Allocating Charges to Federal Awards: Overview and Risk Assessment

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This article is the second of a three-part series addressing the research compliance risk areas highlighted by the Office of Inspector General of the Department of Health and Human Services in its recent proposed guidance on compliance programs in the federal research area. The articles are intended to provide an overview of the applicable federal rules in each risk area and to identify the issues in each area that present the greatest problems for grantees. An article in the January issue of the Report on Research Compliance *discussed the first of these risk areas — time and effort reporting.*

By now the college and university research community is well aware of the Office of Inspector General (OIG) of the Department of Health and Human Services (HHS) proposed guidance addressing compliance programs in the federal research area. 70 Fed. Reg. 71312 (Nov. 28, 2005). In the guidance, the HHS OIG highlighted three examples of research compliance "risk areas" that had come to its attention: (1) time and effort reporting; (2) proper allocation of charges to federal awards; and (3) reporting of financial support from other sources. Although the HHS OIG did not say so explicitly, it is clear that it considers the highlighted risk areas to be significant potential areas of fraud and abuse by grantees. This article addresses the OIG's second highlighted risk area — allocation of charges to federal awards.

The Cost Allocation Risk Area

The HHS OIG's proposed compliance guidance briefly describes the cost allocation risk area in these terms:

> Research institutions commonly receive multiple awards for a single research area. It is essential that accounting systems properly separate the amount of funding from each funding source. Institutions must also be vigilant about clearly fraudulent practices such as principal investigators on different projects banking or trading award funds among themselves. The failure to account accurately for charges to various award projects can result in significant disallowances or, in certain circumstances, could subject an institution to criminal or civil fraud investigations.
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> 70 Fed. Reg. 71312 at 71315-16.

The question of how to allocate costs appropriately to federal projects can be quite simple and straightforward or highly complex and technical, depending on the circumstances. Researchers often point out that it can be very difficult to decide how a particular cost should be allocated, and they are right. Some expenditures relate to equipment, supplies, or services that benefit several grants, often in varying degrees. It is usually not cost-effective, and sometimes not even possible, to track the relative usage of a particular piece of equipment or category of supplies by multiple projects.

Fortunately, the federal cost principles do not demand absolute precision. They provide that costs benefiting two or more projects should be allocated between or among them based on "proportional benefit," but only if such an allocation can be made "without undue effort or cost." Otherwise, the allocation can be made "on any reasonable basis." In some cases, as discussed below, even a somewhat arbitrary allocation of costs may be deemed "reasonable."

Researchers need not be particularly concerned, therefore, that their good faith attempts to allocate costs reasonably will expose them or their institutions to serious allegations of civil or criminal fraud. It is only when costs are deliberately mischarged to a project or charged with reckless disregard for whether they are allocable to a project or not, that federal law enforcement authorities are likely to allege fraud.

That's the good news. The bad news is that once a fraud investigation begins, the government usually has little difficulty identifying any abusive cost allocation that may have occurred. The very fact that federal enforcement authorities are concerned mainly with gross and obvious misallocations means that such misallocations, when they do happen, are not difficult to detect.

The Basic Cost Allocation Principles

The cost principles applicable to federal grants and contracts awarded to colleges and universities appear primarily in OMB Circular A-21, "Cost Principles for Educational Institutions." In order to be allowable as a charge to a federal award, a cost must first be *reasonable* — that is, reasonably necessary for the performance of the award and not overpriced. Second, no cost may be charged to a federal award if it is in a cost category specifically *prohibited* by Circular A-21 or the terms of the award — the cost of alcoholic beverages, to take just one of many possible examples. Third, the cost must be *consistent* with the grantee's treatment of other similar expenses in like circumstances. For example, an employee

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may not be charged to federal grants at a salary rate that is higher than the salary rate applied to his or her other university responsibilities, such as instruction. Finally, and most importantly for purposes of this article, in order to be allowable as a charge to a federal award, a cost must be *allocable* to that award under the cost principles of Circular A-21.

