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FEDERAL RESEARCH COMPLIANCE: FINANCIAL & ADMINISTRATIVE ISSUES

By Robert J. Kenney, Jr. and Michael F. Mason

Thousands of colleges and universities, academic medical centers, research institutions, hospitals, and other research entities throughout the United States receive funding from the Federal Government to conduct biomedical and other scientific research. In Fiscal Year 2001, the National Institutes of Health alone awarded an estimated $16 billion in grants, cooperative agreements, and contracts supporting the biomedical and behavioral research and training of over 50,000 scientists at more than 2,000 institutions.[1] Since World War II, the support of extramural research—research conducted by entities other than federal agencies—has developed into one of the Federal Government's most dramatically successful programs. The strong links of financial support and scientific cooperation between the Federal Government and the U.S. research community have played and continue to play an indispensable role in the advancement of science in the United States and the world.

From the perspective of recipients of federal research funds, however, that support comes with important strings attached. Legal obligations and potential liabilities that are generally nonexistent in privately funded research are an everyday reality for those who conduct federally sponsored research. These obligations and liabilities are imposed by a formidable and increasingly complex web of statutes, regulations, policy statements, and agreement terms and conditions. This unique federal regulatory framework covers virtually all aspects of the research process. There are detailed Government-wide and agency-specific "cost principles" and "Cost Accounting Standards" that govern federal reimbursement of costs incurred by research entities.[2] There are pervasive administrative requirements designed to promote the efficient use of Government funding and property. There are rules and procedures on scientific misconduct[3] and conflicts of interest intended to help ensure that research is conducted with integrity and is not tainted by inappropriate financial and personal interests. Other important rules and procedures protect the safety and rights of human research subjects and promote the ethical treatment of laboratory animals. Still others implement federal law and policy on

IN BRIEF

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the use and commercialization of intellectual property and on a wide variety of socioeconomic issues. Backing up many of these rules and regulations are federal statutes containing civil, administrative, and even criminal penalties for violations. Nothing even remotely like this federal regulatory structure governs privately sponsored research.

Any research institution that receives federal funding must build and apply compliance mechanisms addressing all applicable federal regulatory requirements. The most fundamental step in any federal research compliance program—although by no means the only step—is to understand what the applicable rules are and to keep up with their frequent changes. To that end, this BRIEFING PAPER addresses some key points and recent regulatory developments affecting federally sponsored research, with a focus on financial and administrative compliance issues. (A future PAPER will cover scientific and bioethics compliance issues.) This PAPER is not intended to be a definitive discussion of the topics addressed—indeed, many of the individual topics could themselves be subjects of small books. The aim, rather, is to discuss each development in sufficient depth to indicate how it affects or may affect a research institution's compliance program.

Specifically, this BRIEFING PAPER discusses (a) the often troublesome subject of *effort reporting*, a requirement that applies to any institution charging salaries of employees to federally sponsored agreements, (b) *voluntary cost sharing*, including a discussion of the Office of Management and Budget's important clarification of the treatment of voluntary uncommitted cost sharing, (c) the rules applicable to the direct charging of *administrative and clerical salaries* to federally sponsored agreements—a practice that has been the subject of increasing scrutiny by Government auditors and investigators, (d) the OMB's clarification of rules applicable to reimbursement of *graduate student tuition remission* costs, and (e) some of the more significant changes set out in the March 2001 *NIH Grants Policy Statement*—one of the major sources of federal research rules. In addition, this PAPER concludes with some advice for research institutions on transforming substantive knowledge of these complex rules into *effective compliance programs*.

Background

An institution's performance of research with Government funds is constrained by a set of statutory, regulatory, and administrative requirements that govern the expenditure of funds. Some of the more important requirements are set forth in various federal "cost principles" that govern the institution's ability to charge direct and indirect (also referred to as "facilities and administrative" or "F&A") costs to federally sponsored agreements (i.e., grants, cooperative agreements, and sometimes contracts). The applicable set of cost principles for educational institutions is set out in OMB Circular A-21.[4] OMB Circular A-122 provides the cost principles for nonprofits other than education institutions,[5] and Appendix E to Title 45 of the *Code of Federal Regulations* governs hospitals. Part 31 of the Federal Acquisition Regulation contains the cost principles that

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apply to commercial organizations and certain nonprofit institutions exempt from OMB Circular A-122.[6]

The following discussion focuses on several current subjects of interest concerning compliance with the federal cost principles and administrative requirements. Each subject has been selected either because it has recently been the focus of one or more significant developments or because it involves issues that are likely to become the subject of increased scrutiny by federal auditors and investigators. The discussion focuses on compliance with OMB Circular A-21 because educational institutions are by far the largest recipients of federal research dollars and because much of the recent activity with respect to these topics has involved the application and interpretation of OMB Circular A-21.

Effort Reporting

Compliance with effort reporting requirements, particularly faculty effort reporting, is an area of significant and growing risk for research institutions. Because there are many different ways of thinking of what "effort" is and how it relates to particular sponsored projects, the process of estimating and reporting effort associated with federal research is, at best, an inexact science At worst, effort reporting systems can become corrupted by myths, some of which are used to rationalize effort reporting methods that are simply wrong.

Historically, federal auditors have given institutions that receive Government funding a certain degree of latitude in reporting faculty effort. This qualified level of tolerance is supported by OMB Circular A-21, which provides as follows in its selected cost provision on compensation for personal services: [7]

> In the use of any methods for apportioning salaries, it is recognized that, in an academic setting, teaching, research, service, and administration are often inextricably intermingled. A precise assessment of factors that contribute to costs is not always feasible, nor is it expected. Reliance, therefore, is placed on estimates in which a *degree of tolerance* is appropriate.

Notwithstanding the "degree of tolerance" that OMB Circular A-21 permits, there are certain *basic requirements* that any compliant effort reporting system must meet. Recently, federal auditors and investigators have increasingly questioned whether particular institutions' effort reporting systems are in compliance with these basic requirements. Broadly speaking, this increased attention has focused on three types of situations: (1) significant and widespread noncompliance with the *procedural* requirements of the applicable cost principles, (2) egregious or widespread *overstatement* of federal research effort, and (3) systematic *understatement* of other organized research effort.

