the organization converts from use allowance to depreciation, future depreciation on each asset should be computed as if the asset has been depreciated over its entire useful life (i.e., from the date the asset was acquired to the date it is expected to be disposed of or withdrawn from active use).
- If use allowances are proposed, ensure that a factor no greater than 6 2/3 percent has been used for equipment and 2 percent has been used for buildings.

- Rental Costs
  - Refer to the Circular, Appendix B, section 37, for limitations on the amount of rental costs that may be charged to Federal awards under various types of leasing arrangements (e.g. sale and leaseback arrangements, less-than-arms-length leases or capital leases).
- The central service costs which are allocated in the plan should properly exclude the “general costs of government.”
  - The “general costs of government” are not explicitly defined in the Circular. They have been construed, however, to include the general costs required to carry out the overall responsibilities of the state or local unit of government. The principal examples of these costs are those incurred in operating the governor’s office and those incurred in operating state/local legislative bodies. This does not preclude the recovery of special, identifiable expenses incurred pursuant to the administration of Federal grants/contracts in one of these normally unallowable activities.
- Applicable portion of the costs of department/agency heads and their immediate staff should be excluded from the plan, if there are any unallowable functions reporting to them.
- Appropriate consideration should be given to any “applicable credits” in the determination of the expenses included in the plan.

    - Income generated by activities conducted by the state agencies providing central services and certain negative expenditure types of transactions should be used to offset or reduce expense items (e.g. sale of scrap and publications, parking fees, cafeteria income, purchase discounts and rebates, etc.).

REVIEW OF COST ALLOCATION METHODS

The central service costs are normally distributed on a number of different bases dependent upon the element of the cost being distributed. This area is critical to the propriety of the plan. Therefore, the bases should be thoroughly documented to show that their use results in an equitable distribution of costs to the benefiting activities.

- Ensure the bases chosen are appropriate for allocating each central service.
    - Any method of distribution which will produce an equitable distribution of the cost can be used. In selecting one method over another, it is important to consider the additional effort required to achieve a greater degree of accuracy. Suggested bases are shown in Part 4.6.2 of the ASMB C-10.
- The proposed bases should include all activities which benefit from the central services being allocated, including all departments/agencies benefiting from the services, and where appropriate:
    - Activities associated with general funds
    - Activities associated with restricted, special purpose, or other funds
    - Grants and contracts
    - State institutions (e.g. hospitals, universities)
    - Cost used for sharing or matching purpose
    - Non-state organizations which receive services (e.g. an affiliated foundation, a local government agency, etc.)
- The data included in the bases (e.g. square footage, number of employees, time studies, etc.) should be current and accurate.
- Ensure that activities supported by "flow-through" funds have been properly treated.
    - In some state departments/agencies, notably the Departments of Education, the state acts mainly as a conduit of certain grant funds which "flow through" the state to local units of government and, in some cases, to other types of organizations (e.g. universities, non-profit institutions, etc.). In such cases, the activities supported by the funds generally do not receive central services from the state and, therefore, should normally be excluded from the base(s) used to allocate the central service costs.
- If the proposed base is state operating expenditures, the recipient payments should be excluded.
    - Inclusion of recipient payments (e.g. financial assistance, food stamps or medical vendor payments) in the base will distort the distribution of costs to benefiting departments/agencies.

C. Recommended Review of Section II Costs

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

INTERNAL SERVICE FUNDS

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

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

Preliminary Steps:
For each ISF or similar activity with operating budgets of $5 million or more, ensure the plan contains[5]:

- A brief description of each service
- A financial report balance sheet
- A revenue/expense statement with revenues broken out by source (e.g. regular billings, interest earned, etc.)
- A listing of all non-operating transfers (as defined by GAAP) into and out of a fund.
- A description of the procedures (methodology) used to charge the costs of each service to users, including how billing rates are determined.
- A schedule of current rates.
- A schedule comparing total revenues (including imputed revenues) generated by the service to the allowable costs of the service under the Circular, with an explanation of how variances will be handled.
    - For example format, see ASMB C-10 Illustration 4-7. For funds which utilize multiple billing rates (e.g. data processing funds), a separate reconciliation schedule for each billing rate may be required.
- A schedule of billed services (by user and consisting of all revenues, including unbilled, uncollected and imputed revenues).
    - See ASMB C-10, Illustration 4-6 for an example

Data on ISFs should be submitted in accordance with the Circular. It is important to be aware that these requirements are also applicable to activities that function like ISFs but are not formally setup as an ISF.

Ensure that all ISF's are identified by reviewing:

- Internal Accounting Manuals
- Financial Statements (Certified, Internal, other)
- Budget Documents
- Discussions with appropriate state/local personnel

Review all ISF's and identify:

- Those that are central service versus those of an operating department.
    - A Department of Corrections may run a farm, operate a laundry, build furniture, etc., for which an ISF was established. A Department of Health may charge out for laboratory services.

[5] Although the documentation is required by the Circular for those ISFs with operating budgets of $5 million or more, the federal government negotiator has the option of requesting any of the information for ISFs with operating budgets less than $5 million. This is applicable when reviewing smaller state governments.

- The specific nature of the central service function.
- All potential users.
- Those with potential Federal recoveries.
    - o These central service costs can be a direct charge to a Federal program, an overhead account at the operating department level or a charge to a Section I central service function which is subsequently allocated to Federal programs.

Obtain a copy of the latest audit to identify departments/agencies with Federal funds and potential problem areas. This would include[6]:

- OMB A-133 Single Audit or other independent audits
- HHS OIG audits
- State internal audits

For new ISF's ensure adequate documentation is provided for:

- When the fund was first established.
- How the fund was initially funded (capital transfer, etc.).
- Existence of external and/or internal financial statements.
- Manner in which services are charged out, i.e., billing rate system or cost allocation procedures.