The Meaning of 'Allocable'

In a broad sense, the meaning of the term "allocable" is fairly obvious — it means that the cost must be related in some reasonable way to the federal award to which it has been charged. Section C.4.a of Circular A-21 expresses the general rule of allocability in two ways — "relative benefits received" or "equitable relationship":

> A cost is allocable to a particular cost objective (i.e., a specific function, project, sponsored agreement, department, or the like) if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received or other equitable relationship.

Section C.4.a of Circular A-21 goes on to identify the three types of circumstances in which a cost may be allocable to a sponsored agreement:

(1) it is incurred solely to advance the work under the sponsored agreement;

(2) it benefits both the sponsored agreement and other work of the institution, in proportions that can be approximated through use of reasonable methods; or

(3) it is necessary to the overall operation of the institution and, in light of the principles provided in this Circular, is deemed to be assignable in part to sponsored projects.

The first two of these types of circumstances relate to *direct costs*, and the third relates primarily to *indirect (F&A) costs*.

Direct costs. Direct costs are those costs that can be identified specifically with the sponsored project or can be assigned to the project relatively easily with a reasonable degree of accuracy. For example, where lab supplies are purchased and used exclusively for a particular sponsored project, the cost of those supplies would obviously be allocable in full to that project. That cost would be a category (1) cost. An example of a category (2) cost would be the salary of a faculty member who works on both sponsored projects and other institutional activities, such as teaching or administration. In that case, the institution would be required to employ a "reasonable method" for approximating the portion of the faculty member's salary that is chargeable to sponsored projects. The allocation method normally used for this purpose is periodic effort reporting. If a faculty member's effort report were to indicate that 40 percent of his or her total institutional effort was devoted to a particular project, then 40 percent of the faculty member's salary could be charged to that project as a category (2) cost.

Indirect costs. Category (3) refers essentially to indirect (F&A) costs. Indirect (F&A) costs are those costs that, while necessary in general for the conduct of sponsored research and other university activities, cannot readily be associated with any particular sponsored project or group of sponsored projects. Good examples of F&A costs are the costs of operating the university president's office or the institution's library system. Such costs are allocable to federal projects, but not as direct charges. Instead, they are allocated by means of a general F&A rate that is negotiated from time to time with the Government and applied to the modified total direct costs (MTDC) of individual sponsored projects. For example, if an institution's F&A rate is 50 percent, then for every dollar of MTDC allocable to a given project, the institution would be entitled to charge the project an additional fifty cents in F&A costs.

Allocability of direct costs. The allocability of a given cost as a direct cost of a federal award is usually made on the basis of the first prong of the allocability rule in Section C.4.a — relative benefits. Unless it can be said that a cost "benefits" a federal award in some way (even if that benefit can only be approximated), the cost will not be allocable to the award as a direct cost. It should be noted that although it is conventional to speak in terms of a "cost" benefiting a project, obviously any benefit associated with a cost is conferred not by the incurrence of the cost itself, but by the underlying item or service giving rise to the cost.

Sometimes even the underlying item or service may not seem to "benefit" a project in the usual sense, yet the cost of the item or service may still be allocable as a direct cost. For example, in some circumstances some or all of a severance payment to an employee who was working on a sponsored project at the time of termination may be allocable to the project as a direct cost, even though by definition the terminated employee is no longer working on the project and therefore unable to "benefit" it in any way. In this case, the cost is directly allocable not because of any "benefit" resulting from the severance itself, but rather as a form of entitlement associated with and arising out of the employee's former service on the sponsored project.

Allocability of indirect costs. The concept of "equitable relationship" in the Section C.4.a definition of allocability relates primarily to indirect costs. The word "equitable" in this definition conveys the idea that a cost "ought" to be borne by a project or activity, even though the project or activity does not "benefit" from the incurrence of the cost in any specifically identifiable or measurable way. For example, even though the activities of the university president may not specifically "benefit" any particular sponsored projects, it is considered that the cost of the president's salary ought to be allocated across all university activities, including each sponsored project, on some equitable basis. This equitable allocation is accomplished through application of the F&A rate, as discussed above.