■ Basic Requirements

The effort reporting requirements applicable to educational institutions that conduct Government-funded research are based largely on the cost principles set out in OMB Circular A-21. Pursuant to OMB Circular A-21, educational institutions that conduct federally funded research must establish payroll distribution systems that are maintained as part of their official records.[8] These systems, which are commonly referred to as "effort reporting systems," must keep track of the *total activity* of each employee whose salary is charged to a federally sponsored agreement.[9] The determination of what constitutes an employee's total activity is not confined to sponsored research activities but includes administration, instruction and unsponsored scholarly activity, clinical activity, and other activity for which the institution compensates the employee. OMB Circular A-21 does not require that the effort reporting system keep track of "incidental work" for which an employee receives supplemental compensation in accordance with the institution's policies, provided that such work and compensation are separately identified and documented in the institution's financial management system.[10]

The amount of an employee's compensation that an institution may charge to a federally sponsored agreement is based on the employee's level of effort expended performing

research under that agreement compared to the employee's university-compensated effort expended across all activities.[11] For example, in the case of an employee whose university salary is $60,000 and who spends 50% of his or her total university-compensated effort on a particular federally sponsored agreement, the institution may charge to the sponsored agreement up to $30,000 of that employee's annual salary. An employee's recorded total effort across all activities may not exceed 100%, regardless of the number of hours that constitutes a "full workload" for the employee. Therefore, for an employee who expends 10 hours of a 50-hour workweek on a particular federally sponsored agreement, the institution generally may charge to the agreement no more than 20% of the employee's salary. The institution may not, for example, charge to the agreement 25% of the employee's salary based on an argument that a 40-hour workweek is considered to be the "norm" for the Federal Government or in general.

OMB Circular A-21 also requires that the institution's effort reporting system include some form of confirmation to ensure that each salary being charged to a federally sponsored agreement is based on actual expended effort.[12] This confirmation must be performed by a responsible person with a suitable means to verify each employee's actual level of effort.[13] Accordingly, the confirmation can be obtained from the employee himself or from another individual, such as the principal investigator, who has sufficient knowledge of the employee's work to confirm the effort being charged to the research project.

Although OMB Circular A-21 provides that there is no single best system of effort reporting (as long as the system meets the OMB Circular A-21's basic requirements),[14] the type of system most commonly used by educational institutions is the "after-the-fact activity records" system.[15] Under this system, employee effort allocations are supported by effort reports that list the employee's compensated activities and the percentage of the total for each activity. Institutions may charge employee compensation to a sponsored agreement initially on the basis of estimates made before the services are performed, provided that such charges are promptly adjusted if "significant differences" are indicated by the effort reports.[16] For purposes of the reporting system, "[s]hort-term (such as one or two months) fluctuation between workload categories need not be considered as long as the distribution of salaries and wages is reasonable over the longer term, such as an academic period."[17] Effort reports must be signed by the employee, principal investigator, or responsible official able to verify the level of work performed.[18] Effort reports must be generated no less frequently than every six months for professorial and professional staff and generally no less frequently than monthly for all other employees.[19] For effort reporting systems that satisfy OMB Circular A-21's standards, the institution is not required to provide additional support or documentation for the effort actually performed.[20]

■ Noncompliance With Procedural Requirements

Although serious misreporting of effort sometime occurs in individual cases, in general, federal auditors and investigators are concerned with *systematic* defects in effort reporting procedures. Given the "degree of tolerance" prescribed by OMB Circular A-21[21] and the practical difficulty of estimating effort in an academic research setting, federal auditors and investigators are unlikely to insist on precise accuracy of effort in every case. They are, however, likely to raise concerns if there is evidence that an institution's *systems and procedures* for effort reporting are deficient, or that the systems and procedures are not followed or adequately enforced.

One common example of a systematic compliance defect is the failure of individuals who are responsible for confirming effort reports to adjust *inaccurate information* contained in the reports. In many institutions that use the after-the-fact activity records system, the effort report form generated for the employee's or responsible official's signature contains *preprinted* percentages representing the individual's effort expended on each sponsored agreement. These preprinted percentages are often based

on the institution's original before-the-fact budget projections, which in turn have been entered into the institution's payroll distribution system to allocate salary to sponsored agreements pending the completion of the after-the-fact activity reports. Since circumstances frequently change between the time a budget estimate is prepared and the time that work on a sponsored agreement is actually performed, the preprinted percentages that appear on the effort report form may not accurately reflect the actual percentage of effort that an individual has expended. If the preprinted percentages do not substantially correspond to the effort actually expended by the individual during the report period, they must be manually corrected to reflect actual effort. Faculty members and personnel responsible for confirming effort reports, however, sometimes wrongly believe that they are not permitted to change the preprinted effort percentages. Even where individuals understand that they are permitted (indeed required) to correct inaccurate preprinted effort percentages, they sometimes fail to do so. Where Government auditors or investigators observe that preprinted effort percentages are never or rarely amended, they may question whether the institution's effort report forms may be reasonably relied upon to justify charges to federally sponsored agreements.

Systematic noncompliance with effort reporting procedures may also be reflected in noncompliance with *documentation requirements*. OMB Circular A-21 requires that payroll distribution systems be maintained as part of the institution's official records.[22] Moreover, OMB Circular A-110, which sets forth uniform administrative requirements applicable to institutions of higher education, hospitals, and other nonprofit organizations, includes a general requirement that institutions conducting federally sponsored research maintain supporting records pertinent to the research.[23] Missing effort report forms, report forms with missing signatures, and report forms signed by persons with no reasonable basis to confirm an individual's actual level of effort are all defects that could give rise to allegations of mischarging, especially if the institution lacks backup data to verify the costs charged to the agreement.[24]

Systematic effort reporting problems may also arise in connection with the *compensation cap* that applies to research funded by the NIH. Pursuant to the Department of Health and Human Services Appropriations Act, 2001, an institution may not charge an employee's salary to an NIH-sponsored agreement funded with FY 2001 appropriations at an annual rate that exceeds Executive Level I of the Federal Executive Pay Scale—currently set at $161,200 per year.[25] Salary restrictions imposed in previous appropriations acts cap salaries at Executive Level II for awards made with FY 2000 appropriations and at Executive Level III for awards made with FY 1999 appropriations.