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

Federal funds are usually billed upon usage of specific service with funds transferred at that point from the Federal program to the ISF. State funds may be handled in the same manner or the entire funds appropriated to operating departments may be transferred to the ISF at the beginning of the state year setting up payable/receivable amounts in their respective accounts. Under the latter approach, the billings to state programs during the year only result in reductions to payable/receivable accounts. Recommended review of the billing rate system[7], is as follows:

- Ensure the current billing rate schedule of charges is adequately supported for rates and data is current and accurate, and unallowable costs are excluded.
- The rate should provide for all costs, e.g. fringe benefits, SWCAP, etc.
    - o A problem consistent with the billing method is that the billing rate may provide for replacement of assets rather than depreciation on existing equipment.
- Review the schedule of billings by user to ensure all users (including outside the governmental entity) are billed the same rate for the same service. Also, ensure that any differences in billing state and non-state functions are fully explained.
    - o Assets, such as motor vehicles, may be purchased directly under Federal awards. The consistency principle must be applied where the same department

[6] If there is no audit, this may cause the federal negotiator to be concerned that there may not be a complete tracking of sales and related accounts receivable. Potential problems may be that charges are based on revenue received rather than charges for total usage of the services provided.
[7] Once the billing rate system is established and approved, key aspects of the billing rate system will likely be selectively reviewed by DCA with each subsequent submission to assure compliance with the approved procedures. The review will address the need for multiple rates.

is being billed for a central service such as motor pool. However, as a general rule, separate billing rates for Federal programs should not be required from those that a state uses for its own purposes.

- Ensure that serviced department are not overbilled as the result of another department's underbilling
  - o Any costs allocable to a particular Federal award or cost objective should not be charged to other Federal awards to overcome fund deficiencies. In other words, the over recovery of expenses from one billed service center should not be used to offset the under recovery of another service center. See the Circular, Appendix A, Section C, 3, c.
- Identify any procedures followed by service and serviced departments where billings exceed original appropriated amounts.
- Review rate base to ensure it equitably distributes the cost of the service provided.
- Determine if past profit/loss is properly treated.

Review cost allocation procedures[8], as follows:

- Review the method used to bill out the cost.
  - o Under this approach, costs are charged out on a periodic basis (e.g. monthly) based on actual usage during that period.
- Verify the composition of cost. The data should be current and accurate, and unallowable costs excluded.
- Ensure all users are charged on the same basis.
- Ensure that serviced departments are not overbilled because of another department's underbilling.
- Identify any procedures followed by service and serviced departments where billings exceed original appropriated amounts.
- Review charge out base (i.e., allocation statistics) to ensure it equitably distributes the cost of the service provided.

Review of Reconciliation of Net Assets/Retained Earnings:
Review annual reconciliation of net assets (previously called retained earnings), i.e., the schedule comparing total revenue (including imputed revenue) to the allowable costs. It is important to document that variances were properly treated.

- Funds which utilize multiple billing rates/functions may be required to have separate reconciliation schedules for each billing rate/function.
  - o For example, an ISF may consist of both ADP and telecommunication services where each function separately identifies its own revenues and expenditures. An overall fund balance may not be appropriate, because excess charges may occur in one billed service but undercharges may occur in other billed services. In addition, various users do not utilize each billed service to the same extent.
- Verify the accuracy of the reconciliations to supporting documents (e.g. CAFR). Also, math check the schedules.
- Review the accuracy of the beginning A-87 Net Asset balances.
  - o If the fund has not been reviewed or if adjustments have not been made for

[8] Once a system is reviewed and approved by DCA, it will likely be selectively reviewed in the future to assure compliance with the approved procedures.

overcharges in prior years, the beginning balance is the Net Asset balance on the state's CAFR including allowable adjustments (e.g. transfers in/transfers out, unallowable/allowable costs, imputed interest).
    - If the fund has been reviewed in prior years, the beginning balance will be the ending balance from the previous year's reconciliation schedule. However, if adjustments for excess reserve balances have been made, then the starting balance would be the fund balance that was allowed to be retained at the end of the previous year.
- The A-87 Revenue should reflect total charges for all services provided for the year whether billed or not.
    - If some users were not billed for services (or not billed at a full rate), a schedule showing the full imputed revenues should be provided (see ASMB C-10, Illustration 4-6). The revenue should also include all other revenues the fund earns from its operations and interest earned on reserves.
- Verify the accuracy of interest earned or imputed interest. Review fund statements to determine if applicable credit has been given for earnings on ISF cash balances. If earnings are not reported, the Federal negotiator may impute the interest amount and determine through discussions with state personnel how cash balances are invested.
    - When known, actual earnings should be used. However, if funds are commingled, earnings may be imputed by applying the government's rate (e.g. the state's Treasury Average Rate of Return) to the monthly average cash balance for the year.
- Review the expenditure amounts to ensure that unallowable costs are excluded and that remaining costs meet the Circular requirements.
    - Common problem areas are replacement costs, and expensing of capital assets rather than depreciating.
- Review the allowable reserve to ensure the amount is not excessive. Review is recommended by individual billed service within the fund, if material.
    - ISFs are dependent upon a reasonable level of working capital reserve to operate one billing cycle to the next. A working capital reserve as part of the retained earnings of up to 60 days allowable cash expenses is considered reasonable. See ASMB C-10, Question 4-10 and Illustration 4-7 for detailed instructions on computing allowable reserves for ISF's, and for general funded ISF's.
- Review the details for the fund transfers made during the year.
    - It is recommended that all funds transfers should be reviewed in detail.
    - Ensure that transfers have been correctly classified as "operating" vs. "non-operating". Sometimes non-operating transfers are inappropriately classified as operating transfers on the reconciliation. An operating transfer directly results from the provision of goods or services to customers, or is otherwise directly related to the principal and usual activity of the fund. Operating transfers should be part of expenditures in Part I of the Reconciliation. However, if the transfer is for purposes other than originally billed and reimbursed by the Federal programs (for example, transfers to the General Fund for general purposes of the State government or transfers to other funds to cover the other funds' deficiencies), then the transfer is non-operating.
    - For non-operating transfers, the State should refund the Federal government for its share at the date of transfer. The only exception to this requirement is if the State has enough contributed capital (Part II of the reconciliation) to make the

transfer from Part II contributed capital, in which case a refund may not be necessary.
    - However, if the State does not have sufficient contributed capital, and the State does not refund the Federal share at the time of the unallowable non-operating transfer, DCA may seek repayment of the Federal share of the transferred funds, including interest from the date of transfer. In the case of an untimely refund, the State's refund of the Federal share should be paid from the Fund that received the transfer-out, usually the General Fund. The reason for this is that if the State pays the untimely refund of the Federal share from the ISF's reserves, this causes an additional unallowable diversion of ISF funds, thereby necessitating a larger refund. The interest rate assessed prior to the determination letter would usually be the State Treasurer's Average Rate of Return. If the State does not make the refund within 30 days of the determination letter, then interest at the current Private Consumer rate will be assessed in accordance with regulations at 45 CFR Part 30.13.
- Determine if there is an excess fund balance; if so an adjustment may be required.
    - Variances may be handled as adjustments to future billing rates, cash refunds, credits to individual programs, or, if less than $500,000, as a Section I allocated costs. If a method other than a cash refund is negotiated, an interest assessment may be made.

Useful Reference Materials Regarding ISF's

The following materials can be helpful during the review of internal service funds.

HHS Departmental Appeals Board Decisions

- No. 1336 New York (Allowable Costs of State-Owned Buildings)
- No. 1766 Wisconsin (Excess Reserves)
- No. 1802 Missouri (Allocating State Unemployment Insurance Taxes)
- No. 1811 Michigan (Cash Repayment of ISF Overcharges)
- No. 1822 Idaho (Repayment of Transferred Funds)
- No. 1872 Colorado (Repayment of Transferred Funds/Applicable Credit)
- No. 1876 New Mexico (Unallowable offsetting of Overcharges/Cash Repayments)
- No. 1994 Michigan (Rebates/Applicable Credits)
- No. 2010 Arkansas (Unallowable Offsetting of Overcharges)
- No. 2047 Arkansas (Unallowable Offsetting of Overcharges)

INSURANCE

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

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

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

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

Insurance may be funded by:

- Establishment of Internal Service Fund
- Accounting for funding within a General Fund

Identify all types of insurance coverage, and determine for each type of insurance whether the State purchases insurance or self insures, or a combination of both. For self insurance, determine whether the State funds reserves or uses “pay as you go” funding (see below for reviewing “pay as you go” insurance). This can be determined by reviewing:

- Internal Accounting Manuals
- Financial Statements and notes
- Budget Documents
- Discussion with appropriate state personnel

Obtain copies of applicable financial statements, including actuarial reports.

- If financial statements are not available, the fund manager should have some internal statements for use.

Determine which insurance coverages, identified above, are charged to Federally funded programs.

- Only those coverages ultimately charged to Federally funded programs need to be considered for review. For those insurance coverages with Federal participation, estimate the federal share of the annual cost or fund balance of the insurance being reviewed. The focus should be on determining whether federal programs are paying the same per unit costs as state funded programs, and whether unallowable transfers/diversions have been made from any fund reserves.

For insurance coverages identified above, review the specific coverage, the cost, and the mechanism used to charge Federal programs.

- Depending on the coverage, Federal programs could be charged through the central service plan (Section I), billing rates to departments (Section II), “pass-thru” vendor bills, fringe benefit rate, or other mechanisms. Review should include determining the reasonableness of the method(s) used to allocate the cost of insurance.

If the organization has changed from purchased insurance to self-insurance, provide a rationale for conversion and a comparison of before and after rates. If rates have increased significantly, provide an explanation for the increases.

- For most of these changes DCA can only reasonably be expected to be kept informed as to the current situation.

Where funded reserves are used:

- Ensure there is adequate rationale and support for the year's insurance expense
  - If actuarially determined, ensure a copy of the study is included. The report should provide for the following:
    - Identify the three reserve balance components identified in the Circular, Appendix B, Section 22, d, (3)
    - Contain rate recommendations
    - The rate recommendations used by the state to fund the reserve
    - Document that the assumptions are reasonable
    - How recent investment earning (i.e. stock market) have impacted the reserve balances
    - An explanation of the state's plans concerning increasing or reducing the fund balance in the future.
  - If historical experience, provide supporting data.
  - If created by law/statute, provide a copy and note any pertinent provisions.
- Reconcile expenses to the financial statements
  - Accrual basis of accounting should be used. Cash basis will not reflect true reserves because cash statements will only reflect users paying for services rather than actual costs of services provided during the accounting period to all users.
- Review expense support to identify:
  - Contingencies included (i.e., catastrophic losses, etc.)
  - Unallowable costs under the circular (i.e., Coverage of Federal Government Property)
  - Unallocable costs (i.e. Coverage for false arrest, tort claims, etc. that would be considered as costs of general government and not of benefit to the Federal programs).
- Review fund statements to identify:
  - Extent of contributed capital. Depending on source of contribution, this part of the reserve balance would not be a potential credit to the Federal government.
  - How interest and other investment earning on reserves are accounted for.
    - All interest and other investment earnings must be credited to the reserve to ultimately be used for the purpose of the fund.
  - Reserve balances that represent an aggregate of different types of insurance, (e.g. medical malpractice, general liability, auto insurance). These should be analyzed separately. The revenues, expenses, and reserves should be separated by type of insurance.
    - Federal participation can vary significantly among the different types of insurance.
  - Reserve balance amounts and support to ensure the reserve is not excessive. Documentation should be provided on the need for a reserve and explanation of any level in excess of claims run-off. That includes claims that are: submitted and adjudicated, but not paid; submitted but not adjudicated; or incurred but not submitted.
  - The purpose of intergovernmental transfers such as "Amounts due the General Fund" and similar accounts/transactions. Such accounts/transactions sometimes

include unallowable transfers of excess reserve balances or interest/investment income from the fund.

- Document all transfers during the year other than charges for self-insurance.
  - o Federal programs must be credited their share, including earned or imputed interest from the date of transfer, if the transfer is not for self-insurance payments or return of contributed capital.
- Verify all funds, programs, etc. are charged consistently.
  - o All users should be charged the same rate for the same service
  - o All state agencies/departments should pay their costs in the same manner. If not, determine if the "cost per" is the same for federally funded programs as it is for non-federally funded programs. As a result, Federally funded programs may be charged inflated actuarially determined rates based on state funded programs underpaying their costs in previous years.
  - o Funds should flow directly from state agencies to the insurance fund. If not, additional opportunities for transfer of funds for other uses exist. If funds are not transferred promptly, interest earnings may in effect be transferred for other uses.
- Document the reasonableness of the allocation or charging basis depending on the specific insurance coverage.
  - o Overall average rates of certain components may not be appropriate, e.g. workers' compensation expenses may vary significantly from department to department based on employee classifications i.e., office worker, mechanic, laboratory worker, etc.

Where "Pay as You Go" method is followed

- For liability and property insurance, assure compliance with the Circular, Appendix B, Section 22.
- For fringe benefit type insurance (e.g. unemployment, workers compensation, health, etc.), document that the amounts proposed represent "employee benefits in the form of employers' contribution or expense" for the current year, and such amounts are properly determined and allocated. Refer to the Circular, Appendix B, Section 8, d, (5). The entity may use trust or agency funds to account for these items. Be sure to document:
  - o The basis of the expense, i.e., the amount paid to the fund or the actual payment from the fund. (If the expense is handled as an agency fund rather than a trust fund, the expense of the period should be the payments from the fund. An agency fund is basically a holding account and the payment from the fund is the true expense of the period.)
  - o Whether there were any transfers from the fund to the general fund.
  - o Extent of interest earned and need to credit Federal programs, etc.
- Ensure reasonableness of the allocation bases.
  - o Allocations should be based on benefits received.