The NIH salary cap limitation applies to the "institutional base salary," which is the annual compensation that the institution pays for an individual's appointment (including time spent on research, teaching, patient care, and other activities).[26] The limitation, however, is exclusive of fringe benefits and F&A costs.

The following chart sets forth the amounts of the most recent NIH salary caps, by appropriation and award date:

Compensation Cap	Applicable Dates
$125,900	Oct. 1, 1998—Dec. 31, 1999 (FY 1999 awards)
$130,200	Jan. 1, 1999 and beyond (FY 1999 awards)
$136,700	Oct. 1, 1999—Dec. 31, 1999 (FY 2000 awards)
$141,300	Jan. 1, 2000 and beyond (FY 2000 awards)
$157,000	Oct. 1, 2000—Dec. 31, 2000 (FY 2001 awards)
$161,200	Jan. 1, 2001 and beyond (FY 2001 awards)

The manner in which an NIH-funded research institution implements the NIH salary cap could have compliance implications with respect to effort reporting. There are at least

three kinds of effort reporting problems that the NIH salary cap could potentially raise:

(a) *Matching "base" salary with "base" effort.* In some cases, institutions have responded to the NIH salary cap by restructuring their faculty salaries into a "base" component and one or more "extra" components (such as a clinical component or a "bonus" component). As indicated above, the NIH salary cap applies only to the base salary component. For example, assume that a medical school faculty member earns $241,800 (50% more than the $161,200 cap) and that the faculty member's effort is equally divided among three activities: (1) teaching, (2) one federal grant, and (3) clinical practice. The faculty member's effort report would show one-third of his effort on his federal grant, but because of the NIH salary cap, only one-third of $161,200, or about $53,733, could be charged to the NIH grant. The institution might respond to this situation by designating the $80,600 salary overage as separate compensation attributable solely to the faculty member's clinical activities, leaving a "base" salary of only $161,200. Since the base salary would then be compensation only for teaching and research (and not clinical practice), and since the faculty member's teaching and grant effort are equal, 50% of the faculty member's base salary ($80,600) could be charged to the grant.

Such restructuring is not inherently problematic and may in some circumstances more accurately reflect the nature and sources of faculty members' compensation. However, care must be taken to ensure that the "base" salary and the categories of effort associated with the base salary are properly matched. For example, if the $80,600 attributed to the faculty member's clinical practice is significantly less than the market value of the faculty member's clinical effort, a federal auditor might conclude that part of the "base" salary is also attributable to clinical effort, so that the base salary cannot properly be allocated 50% to teaching and 50% to research. Conversely, if the $80,600 "clinical component" is far more than the market value of the faculty member's clinical activity, a federal auditor might contend that the "base" salary attributable to teaching and research should be substantially higher than $161,200—for example, $200,000. This contention would not cause the institution to recover less salary on the federal grant (it would still recover 50% of $161,200, or $80,600), but the unrecovered portion of the faculty member's salary ($19,400 in the case of a recalculated "base" salary of $200,000) would be considered "cost sharing" and would have to be treated as such for purposes of the institution's indirect cost rate calculation (see paragraph (c) below).

(b) *Distortions caused by some payroll distribution systems.* In some cases, an institution's payroll distribution system may not be flexible enough to recognize any salary amount for an individual other than the individual's actual salary. Where the amount of an employee's salary actually charged to a federally sponsored agreement is constrained by the NIH salary cap, such inflexible systems may result in distortions in effort report forms. For example, in the case of a faculty member earning a base salary of $201,500 who spends one-half of his total effort on an NIH grant, the grant could be charged only $80,600 (50% of the cap of $161,200). Some payroll distribution systems would compare this $80,600 to the faculty member's total salary of $201,500 and infer that only 40% of the faculty member's effort was expended on the federal grant since only 40% of the faculty member's salary ($80,600 divided by $201,500) was charged to the grant. This 40% figure would then be preprinted on the employee's effort report and, if not corrected, would lead to an overstatement of the percentage of effort expended on other activities.

(c) *Capturing cost sharing.* The Government generally contends, although there is considerable room for argument on the point, that the amount of an individual's salary that is allocable to an NIH-sponsored agreement but not recovered because of the NIH cap should be treated as "cost sharing"—that is, an institutional contribution to the sponsored agreement effort. In effect, this means that if 20% of a faculty member's salary allocable to an NIH-

sponsored agreement is "lost" to the NIH cap, then 20% of the indirect (F&A) costs that would otherwise be recoverable by the institution with respect to that sponsored agreement effort would also have to be forgone by the institution. This effect is not felt on an agreement-by-agreement basis but results from the way in which F&A cost rates are calculated. (See the discussion below of voluntary cost sharing.) Given the Government's position, an institution should have some mechanism for keeping track of salary "lost" to the NIH cap so that the "lost" salary can be reflected as cost-sharing for F&A cost recovery purposes. Not all payroll distribution systems, however, are capable of such tracking. For example, in the example discussed above in paragraph (b) of a faculty member earning a base salary of $201,500 who spends one-half of his total effort on an NIH grant, the Government would contend that there was cost-sharing in the amount of $20,150 (50% of $201,500, less the $80,600 actually recovered), but the payroll distribution system would ignore this amount and convert the $80,600 recovery into an erroneous 40% effort allocation.

■ Overstatement Of Actual Effort

The incentive to overstate effort on a sponsored agreement can be significant. The great pressures on researchers in many institutions to cover a high percentage of their compensation through outside funding sources sometimes creates temptations for faculty or administrators to overstate how much effort is actually being expended on a particular federally sponsored agreement. Moreover, principal investigators who are responsible for more than one sponsored project are on occasion somewhat arbitrary in charging effort to one project or another, or they may adjust effort allocations depending on the level of available funding of the projects without regard to how the effort is actually being expended.

Overstatement of actual effort expended on federal projects is a significant source of liability exposure for research institutions. Where an overstatement exceeds even the "degree of tolerance" for effort reporting prescribed by OMB Circular A-21,[27] the overstatement will often be relatively easy for federal auditors to detect and prove. For example, a faculty member claiming to have performed research on federal projects equal to or approaching 100% of the faculty member's total effort may find it difficult to reconcile this claim with the effort required for the faculty member's other known duties, such as teaching and administrative or clinical activities. A similar situation arises where a faculty member who is a principal investigator under a federally sponsored agreement receives an additional sponsored agreement under which he or she commits to performing a significant level of effort but does not adjust his or her claimed effort on preexisting agreements. A federal auditor's examination of that faculty member's responsibilities and time spent regarding other activities may make it readily apparent that the effort claimed to have been expended on a federally sponsored agreement has been significantly overstated.

Monetary liability posed by overstatements of effort can be substantial. The Government may demand repayment of costs charged based on such overstatements. In addition, private institutions[28] may face significant liability under the civil False Claims Act.[29] Under the Act, institutions found to have knowingly presented a false claim to the Government may be assessed treble damages and penalties up to $10,000 per false claim[30] (or $11,000 for violations on or after September 29, 1999[31]). Intentional overstatements of effort that form the basis for the charging of salaries to a federally sponsored agreement could well fall within the concept of "claims" that may give rise to liability under the Act. Moreover, false effort reporting claims are relatively easy for prosecuting Department of Justice attorneys—and juries—to understand, compared to other more technical, complex, or ambiguous accounting issues arising under the OMB Circular A-21 cost principles.

■ Understatement Of Actual Effort

It is not uncommon for Government auditors and F&A cost rate negotiators to suspect

that an institution has failed to account for all effort, whether charged or not charged to an agreement, spent by faculty members or senior researchers on federally sponsored agreements. This is especially true for research projects for which little or no faculty or senior research effort has been reported. The Government's position is that some level of such effort, even if only supervisory effort, is necessary and expected on most research projects.

Effort expended but not charged to a federally sponsored agreement is commonly referred to as "voluntary cost sharing." From the Government's perspective, voluntary cost sharing represents effort that should bear F&A costs in proportion to that assigned to other organized research effort. By not accounting for voluntary cost sharing, the institution's organized research base is lower than if the base included such effort, which, in turn, may have a downward effect on F&A cost rates negotiated in subsequent years. The topic of voluntary cost sharing, including the OMB's clarification on the treatment of voluntary uncommitted cost sharing, is addressed more fully in the next section of this BRIEFING PAPER.

Voluntary Cost Sharing

■ Committed vs. Uncommitted

Voluntary cost sharing refers to a variety of methods by which educational institutions and their faculty members contribute to the costs of performing federal research. One common form of voluntary cost sharing is the principal investigator's voluntary offer in a grant proposal to charge a federal sponsor for only a portion of the effort that the principal investigator plans to devote to the grant. This type of voluntary cost sharing is sometimes referred to as *voluntary committed cost sharing*.

Another form of voluntary cost sharing is *voluntary uncommitted cost sharing*. This type of cost sharing occurs in situations in which the principal investigator devotes a greater percentage of effort to the project than indicated or mandated in the grant proposal or award document. For example, a principal investigator may propose to devote 25% of his or her effort to a federal grant and to charge 25% of his or her salary to that grant. If the principal investigator actually devotes 40% of his or her effort to the grant but charges for only 25%, the 15% not charged to the Federal Government represents voluntary *uncommitted* cost sharing because it was not promised in the grant proposal or otherwise. In the case of a principal investigator whose annual salary is $100,000, this 15% in voluntary uncommitted cost sharing would translate into $15,000 of service provided at no cost to the Government.

■ Accounting Issues

For years, the problem with voluntary cost sharing (whether "committed" or not) has been that federal auditors and rate negotiators have interpreted certain provisions of Circular A-21 and the Cost Accounting Standards applicable to educational institutions[32] to require that the institution assign a proportionate share of F&A costs to any voluntary effort, thereby in effect forgoing not only the direct cost of the effort voluntarily provided but also the F&A costs associated with that effort. This proportionate allocation of F&A costs associated with voluntary cost sharing can be accomplished either by including the full amount of voluntary cost sharing in the institution's organized research base or by reducing the pool of F&A costs allocated to organized research by an amount proportional to the amount of voluntary effort. A 1999 report by the National Science and Technology Council described research institutions' view of the Government's proportionate allocation requirement as follows:[33]

> Universities regard this requirement as a double penalty; not only does the university bear the costs of the direct charges for faculty time spent on the project above that expected, but including those direct costs in the base of organized research decreases the F&A rate for the school for all projects.

As applied to the example above of a principal investigator with a $100,000 salary and 15% of effort in voluntary uncommitted cost sharing, the institution would, in effect, wind

up contributing not only the $15,000 it intended to contribute but also an additional amount that may take the form of a reduction in the institution's F&A cost rate caused by the inclusion of the $15,000 in the institution's organized research base.

The Government's interpretation also resulted in a substantial reporting burden for research institutions. It required institutions to expend administrative effort to perform the difficult task of documenting faculty time being freely donated to research projects. As a result, some universities developed policies to limit or even prohibit voluntary cost sharing.