Where the cost of administering these programs is charged as either part of the billing rates or allocated as a Section I activity, ensure that only costs applicable to the state activity are included for allocation.

- Many states administer fringe benefit programs such as health, dental, pension, etc. for both themselves and other governmental entities such as local governments. The methodology for charging administrative costs of the program must result in federally funded programs not paying more than their share of these administrative costs. The state should use some combination of (1) charging the non-state entities their relative share of the administrative costs and (2) paying for them with only state funds.

Useful Reference Materials Regarding Insurance
The following materials can be helpful during the review of self-insurance funds:
HHS Department Appeals Board Decisions

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

FRINGE BENEFITS

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

The following information should be submitted as part of its proposal:

- Listing of fringe benefits (FB's) and the annual cost of each.
- Current FB policies for each FB listed including coverage and funding.
    - After the initial review, only submit the policies when there are changes.
- Method used for budgeting and charging FB's to Federal awards.
- Future changes in FB policies or charging/budgeting methods.
    - Multiple rates may be necessary if there are different classes of employees or pension systems.
- FB proposal.
- Reconciliation to financial statements (CAFR) or other official expenditure reports for each component of the FB proposal.
- Copies of any state, CPA, or other audits of any FB component.
    - Including annual reports prepared by or for Retirement Systems, Insurance Commissions, etc.
- Copies of the most recent actuarial reports.
    - An actuarial valuation is recommended at least every two years.
- Any applicable state laws or regulations concerning any of the FB's.

Review the financial statements and especially any notes relative to FB costs.

- The financial statements are an important source of background information on FB's and any changes with respect to their provisions. Information on the status of reserves and transfers of funds will also be found in the financials.

Provide documentation that is sufficient to convey a complete understanding of the methods used to both charge and budget FB's, including budgeting, accounting and recovery of all FB cost claimed for Federal reimbursement.

- Several methods can be used in the accounting for the various FB costs.

  - o FB's appropriated centrally where an average rate is developed, similar to an indirect cost rate, and charged to federal awards. An internal billing system is used only for federal funds and other third parties; there is no billing for state funded programs.
  - o FB's appropriated at the department level resulting in internal billings for all funds. Billing rates may be based on:
    - Average rates developed for individual FB components under the same process described for central appropriations above.
    - Specific FB's identified with each department and departmental rates developed and billed accordingly. Individual rates needed because department experience varies, e.g. workers' compensation, unemployment, etc.
    - Specific FB's identified with individual employees and charged directly to the programs the employees are working on.
  - o Assure that Federal programs have been charged in a manner consistent with other sources of funds, particularly state general funded activities.

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

Review of the Salary and Wages (S&W) base should include:

- Reconciliation to the financial statements.
- Complete description of the base, i.e., whether it is total S&W as recorded in the accounting system or if certain components are excluded, e.g. over-time, part-time employees, etc.
  - o The review must determine whether it is equitable to include S&W of part-time employees, etc., in the base. Some FB's, such as pension, may not apply to these employees. In such cases a separate FB rate may be appropriate.
- Document whether all departments, divisions, agencies, etc., are considered.
- Review actuarial reports.
- Document whether a multiple rate structure for different classes of personnel was used.
  - o Where there are several classes of personnel (e.g. public safety personnel, teachers, etc.), a multiple rate system may be needed or certain areas should be excluded because they skew the rate and have little relevance to Federal programs. Usually uniformed public safety personnel as well as judicial and legislative members should be excluded because they have high FB costs and little or no Federal reimbursement. The significance of this differential is usually, but not always, identified in the actuarial valuation of pension costs.
- Document the method followed to account for vacation, holiday, sick or other leave (i.e., accrued when earned or pay-as-you-go).
  - o See the Circular, Appendix B, section 8.d.(2), (3), and (4) for guidance on allowable costs. Particular attention should be paid to accrual methods of accounting to ensure appropriate credit when leave is used. Also, payments for unused leave when an employee retires or terminates employment should be allocated as a general administrative expense and should not be charged direct

to the last program/project the employee worked on (see ASMB C-10 Question 3-6).

Review of pension costs should include:

- Identification of all pension costs by plan and basis of the recorded expense whether it's actuarial based or pay-as-you-go.
    - In some cases, the state is responsible for funding the employer's share of pension costs for teachers and other local government employees. In such cases, it is important to include those costs in the assessment of allowable pension expenses.
- Document which classes of personnel are included in the pension rate for Federal purposes.
    - Usually police, judiciary and the like should be eliminated or separate rates should be developed.
- Verify that the pension expenditures recorded in the financial statements and the FB proposal are funded.
    - The Circular, Appendix B, section 8. e. (2) and (3) provides guidance on the timing of actual contributions to a pension system. In general, the costs must be funded within six months after the end of the fiscal year to be included in that year's expenses. Further guidance concerning allowable pension costs is also contained in ASMB C-10 on pages 3-8 through 3-10.
- Differences between expenses determined under GAAP and actual funding should be identified and explained.
    - Overfunding may occur in a year because funds are available. Such excess is not acceptable as a current period expense but is a prepaid expense which should be applied to a future period. (See the Circular, Appendix B, section 8. e. (3).) Underfunding will increase future costs due to interest lost and an increase in the unfunded liability of the pension plan.
- For plans based on actuarial methods of funding, provide an analysis of the composition of the year's expenses.
    - This could include normal costs, amortization of prior service costs, life insurance, etc. The costs included could vary depending on the actuarial method used. Document what assumptions, regarding timing of contributions, were made by the actuary for valuation purposes and whether or not they were followed. The effect on Federal reimbursement should be considered.
    - Further information on the requirements of accounting for and reporting pension plan expenditures is also available in GASB Statement No. 25.
- Ensure the interest amounts included in pension costs are allowable.
    - Pension expenses may include an element of interest expense arising from several sources, e.g.
        - Allowable: unfunded liability from the establishment of the plan or changes to the plan (past/prior service costs); unfunded liability created by a prior failure to adequately fund the plan in accordance with actuarial determinations because of a lack of funds or other considerations; unfunded liability caused by the use of outdated actuarial assumptions.
        - Unallowable: late payments to the pension fund; delay in contribution caused by a state mandate.
- Where possible, identify the various unfunded liabilities and their amortization periods.