■ OMB Memorandum M-01-06

On January 5, 2001, the OMB issued a memorandum to clarify the proper treatment of voluntary uncommitted cost sharing.[34] Rejecting the interpretation of many Government auditors and cost negotiators, OMB Memorandum M-01-06 provides that educational institutions may treat voluntary *uncommitted* cost sharing differently from *committed* effort on the ground that voluntary uncommitted cost sharing effort is faculty-donated additional time above that agreed to as part of the award. The memorandum specifically provides that voluntary uncommitted effort should neither be included in the institution's organized research base for F&A cost purposes nor reflected in the allocation of F&A costs.[35]

The memorandum also addresses the difficulties associated with "capturing" voluntary uncommitted cost sharing. It provides that educational institutions may exclude voluntary uncommitted faculty effort from the effort reporting requirements of OMB Circular A-21. This interpretation is consistent with the Circular's recognition that a "precise assessment of factors that contribute to costs is not always feasible, nor is it expected" because of the inexplicably intermingled functions performed by faculty in an academic setting (i.e., teaching, research, service, and administration).[36]

In what appears to be a special exception to the "committed vs. uncommitted" distinction in OMB Memorandum M-01-06, the memorandum indicates that even uncommitted voluntary cost sharing must be accounted for if it results from an express assignment of faculty effort by the institution:[37]

> [W]hen an institution reduces a faculty member's level of activities dedicated to other institutional responsibilities in order to shift his/her activities to organized research activities, the institution must reflect this reduction in the payroll distribution system (as an increase to the research effort component) and in the F&A proposals.

For example, if a faculty member's appointment document is revised to indicate that some percentage of the faculty member's effort will be expended in unreimbursed organized research, the institution must include that effort in the organized research base even though it has not been "committed" to in any grant proposal. This situation will presumably be quite rare.

The memorandum also states that most sponsored research programs should have some level of committed faculty (or senior researcher) effort, paid or unpaid by the Federal Government. If a sponsored agreement for research identifies no such effort, "an estimated amount must be computed by the university and included in the organized research base."[38] This requirement excludes, however, research programs such as programs for equipment and instrumentation, doctoral dissertations, and student augmentation that do not require committed faculty.[39]

OMB Memorandum M-01-06 may signal the end, or at least the beginning of the end, of the decades-long battle between the Federal Government and research institutions over the accounting treatment of voluntary cost sharing. The memorandum does, however, leave some skirmishes still to be fought. One important issue that the memorandum does not squarely address is how to treat voluntary committed cost sharing that is not actually provided. For example, if a principal investigator "commits" in a grant proposal to expend 40% effort on a federal grant and charge for only 25%, but in the end provides only 35% effort (and charges for 25%), it is unclear what amount should be included in the organized research base—the 15% promised or the 10% actually

provided. The Government may be expected to contend that the 15% must be included—even though legally the principal investigator had the right to reduce his or her total effort from 40% to 35% without federal approval. As a practical matter, institutions should probably proceed on the assumption that they must either include the full committed amount or be prepared to prove convincingly that less than the full amount of voluntary effort was actually provided.

Administrative & Clerical Salaries

The practice of charging administrative and clerical salaries *directly* to federally sponsored agreements is another area of increasing scrutiny by federal auditors and investigators. In general, administrative and clerical salaries should not be charged directly to federally sponsored agreements but should instead be included in the cost pools used to determine the institution's F&A cost rate.[40] There may be circumstances, however, in which administrative and clerical salaries (e.g., salaries of secretarial staff, accountants, and administrators) may be charged directly to a federally sponsored agreement.[41]

Specifically, OMB Circular A-21 permits educational institutions to charge administrative and clerical salaries directly to a federally sponsored agreement if (a) the costs are incurred in connection with a "major project" or activity, (b) the project or activity explicitly budgets for administrative or clerical services, and (c) the individuals involved can be specifically identified with the project or activity.[42] The determination of whether this test has been met frequently depends on whether the project qualifies as a "major project." OMB Circular A-21 defines "major project" as "a project that requires an extensive amount of administrative or clerical support, which is significantly greater than the routine level of such services provided by academic departments."[43] The Circular lists the following examples of "major projects":[44]

(1) Large, complex programs, such as general clinical research centers, primate centers, program projects, environmental research centers, and other grants and contracts that entail assembling and managing teams of investigators from a number of institutions.

(2) Projects that involve extensive data accumulation, analysis, and entry, surveying, tabulation, cataloging, searching literature, and reporting, such as epidemiological studies, clinical trials, and retrospective clinical records studies.

(3) Projects that require making travel and meeting arrangements for large numbers of participants, such as conferences and seminars.

(4) Projects where the principal focus is the preparation and projection of manuals and large reports, books, and monographs (excluding routing progress and technical reports).

(5) Projects that are geographically inaccessible to normal departmental administrative services, such as seagoing vessels, radio astronomy projects, and other research field sites that are remote from the campus.

(6) Individual projects requiring significant amounts of project-specific database management, individualized graphics or manuscript preparation, human or animal protocols and other project-specific protocols, and multiple project-related investigator coordination and communications.

It would be a mistake, however, to treat the "major project" provision as a blanket exception, superseding even OMB Circular A-21's requirement that institutions treat the same costs similarly in similar circumstances.[45] For example, OMB Circular A-21 states that "[i]t would be inappropriate to charge the cost of such activities directly to specific sponsored agreements if, in similar circumstances, the costs of performing the same type of activity for other sponsored agreements were included as allocable costs in the institution's F&A cost pools."[46]

The Circular further provides that application of predetermined F&A cost rates may make charging administrative or clerical salaries related to major projects inappropriate if such costs were not provided for in the allocation base that was used to determine the predetermined F&A cost rates.[47] Thus, even if other criteria for major projects are satisfied, it is possible that an institution could not directly charge administrative and clerical salaries associated with major projects if costs of that type were not included in the indirect cost pool for purposes of computing the institution's last F&A cost rate.