Each should be reviewed for allocability to Federal programs.
  - o Review may highlight areas where the allocability to Federal programs is questionable.
- Review the pension plan's financial statements to determine if the fund is maintaining a contingency reserve which has not been included in the actuarial computations.
  - o Failure to consider all funds held by the pension system could understate assets and result in excess contributions.
- If pension obligations bonds (POB's) were used to liquidate some or all of the unfunded liability, ensure Federal regulations and guidelines were followed.
  - o See OMB interpretation dated 1/31/94[9]. If this was done in a prior period, note if the actuary or single auditor has reported any changes.
- Where early retirement programs are initiated document their allocability to Federal programs and, that required prior approval was obtained.
  - o Refer to ASMB C-10, Question 3-13 for further information.
- Review actuarial assumptions and computations to determine if any areas require further supporting documentation.
- Review the pension plan, trust agreement, etc., to determine if it is possible to access the pension funds for reasons other than the payment of pensions. Ascertain if any withdrawals or diversions of assets have taken place.
  - o If the funds were withdrawn from the pension system for general fund purposes, such a transfer would require an appropriate credit, including interest from the date of withdrawal, to the Federal government. This issue is most likely to present itself during times of economic downturn and can be an attractive alternative to raising taxes. Such transfers/withdrawals will most often be identified in the CAFR and, if applicable, the annual report of the pension fund. If the State does not refund the Federal share at the time of the transfer, then the refund should usually be paid from General Funds, as additional pension reserves should not be diverted for the untimely refund.
- The funding status of the plan should be reviewed to determine if there is apparent overfunding. Documentation should be provided explain the overfunding and how it will be liquidated.
  - o The funding status of the plan should be viewed in the "long run." Potential overfunding should be considered by both the state and its actuary to obtain a thorough understanding of the status of the plan.
- Where the state administers the pension plan, document how administrative costs are handled, i.e., part of the pension rate, separately recovered as a Section I cost, other.
  - o Ensure amounts are not duplicated. In addition, costs associated with administering portions of the pension plan not related to state employees (local government employees, teachers) should be identified and not included in any

[9] Some entities have refinanced POBs. While the 1994 policy statement did not discuss refinancing of the POBs, it is DCA's opinion that if the aggregate cost of the refinanced POBs is less costly than the POBs it replaces, the refinanced POBs would be acceptable under the 1994 policy statement. Conversely, if the aggregate cost of financing the POBs is more costly than the POBs it replaces, the excess cost would not be allowable. This interpretation is consistent with the 1994 policy that made the original POB allowable if it accomplishes the same purpose at a lower cost.

allocation at the state level.

- The method used to compute the state contribution to the pension plan should be compared to the method used to compute charges to Federal programs.
    - o Ensure that the state contribution is the same percentage of S&W as is used to claim Federal reimbursement. Where the state amount is based on estimated S&W, it may be necessary to make an adjustment to reflect actual S&W cost at year end to equalize the contribution, if the state uses a specific identification method to charge pension expense.

Review of Other Fringe Benefits

- Ensure the amounts and benefits are allowable and reasonable.
- Verify that coverage is the same for all employees.
- Provide an analysis of the portion of cost paid for current/retired employees, e.g. health insurance.
    - o The employer share of post-retirement health insurance may be funded on a pay-as-you-go basis or actuarially determined, similar to pension costs. In some cases post-retirement health insurance may be paid by the pension system and treated as an element of the pension rate. Consistent treatment of this, and all costs, is extremely important. “Pay-as-you-go” costs should be allocated as a general administrative expense to all activities, and should not be charged direct to the last program/project that the retiree worked on. Allowability of costs for post-retirement health insurance is addressed in the Circular, Appendix B, Section 8, f. Allocability is addressed in the Circular, Appendix B, Section 22, d. (4) and e.
    - o In 2004, GASB issued Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions, which requires state and local governments to report their costs and obligations for post-employment healthcare and other post-employment benefits (called “OPEBs”) much like they now report pension plan obligations. Many state and local governments will be accruing large liabilities for these OPEBs. The accrual is only allowable if it is calculated and funded in accordance with the Circular, Appendix B, Section 8f. In addition, some states are issuing bonds to fund OPEBs. The bond interest is not allowable.
- Document the reasonableness of including the cost of retiree’s benefits in the FB pool.
    - o Adjustment may be necessary:
        - ▪ Resulting from some employees, like police, that may have shorter service requirements to qualify for a pension. Such employees would therefore make up a larger proportion of retirees. An adjustment would be necessary to compensate for these employees where the health costs are higher and there is little or no Federal involvement.
        - ▪ To Assure that amounts paid by retirees through direct contribution or reduction of pension benefits are properly credited against total cost of the benefit.
- Ensure any rebates or other applicable credits which should be considered in arriving at the allowable costs (e.g. rebates of unemployment compensation insurance, life insurance dividends/rebates, Procurement Card Rebates etc.) are adequately documented.
- If any FB is handled through Trust or Agency Funds, review appropriate financial

statements/annual reports.
    - This could highlight transfers to the general fund, interest earned on funds awaiting disbursement, or other areas requiring further review. Note that interest can be earned on the employer contribution portion as well as the employee withholdings for Social Security, Federal taxes withheld, etc. Interest earned on both employee and employer contributions may be a proper credit against Federal programs
- Coverage should be consistent among all employee groups and, the costs of the benefits should be treated consistently for both Federally and non-Federally funded personnel.
    - If benefits for any group are higher than another, the need to adjust the FB rate computation should be considered. This is especially true for Workers' Compensation or Unemployment Insurance where expense could vary significantly between departments or other employee groups.
- In some cases the state may elect to be self-insured for certain FB's (e.g. workers' compensation and unemployment). In such cases, assure that the costs are allocated in accordance with the Circular.
    - The Circular, Appendix B, Section 22, e. requires such costs to be "allocated as a general administrative expense to all activities of the governmental unit." It is not appropriate to allocate these costs directly to the program to which the employee receiving the benefit had been assigned.
- For FB's that are self-insured, see separate section of this guide for further review steps.

Useful Reference Material Regarding Fringe Benefits

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

- Actuarial Standard of Practice No. 4 "Measuring Pension Obligations" Actuarial Standards Board, 10/93
- Governmental Accounting Standards Board (GASB) Statement No. 16 "Accounting for Compensated Absences" 11/92
- GASB Statement No. 25 "Financial Reporting for Defined Benefit Pension Plans and Note Disclosure for Defined Contribution Plans" 11/94
- GASB Statement No. 26 "Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans" 11/94
- GASB Statement No. 27 "Accounting for Pensions by State and Local Government Employees" 11/94
- GASB Statement No. 43 "Financial Reporting for Postemployment Benefit Plans Other than Pension Plans" 04/04
- GASB Statement No. 45 "Accounting and Financial Reporting by Employees for Postemployment Benefits Other than Pensions" 06/04
- FASB Statement No. 43 "Accounting for Compensated Absences" 11/80
- FASB Statement No. 74 "Accounting for Special Termination Benefits paid to Employees" 08/83
- FASB Statement No. 87 "Employers' Accounting for Pensions" 12/85
- FASB Statement No. 106 "Employers' Accounting for Postretirement Benefits Other than Healthcare" 12/90
- FASB Statement No. 112 "Employers' Accounting for Postemployment Benefits" 11/92
- FASB Statement No. 132 "Employers' Disclosure about Pensions and Other Postretirement Benefits" 02/98

- HHS Secretary's Letter to Governors – Charging of different contribution rates to Federal and state programs and diversion of Trust Fund Reserves.
- Interest on Unfunded Pension Liability Bonds – Letter from Norwood J. Jackson, Jr., OMB, to Gary M. Talesnik, HHS 01/94
- HHS Departmental Appeals Board Decisions
    - No. 8 Connecticut (Consistent application of pension billing rates)
    - No. 29 Rhode Island (Consistent application of pension billing rates)
    - No. 314 Indiana (Consistent application of pension billing rates)
    - No. 1034 Massachusetts (Conversion from pay-as-you-go to actuarial method)
    - No. 1465 West Virginia (Offsetting contributions to pension funds)
    - No. 1592 California (Qualifying state contributions to pension reserves)
    - No. 1608 Texas (Health insurance reserves related to new members) No. 1635 Alabama (Transfers of self-insurance reserves and related interest)
    - No. 1659 Maine (Offsetting contributions to pension funds)

D. Recommended Review of University General Obligation Bond Interest

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

GOB Interest Expenses

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

Annual GOB interest expense must be identified to specific capital projects/buildings. However, large states may issue GOB's that are used for more than one university system or campus. In this case, it may not be feasible to review the detailed allocations to each building or project. It is recommended that, at a minimum, the GOB interest should be identified to the university system. In addition, the University should provide sufficient detail in the university proposal to identify the GOB interest to particular projects/buildings. Smaller states may be able to provide this level of detail as part of the SWCAP submission.

If the state has proposed university GOB interest for state universities as part of the SWCAP, ensure the plan contains:

- The annual GOB Interest expense broken out by GOB issuance, including bond issuance dates and amortization schedules.
- The annual GOB interest expense broken out by university system or university campus
- If appropriate, the GOB interest broken out by individual capital project or building.

- o Many states have a legislatively-approved Annual Capital Improvement Project Report, or other similar reports, which may identify for which capital projects the bond proceeds, were used.

Verify actual interest payments and reconcile to the CAFR or supporting schedules.

The financing agreement(s) including the prospectus and schedule of loan payments should contain the amount and purpose of the loan; as well as the applicable interest rate(s), term of the loan, the lender and the maturity schedule.

For major GOB-funded state university projects, document the percent of financing for the acquisition of the building or renovation of the existing facility (this should be done for each individual project).

- For debt arrangements over $1 million, a reduction of interest expense is required unless the State or university makes an initial equity contribution to the asset purchase of 25 percent or more. The reduction will be an amount equal to imputed interest earnings on excess cash flow. See ASMB C-10 Illustration 3-1 for an example.

GOB INTEREST ALLOCATION METHODS

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

Review the state's GOB issuances and document the benefiting state agencies. GOB issuances may benefit a single university campus or they may benefit all of the state's universities and colleges and even other state agencies.

- The State's annual listing of legislatively approved capital improvement projects, or other similar reports, should also be reviewed.

The state's GOB issuances should be allocated equitably to all benefiting state agencies. For example, the state may allocate GOB interest based upon the amount of GOB proceeds that are provided to each agency or campus for each benefiting capital project.

E. Recommended Concluding Steps

Identify any significant anticipated changes in the state's operations (e.g. organization structure, accounting system, etc.) that should be taken into account in negotiating provisional or fixed central service costs.

- Normally these costs are based on the actual costs for the state's most recently completed fiscal year. However, if the state anticipates significant changes in its operations that would affect the costs, the state would be permitted to use appropriated budget amounts which reconcile to official documents.

Advance agreements are often established when they are needed to preclude future disputes or problems or when they will help ensure equitable cost determinations in the future. Examples of areas where these agreements may be needed include (a) the performance of special studies or analyses in the development of future plans, (b) changes or refinements in allocation bases, (c) the treatment of certain types of costs, (d) changes in the agency's accounting system, etc. If an advance agreement is established it should be provided in the letter transmitting the Negotiation Agreement.

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

IV. RECOMMENDED REVIEW OF INDIRECT COST RATE PROPOSALS

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

A. Recommended Preliminary Review

- Document the rate is needed.
    - A rate is needed if the state or local agency has any awards that provide for the reimbursement of indirect costs. However, if only training awards that limit reimbursement to eight percent of total direct costs are involved, a rate is not required.
    - In accordance with Circular, Appendix E, section D.1.b., governmental units or agencies that OMB has not assigned a Federal cognizant agency, must develop an indirect cost rate proposal in accordance with the requirements of the Circular and maintain the proposal and related supporting documentation for audit. These governmental units are not required to submit their proposals unless they are specifically requested to do so by the cognizant agency responsible for reviewing, negotiating, and approving indirect cost proposals.
    - Where a local agency only receives funds as a sub-recipient, the primary recipient will be responsible for negotiating and monitoring the sub-recipient's plan. A negotiated rate is not required with DCA.
- If a rate is required, and it is the agency's first negotiated rate with HHS extra effort should be expended to ensure an understanding of Federal requirements and that the agency's accounting system and method of operation can accommodate these requirements.
- Before submission, entities should ensure the proposal is complete and that all of the necessary supporting data and documentation has been included. This documentation may vary depending upon the particular circumstances involved in the negotiation. The items listed here are recommended to constitute the minimum documentation necessary and will normally have been requested in previous correspondence with the DCA. It is recommended that the submission, at a minimum, should include the following:
    - The rate(s) proposed, including subsidiary worksheets and other relevant data, cross-referenced and reconciled to the financial data.
        - The proposal should include detailed schedules on the composition and

allocation of all indirect cost centers. If a fixed rate is involved, the proposal should also include a schedule that computes the rate along with the carry-forward adjustment (examples of carry-forward computations are included as Attachment C).