Graduate Student Tuition Remission

In addition to clarifying the treatment of voluntary uncommitted cost sharing, OMB Memorandum M-01-06 addressed the proper treatment of the costs of graduate student tuition remission—the forgiveness of tuition as a form of compensation. The charging of the graduate student tuition remission costs to federally sponsored agreements became a point of concern for many research institutions after the filing of a qui tam lawsuit under the civil False Claims Act[48] in 1998 against a leading research university in which the plaintiff alleged that the university defrauded the Federal Government of $100 million.[49] The plaintiff alleged that the university treated graduate student researchers as "employees" for purposes of charging the cost of tuition remission to federally sponsored agreements but treated the same costs as student aid rather than compensation for federal income tax purposes.[50]

The OMB Circular A-21 selected cost provision on the allowability of scholarships and student aid costs is the cost principle that governs the charging of graduate student tuition to federally sponsored agreements. It provides as follows on tuition remission costs:[51]

> Tuition remission and other forms of compensation paid as, or in lieu of, wages to students performing necessary work are allowable provided that (1) there is a bona fide employer-employee relationship between the student and the institution for the work performed, (2) the tuition or other payments are reasonable compensation for the work performed and are conditioned explicitly upon the performance of necessary work, and (3) it is the institution's practice to similarly compensate students in nonsponsored as well as sponsored activities.

The issue raised by the lawsuit was whether the university could treat graduate student researchers as bona fide employees under this cost principle for purposes of charging tuition remission to federally sponsored agreements, while at the same time excluding the amount of tuition remission from gross student income for federal tax purposes.

The uncertainty concerning this issue prompted OMB to address it in its January 5, 2001 memorandum. OMB Memorandum M-01-06 unequivocally indicates that the "bona fide employer-employee relationship" requirement does not mean that educational institutions must treat students as university employees for tax purposes in order for tuition remission costs to be an allowable expense.[52] Although labeled a "clarification," the memorandum in reality sets forth a revised test for determining whether the cost of tuition remission may be charged to federally sponsored agreements. [53] Under the OMB's revised test, such charges are allowable under the following conditions:[54]

> (1) The individual is conducting activities necessary to the sponsored agreement;
>
> (2) Tuition and other support are provided in accordance with established educational institutional policy and consistently provided in a like manner to students in return for similar activities conducted in nonsponsored as well as sponsored activities; and
>
> (3) During the academic period, the student is enrolled in an advanced degree program at a grantee or affiliated institution and the activities of the student in relation to the Federally-sponsored research project are related to the degree program.

Accordingly, the memorandum makes it clear that the OMB views the treatment of graduate student tuition remission for federal income tax purposes as having no bearing on the allowability of such costs under OMB Circular A-21. Although the memorandum does

not address how institutions are to treat tuition remission costs for federal income tax purposes, the Internal Revenue Service has informed the General Accounting Office that the treatment of compensation under Circular A-21 is irrelevant for determining tax consequences under the Internal Revenue Code.[55]

NIH Grants Policy Statement

The *NIH Grants Policy Statement* (GPS) sets out terms and conditions that apply to NIH-sponsored agreements. The GPS, which typically is incorporated by reference in NIH Notices of Grant Award, contains an extensive list of financial, administrative, socioeconomic, scientific, and bioethics requirements. It is important that institutions conducting NIH-funded research ensure that their financial and administrative policies and procedures promote compliance with GPS requirements.

In February 2001, the NIH revised the GPS effective for NIH-sponsored agreements with budget periods beginning on or after March 1, 2001. For these agreements, the 2001 GPS supersedes the October 1998 version of the GPS as a standard term and condition of award.[56] The 1998 GPS, however, still applies to sponsored agreements with budget periods commencing between October 1, 1998 and February 28, 2001.

One useful change in the revised GPS, from a convenience standpoint, is a consolidated listing of actions requiring NIH prior approval.[57] The revised GPS also contains several substantive changes.

One substantive change in the GPS pertains to an institution's ability to rebudget between direct and F&A costs. Under both the 1998 GPS and 2001 GPS, the institution's negotiated F&A cost rate in effect at the beginning of a "competitive segment" is used to determine the amount budgeted for F&A costs for each year of the competitive segment.[58] The GPS defines "competitive segment" as "the initial project period recommended for support (up to 5 years) or each extension of a project period resulting from the award of a competing continuation grant that establishes a new competitive segment for the project."[59] The NIH will award supplemental funds to account for increases in an institution's F&A cost rate only in limited circumstances.[60]

The GPS does provide, however, some flexibility for institutions to rebudget costs within the budget. With respect to F&A costs, the 1998 GPS permitted funding recipients *other than educational institutions* to rebudget between direct and F&A costs (in either direction) to account for changes in the recipient's F&A cost rate (provided there is no change in the project's scope).[61] Educational institutions were permitted to rebudget only if the rate in effect at the time of award was a provisional rate (essentially the rate in effect pending negotiation of a negotiated fixed-rate with carry-forward or predetermined rate). The 2001 GPS changes this rule. Under the 2001 GPS, educational institutions may rebudget between direct and F&A costs, provided no change occurs in the project's scope.[62]

Another change is the NIH's elimination of the prior approval requirement for any "significant rebudgeting," defined as a change in a single direct cost budget category of more than 25% of the total costs awarded. For example, if the award budget for total costs is $200,000, the institution under the 1998 GPS was required to obtain the NIH's prior approval for any increase or decrease of more than $50,000 in a budget category.[63] Under the 2001 GPS, such rebudgeting no longer automatically requires the institution to obtain prior approval but is considered to be one of several indicators of a change in the project's scope. Changes in project scope still require the NIH's prior approval.[64]

The 2001 GPS also changes the rules governing the allocation of costs to grants associated with closely related work. The 1998 GPS permitted institutions, with the NIH's prior approval, to charge costs associated with closely related work under two or more NIH-funded projects to any one of those projects or to treat multiple projects as a single cost objective if the projects had the same prin-

cipal investigator and were funded by the same Institute/Center.[65] Under the 2001 GPS, an institution may allocate costs normally assignable to multiple projects to one of those projects or treat multiple projects as a single cost objective, regardless of the funding Institute/Center or whether the awards involve the same or different principal investigators.[66] The identification of projects as "closely related" continues to require the NIH's prior approval.[67]

Effective Compliance Programs

Knowledge of the complex rules applicable to federally sponsored research is only the first and most basic component of an effective research compliance program. Unfortunately, too few compliance programs go beyond this first step.