- A copy of the financial data (financial statements, expenditure reports, etc.) upon which the rate(s) are based.
  - If the entity does not have certified financial statements, include statements that have been audited by state or local auditors in lieu of certified statements.
- The approximate amount of direct base costs incurred under Federal awards. It is recommended that these costs be broken out between salaries and wages and other direct costs.
  - Indicate the amount of salaries and wages (or total direct costs) incurred under grants and contracts which limit indirect cost reimbursement.
- A Certificate of Indirect Costs signed by the authorized official.
  - See the Circular, Appendix E, section D.3 for an example of the required certification.
- An organizational chart and functional statement(s) noting the duties and responsibilities of all units that comprise the agency.
  - If these documents were submitted with a previous proposal, only revisions to them need to be submitted with the subsequent proposal.

- The proposal should be adequately cross-referenced and reconciled to the financial data. In addition, it is recommenced that support be provided for non-agency expenditures, such as use allowance/depreciation expenses and central service costs (both Sections I and II), that are included in the proposal.
  - It is important to take care in assuring the amounts properly reconcile and all necessary supporting documentation is provided.
- Review prior proposals, negotiation files, negotiation agreements and other correspondence maintained to ascertain what adjustments have been made in previous years. Ensure these corrections were included in the current proposal.
- If any advance agreements were established in prior negotiations, ensure the current proposal is in compliance with the agreements.
  - In prior negotiations, advance agreements or letters received delineating discrepancies that should be corrected in their future proposals may have been established for future negotiations to preclude disputes or problems or to help ensure equitable cost determination in the future. Examples of such agreements include those involving (a) changes in the agency's accounting system, (b) performance of special studies or analysis in connection with the development of future proposals, (c) changes or refinements in allocation bases, (d) the treatment of certain types of costs (e.g. rent, depreciation, computer costs, idle facilities costs), and (e) limitations of certain costs. In some cases, a prior rate may have been accepted with the condition that the agency takes certain actions in the development of future proposals.
- If fixed rates are proposed, verify the carryforward computations.
  - See example at Attachment C
- Document whether a restricted or special rate(s) is or separate rates are needed for major organizational components of the agency.
  - Guidelines on the use of restricted and special rates are contained in the cost

principles. Separate rates for major organizational components of a department/agency are generally not required. However, they may be considered where the dollars involved are substantial and the characteristics of certain organizational components of the agency are such that there is reason to believe that they generate significantly different levels of indirect costs than other components. This is true for an agency which includes significantly different types of operations (e.g. state mental health departments and subordinate state hospitals).

  - The U.S. Department of Education (ED) requires "restricted" indirect cost rates for use on some ED programs awarded to state agencies for which HHS is cognizant. It is important to review the proposal to ensure the required restricted rate has been included.

- Review the OMB A-133 Single Audit report, if there are any audit findings/recommendations that affect the current proposal ensure that corrective actions have been addressed in the current proposal. If the applicable A-133 Single Audit report has not been issued, review the most recent audit report.

B. Recommended Review of Cost Allowability

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

Ensure the proposed expenses were incurred within the period under review.

- Normally, if the expenses as shown in the proposal reconcile to the financial data it can be assumed that they were incurred within that period.

Through the completion of a trend analysis ensure the proposed costs by expense categories are reasonable.

- It is recommended that the prior years' figures should be used in preparing a trend analysis that compares detailed costs for a minimum of three years.
- An explanation of any significant increases in the proposed indirect cost pool should be included.

Ensure the proposed indirect costs benefit Federal awards.

- Generally an expense that is necessary to the overall operation of the department/agency is allocable to Federal awards. When there is a multi-tier distribution involving more than one pool, the criterion is that the expense benefit all activities included in the particular distribution base.

Review the financial data and document if there are any applicable credits or expense off-sets.

- Income generated by the activities in the indirect cost pool and certain negative expenditure types of transactions should be used to off-set or reduce the expenses in the indirect cost pool (e.g. the sale of scrap, parking fees, cafeteria income, purchase discounts or rebates, etc.)

Review the proposal and financial statements to ensure the indirect cost pool does not include unallowable costs. Some examples of unallowable costs include (Unless otherwise noted, the number next to each item refer to the section number in Appendix B of the Circular which prescribe the handling of these costs):

- Equipment and capital expenditures (15)
  - Capital expenditures are allowable as direct costs if they are approved by the awarding agency. They are not allowable as indirect costs but instead are recovered through depreciation or use allowances.
- Alcoholic beverages (3)
- Bad debts (5)
- Contingencies (9)
- Contributions and donations (12)
- Legal expenses for prosecutions of claims against the Federal government (10.b)
- Entertainment (14)
- Fines and penalties (16)
- Fund raising (17)
- General government expenses (19)
- Lobbying (24 &28.d)
- Underrecovery of costs under Federal agreements
  - Refer to Circular, Appendix A, paragraph F.3.b

Review the following costs to determine whether they are properly treated. The costs listed here are particularly sensitive and it is therefore recommended that they be thoroughly reviewed when dictated by materiality.

- Depreciation or use allowance:
  - Ensure the value of the assets for depreciation/use allowance purposes was properly established. The value for depreciation/use allowances purposes is acquisition cost except where the asset was donated to the agency by a third party. Where the asset was donated by a third party, the value is the market value at the time of donation. Where acquisition cost is used it should reflect the actual amount recorded in the records of the state or, if cost records do not exist, an estimate of the acquisition cost, which is usually based on an independent and professional appraisal. Where such appraisals are used, care should be exercised to ensure that the amount used reflects the cost at the time of purchase and not replacement cost at the time of the appraisal. Where depreciation or use allowances are material in amount document that the valuation bases are proper and, if the amounts are based on appraisals, that such appraisals were performed by independent and professional appraisers or by other reliable methods (e.g. insurance valuations).
  - The cost of land and the portion of assets that are Federally financed or financed with matching contributions should have been eliminated from the computation.
  - Ensure that a combination of the use charge and depreciation methods has not been used for a single class of fixed assets.
  - If depreciation is proposed, ensure that the depreciable lives that have been established are reasonable.
    - In the absence of historical usage patterns, guidance in this area can be found in the Circular, Appendix B, section 11.d (1) or IRS depreciation guidelines.
  - Ensure the depreciation/use allowances on idle facilities have been properly handled.
  - The depreciation methods used should result in an equitable allocation of costs to the time periods in which the assets are used.

        - Depreciation methods other than the straight-line method are not be accepted unless the circumstances fully justify their usage (i.e., when it can be demonstrated that the assets are being consumed faster in the earlier years than in the latter years of their useful life).
        - See the Circular, Appendix B, section 11.e. and f.(3) for guidelines on treatment of building components.
    - The charges for use allowances or depreciation should be adequately supported by property records.
        - When the depreciation method is followed, depreciation records indicating the amount of depreciation taken each period must also be maintained.
    - If use allowances are proposed, ensure that a factor no greater than 6 2/3 percent has been used for equipment and 2 percent has been used for buildings.
- Rental Costs.
    - Refer to the Circular, Appendix B, section 37, for limitations on the amount of rental costs that may be charged to Federal awards under various types of leasing arrangements (e.g. sale and leaseback arrangements, less-than-arms-length leases and capital leases).
    - Specialized facilities (e.g. computer centers).
        - The costs of these types of facilities should not be included in the indirect cost pool when they are material in amount or when the facilities benefit a limited number of activities. Normally, costs of this nature should be charged directly to benefiting activities via a schedule of rates designed to recover their total costs.
        - The costs of the facility should consist of its direct costs as well as its allocated share of indirect costs, including general administration, operations and maintenance, depreciation/use allowances, fringe benefits, etc. Variances between the actual costs of the facilities and the direct charges to benefiting activities in a given period should be adjusted in accordance with the Circular.
    - Idle (excess) facilities or capacity.
        - Idle facilities are defined as completely unused facilities that are in excess of the institution's current needs. Idle capacity is the unused capacity of partially used facilities (i.e., the difference between 100 percent capacity and actual usage of the facility). See the Circular, Appendix B, section 21.

Ensure that any state or local central service costs have been included in the proposal are properly supported.

- To be allowable, the costs must be supported by a cost allocation plan prepared by the state or locality. For plans prepared by the state, they must be approved by HHS/DCA. The state's cost allocation file will likely be reviewed to determine whether the cost allocations were approved and whether they agree with the proposed costs.
- The localities should also prepare cost allocation plans but are generally not required to obtain approval unless specifically requested to do so by the cognizant Federal agency.

Review fringe benefit costs.

- Verify that the treatment of fringe benefits in the indirect cost rate proposal is consistent with the central service cost allocation plan.

Ensure the types of costs included in the indirect cost pool are consistently treated as indirect costs.

- Any costs included in the indirect cost pool that have also been charged to any Federal awards as direct costs that are charged directly, should be removed from the indirect cost pool except to the extent that they apply to indirect activities.

C. Recommended Review of Allocation Bases

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

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

- Ensure the proposed bases result in an equitable distribution of indirect costs.
  - Generally, if the proposed bases conform to the suggested or required bases they should be acceptable. However, there may be circumstances which indicate that an inequity will result if a suggested base is used. For example, total expenditures exclusive of capital expenditures is a suggested base. However, the existence of major subcontracts will usually require the use of a modified total expenditure base excluding major subcontracts or a different base such as salaries and wages.
- The proposed bases should include all activities which benefit from the indirect costs that are allocated, including where appropriate:
  - Activities associated with general funds
  - Activities associated with restricted, special purpose, or other funds
  - Grants and contracts
  - State institutions (e.g. hospitals, universities)
  - Cost used for cost sharing or matching purposes
  - Non-state organizations which receive services (e.g. an affiliated foundation, a local government agency, etc.)
  - Unallowable activities
    - Unallowable costs must be included in the direct costs if they represent activities to which indirect costs are properly allocable. Unallowable activities include unallowable compensation costs, such as public relations, fund raising, and investment management activities.
  - Services donated to the agency by third parties
    - The value of donated services utilized in the performance of a direct cost activity shall, when material in amount, be considered in the determination of the agency's indirect costs or rate(s) and, accordingly, shall be allocated a proportionate share of applicable indirect costs. Also, see ASMB C-10, Question 2-15.

- The data included in the bases (e.g. square footage, number of employees, time studies, etc.) should be current and accurate.
    - This applies only to multiple allocation base proposals.

D. Recommended Concluding Steps

Identify any significant anticipated changes in the level of the institution's activities, its organization structure, or its accounting system that should be taken into account in the negotiation of a provisional, fixed or predetermined rate(s).

- Normally this rate(s) is based on the actual costs for the most recently completed fiscal year. However, if the agency anticipates significant changes in its operations that should affect the costs, the changes should be reflected in the establishment of the rate(s).

Advance agreements are often established when they are needed to preclude future disputes or problems or when they will help ensure equitable cost determinations in the future. Examples of areas where these agreements may be needed include (a) changes or refinements in allocation bases, (b) the treatment of certain types of costs, (c) changes in the agency's accounting system, and (d) limitations of certain costs. If an advance agreement is established it should be provided in the letter transmitting the Negotiation Agreement.

Negotiating the appropriate type of rate(s) (e.g. provisional, fixed, predetermined, or final):

- Contact will more than likely be maintained with the agency throughout the review of the proposal. The negotiator at the conclusion of the negotiation should contact the agency to (a) summarize the adjustments (if any) and the term or conditions incident to the acceptance of the rate(s) and (b) gain concurrence on a final position.
- Guidance on the circumstances under which costs will be negotiated on a provisional, final, fixed or predetermined basis are as follows:
    - Provisional rates are typically used only in those situations in which the negotiator has little confidence in the rate proposed and cannot negotiate a rate which will fairly reflect an agency's operations during the period to which the rate applies. Provisional rates are also be used when (i) the propriety of the rates are contingent upon the occurrence of a future event which is uncertain at the time of negotiation or (ii) the agency plans to reorganize or otherwise substantially change its operations in the future. When a provisional rate is established, a final rate must be negotiated when the actual costs for the period become known.
    - Predetermined rates are only negotiated in those situations where there is a high probability that the rate negotiated will result in a dollar recovery to the agency not in excess of the amount that would have been recovered had the rate been established on an "after-the-fact" basis. Predetermined rates are not authorized if there are contracts awarded to the grantee agency.
    - Fixed rates with carry-forward provisions may be used except where the carry-forward adjustment would be difficult or impossible to make because:
        - the agency is unlikely to have active awards in the future periods to effect the carryforward adjustment against,
        - the mix of Federal/non-Federal work performed by the agency from year to year is too erratic to permit a fair carry-forward adjustment,
        - the operating activities of the agency are unstable,
        - the negotiator is not satisfied that the rate proposed will approximate the actual rate.
    - The negotiator will typically avoid setting fixed rates which result in major carry-

forward adjustments. They may consider setting limitations on the amount of permissible adjustment (e.g. spread over more than one fiscal year).

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

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