Many compliance programs, not only in the federal research area but in other areas as well, seem to be founded primarily on the notion that people will follow the rules as soon as they are sufficiently instructed in what the rules are. The corollary to this commonly held belief is that the main "solution" to the compliance problem is better and more extensive personnel training. If it were only that simple, most of the problems of compliance in the area of federal research would have long since been solved.

To be sure, ignorance of the rules applicable to federal research is widespread, and misunderstanding of the rules often gives rise to compliance problems. In general, however, the compliance breaches that create the most significant problems for research institutions—including serious civil and even criminal penalties—are not the result of simple lack of information or training. Poor training creates obvious compliance risks, but even greater risks are posed by the many financial, organizational, informational, management, and cultural obstacles to compliance that exist in any complex organization. Recipients of federal research funding, because they are often not-for-profit entities and are largely decentralized in both mission and organization, are in many ways more at risk from such compliance obstacles than for-profit commercial entities of comparable or even much larger size.

An effective research compliance program includes commitment and leadership at the top levels of the institution, competent compliance personnel with well-defined roles and responsibilities, clearly written policies and procedures, a thorough system of training, sufficient reporting and review mechanisms, strong enforcement mechanisms, and adequate resources devoted to the program. Even more than all of these things, a successful compliance program must find ways to identify and eliminate—or at least mitigate—the obstacles that stand in the way of compliance. If inaccurate reports are being submitted because data systems are inadequate, a good compliance program will identify that defect and see that it is remedied. If employees are falsifying accounting entries because they feel that their institution's internal funding policies are depriving them of the ability to carry out their work, a good compliance program will address the root of the problem rather than just its symptoms. If extreme management pressure to achieve measurable productivity causes some employees to report effort they have not actually expended, a good compliance program will recognize that more training in how to fill out effort reports will not be sufficient to solve the problem.

GUIDELINES

These *Guidelines* are intended to assist you in understanding the financial and administrative compliance requirements for federally sponsored research discussed in this PAPER. They are not, however, a substitute for professional representation in any specific situation.

1. Recognize that your first step in complying with the financial, administrative, and other

requirements applicable to federally sponsored research is to *read the rules*. Cost accountants and other financial and administrative personnel responsible for compliance all too often operate on the basis of hearsay, assumptions, and mythology as to what the applicable rules and regulations provide. Even Government auditors and investigators sometimes seem to be uninformed about the Government's own rules.

2. Keep in mind that the requirements that apply to federally sponsored research are not only difficult to understand, they are *far from static*. Moreover, some federal requirements *differ* significantly *from agency to agency*. Your institution's compliance program must account for these differences and should include proactive monitoring of regulatory and policy developments.

3. Remember that a key aspect of any effective compliance program is *training personnel* at all levels of the institution on the requirements of the applicable rules and their responsibilities under them. In addition to training, effective compliance requires *commitment* and leadership at the top levels of the institution, competent *compliance personnel* with well-defined roles and responsibilities, clearly written *policies* and *procedures*, sufficient *reporting* and *review mechanisms*, strong *enforcement* mechanisms, and *adequate resources* devoted to the program. Understand that *identifying internal obstacles* to compliance and finding ways to work around those obstacles is an *ongoing task*.

4. Be aware that the requirements for *effort reporting* are widely misunderstood and, consequently, pose significant risk of non-compliance. The statement of an employee's level of effort, except in limited circumstances, must be expressed as a *percentage of the employee's total activity*. The salary allocation percentage on a federally sponsored agreement may *not exceed* the actual percentage of effort allocated to that agreement and must be *confirmed* by someone able to verify the employee's *actual level of effort*. If the institution uses effort report forms with *preprinted percentages* based on before-the-fact budget projections, the employees responsible for confirming actual levels of effort expended may need to *manually correct* the percentages where necessary to reflect actual effort.

5. Bear in mind that the *NIH salary cap* applies to the "*institutional base salary*." Your institution must adequately *document* the basis for the "base" salary and ensure that the *categories of effort* associated with it are *properly matched*. In addition, the institution must appropriately account for the *unrecovered* portion of salary that *exceeds* the cap, which the Government will likely treat as *institutional cost sharing*.

6. Understand that the Government distinguishes between voluntary committed cost sharing and voluntary uncommitted cost sharing. For *voluntary committed cost sharing*, the Government requires that the direct cost of the voluntary effort be *included* in the base of *organized research cost pools*, which has the effect of *decreasing* the educational institution's *F&A cost rate* in future years. For *voluntary uncommitted cost sharing*, however, the direct cost of the voluntary effort need *not* be included in the organized research base.

7. Be aware that it is not uncommon for Government auditors to review grant proposals (including the budget and narratives) closely for indications that the principal investigator or other researchers on the project have agreed to provide effort on a *voluntary* basis. A representation that some effort will be voluntarily provided may result in the Government's taking the position that the institution must include the direct cost of such "*committed*" voluntary effort in the *organized research base*.

8. Keep in mind that *administrative* and *clerical salaries* may be charged *directly* to a federally sponsored agreement only in *limited circumstances*. The determination whether such salaries may be charged directly to a project often depends on whether the project satisfies the OMB's definition of a "*major project*" and whether such costs are *treated similarly in like circumstances*. Even where a project qualifies as a "major project," ordinary administrative and clerical costs in the nature of *routine* departmental administration are *not* normally chargeable as direct costs.

9. Remember that an educational institution may charge the cost of *graduate student tuition remission* to federally sponsored agreements only if the practice satisfies the *test* set out in *OMB Memorandum M-01-06*. In addition, the cost must otherwise be *allowable*, *allocable*, and *reasonable* under the applicable cost principles.

★ REFERENCES ★

1/ See <http://www.nih.gov/about/NIHoverview.html>; Wendy Baldwin, Ph.D., An Introduction to Extramural NIH (available at <http://grants.nih.gov/grants/intro2oer.htm>). (President Bush's Fiscal Year 2002 proposed budget includes $23 billion for NIH.)

2/ See generally Debra L. Zumwalt & J. Stephen Lawrence, Jr., "Special Rules for Educational & Nonprofit Institutions/ Edition II," Briefing Papers No. 97-8 (July 1997); Roger N. Boyd & Jeffrey M. Villet, "Cost Accounting Standards Fundamentals," Briefing Papers No. 96-12 (Nov. 1996).

3/ See generally Barbara F. Mishkin & William A. Bradford, Jr., "Scientific Misconduct By Contractors & Grantees," Briefing Papers No. 95-3 (Feb. 1995).

4/ OMB Circular A-21, "Cost Principles for Educational Institutions" (revised Aug. 8, 2000) (available at <http://www.whitehouse.gov/omb/circulars>).

5/ OMB Circular A-122, "Cost Principles for Non-Profit Organizations" (revised June 1, 1998) (available at <http://www.whitehouse.gov/omb/circulars>).

6/ See generally Donald P. Arnavas, "Government Contract Cost Recovery," Briefing Papers No. 01-6 (May 2001).

7/ OMB Circular A-21, supra note 4,§ J.8.b.(1)(c) (emphasis added).

8/ Id. § J.8.b.(2)(a).

9/ Id.

10/ Id. § J.8.a.

11/ See id. § J.8.b.(2)(d).

12/ Id. § J.8.b.(1)(d), (2)(b).

13/ Id.

14/ Id.

15/ Id. § J.8.c.(2).

16/ Id. § J.8.c.(2)(b).

17/ Id. § J.8.b.(2)(e).

18/ Id. § J.8.c.(2)(c).

19/ Id. § J.8.c.(2)(e).

20/ Id. § J.8.b.(2)(g).

21/ Id. § J.8.b.(1)(c).

22/ Id. § J.8.b.(2)(a).

23/ OMB Circular A-110, "Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations," § __.53(b) (revised Nov. 19, 1993, as further amended Sept. 30, 1999) (available at <http://www.whitehouse.gov/omb/circulars>).

24/ See, e.g., Washington Univ., IBCA 1228-1178, 80-1 BCA ¶ 14,297 (upholding Government's decision to disallow salary costs due to weaknesses in payroll distribution system); University of the Pac., DAB No. 15, 1976 WL 30961 (Apr. 21, 1976) (upholding Government's decision to disallow salary and related indirect costs where supporting documentation was created after the fact in response to an auditor's inquiry and not based on records made or compiled contemporaneously).

25/ Consolidated Appropriations Act, Pub. L. No. 106-554, app. A, tit. 2, § 204, 114 Stat. 2763, 2763A-25 to 2763A-26. (If enacted, currently pending H.R. 3061 providing Department of Health and Human Services' appropriations for FY 2002 would cap salaries at Executive Level I.)

26/ Id.

27/ OMB Circular A-21, supra note 4, § J.8.b.(1)(c).

28/ Vermont Agency of Natural Res. v. United States ex. rel. Stevens, 529 U.S. 765 (2000), 42 GC ¶ 204 (ruling that state institutions are not "persons" under the False Claims Act). Note that the U.S. Department of Justice has interpreted the Court's ruling narrowly, indicating that it does not apply where the Government has filed or intervened in the action.

29/ 31 U.S.C. § 3729. See generally Robert K. Huffman, Marcia G. Madsen & Cameron S. Hamrick, "The Civil False Claims Act," Briefing Papers No. 01-10 (Sept. 2001).

30/ 31 U.S.C. § 3729(a).

31/ 28 C.F.R. § 85.3(a)(9) (adjusting civil penalty for inflation).

32/ See 48 C.F.R. pt. 9905.

33/ National Science and Technology Council, Presidential Review Directive – 4, Renewing the Federal Government-University Research Partnership for the 21st Century ch. 5, § 3 (Apr. 1999).

34/ OMB Memorandum M-01-06, "Clarification of OMB A-21 Treatment of Voluntary Uncommitted Cost Sharing and Tuition Remission Costs" (Jan. 5, 2001).

35/ Id. at 2.

36/ Id.; OMB Circular A-21, supra note 4, § J.8.b.(1)(c).

37/ OMB Memorandum M-01-06, supra note 34, at 2.

38/ Id.

39/ Id. at 2–3.

40/ OMB Circular A-21, supra note 4, § F.6.b.(2).

41/ Id.

42/ Id.

43/ Id.

44/ Id. exh. C.

45/ Id. § F.6.b.(1)

46/ Id. exh. C.

47/ Id.

48/ See 31 U.S.C. § 3730.

49/ Julianne Basinger, "GAO Investigates U. of Cal. for Billing of Tuition to Research Contracts," Chron. Higher Educ. (May 29, 1998).

50/ Douglas Lederman, "Research Universities Are Nervous About Inquiries Into Use of U.S. Funds at U. of Cal.," Chron. Higher Educ. (June 5, 1998).

51/ OMB Circular A-21, supra note 4, § J.41.(a).

52/ OMB Memorandum M-01-06, supra note 34, at 43.

53/ Id.

54/ Id.

55/ Letter from Irwin A. Leib, Deputy Assistant Chief Counsel (Income Tax and Accounting), to Kevin P. Craddock, GAO Special Agent (Jan. 6, 1999), in General Accounting Office, Federal Research Grants: Compensation Paid to Graduate Students at the University of California app. I (GAO/OSI-99-8, June 1999).

56/ NIH Grants Policy Statement 2 (Mar. 2001) [hereinafter 2001 GPS].

57/ Id. at 106–107.

58/ Id. at 83; NIH Grants Policy Statement II-34 (Oct. 1998) [hereinafter 1998 GPS].

59/ 2001 GPS, supra note 56, at 15; 1998 GPS, supra note 58, at I-2.

60/ 2001 GPS, supra note 56, at 83.

61/ 1998 GPS, supra note 58, at II-34.

62/ 2001 GPS, supra note 56, at 83.

63/ 1998 GPS, supra note 58, at II-53.

64/ 2001 GPS, supra note 56, at 108.

65/ 1998 GPS, supra note 58, at II-57.

66/ 2001 GPS, note 56, supra, at 114.

67/ Id.