Problems with Multiple Project Allocation

Most allegations of fraudulent cost allocation involve direct costs. In some cases the problem arises because a federal sponsored project has been charged with a cost that does not relate to the project at all. In other cases, the problem is that the project has been charged with all of a cost that relates not only to that project, but to other projects as well.

The only real guidance that Circular A-21 provides on allocating costs among multiple projects appears in Section C.4.d(3), entitled "Direct cost allocation principles":

If a cost benefits two or more projects or activities in proportions that can be determined without undue effort or cost, the cost should be allocated to the projects based on the proportional benefit. If a cost benefits two or more projects or activities in proportions that cannot be determined because of the interrelationship of the work involved, then, notwithstanding subsection b, the costs may be allocated or transferred to benefited projects on any reasonable basis… .

As an illustration of how this guidance might work in practice, assume that the sole duty of an employee in a laboratory is to perform a certain kind of standard test that three different projects in the laboratory require. If the projects are discrete and unrelated, so that it is possible to tell readily which project each test relates to, then the cost of the employee's salary might be allocated among projects based on the number of tests performed for each project. For example, if 20 percent of the tests relate to Project A and 40 percent each to Projects B and C, then the employee's salary could be allocated among the three projects in the same proportions. This would be an example of a cost allocation that might be determined "without undue effort or cost."

But in practice things are rarely so simple. Where Projects A, B, and C are closely related, for example, some test results may be used in more than one of the projects, and it may not always be known at the time the tests are conducted which of the projects will benefit from the tests, and in what degree. In such cases, it may be possible to justify allocating the cost of the technician's salary by some other "reasonable" method, such as by the amounts of the projects' respective budgets, or more simply, by allocating one third of his or her salary to each project.

Sources of Risk in the Cost Allocation Area

The most common sources of problems in the cost allocation area are discussed below. The focus is on abusive misallocation, not technical mistakes. Needless to say, there are many other ways in which cost allocation abuse can occur, but these types of mischarging have accounted for the vast majority of all reported cases involving allegations of fraudulent cost allocation.

Allocating costs directly to the wrong project. Obviously, allocating directly to a federal project costs that have nothing to do with the work on the project would be a clear violation of Circular A-21. In the vast majority of cases, however, such mischarges occur by accident or misunderstanding, rather than deliberately. When such mischarges are discovered they should be corrected, and if they are discovered by a federal auditor or investigator a cost disallowance may be expected. It is only when such mischarges appear to have been deliberate, or part of a pattern of charging costs to federal projects that should have been charged to other university projects or activities, that fraud allegations become likely. For example, knowingly or regularly using funds from a federal award to purchase supplies used solely in a privately sponsored project, or charging a federal project for the salary of someone who is known not to have worked on the project, would certainly be viewed as fraudulent by federal investigators.

Incorrect allocation of costs among multiple projects. As indicated above, it is not always easy to determine how a cost should be allocated if it relates to two or more projects or activities. Circular A-21 says, in effect, that an effort should be made to allocate the cost based on proportional benefit, but that any reasonable method of allocation is permissible if proportional benefit cannot readily be determined. That is a fairly lenient and flexible standard, and it is most unlikely that an institution will be accused of fraud simply because the Government disagrees with the institution's good faith determination of how a cost should be allocated among two or more projects. On the other hand, a pattern of allocation that results in consistent overweighting of allocations to federal projects would be problematic, and in some circumstances, depending on how the pattern developed, could trigger a fraud investigation.

Inconsistent allocation methods. Even where individual allocation methods appear to be reasonable and defensible in themselves, they may be deemed impermissible or even fraudulent if, taken together, they result in an overweighting of costs to federal projects. For example, assume that an institution had the following policy with respect to allocation of costs among multiple projects:

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> Where the largest benefiting project is a federal project, allocate the costs based on the size of the project budgets; otherwise divide the costs evenly among the projects.

Even though each allocation method (allocating based on project budgets or dividing evenly) might be defensible in its own right, this policy would have the predictable effect of causing federal projects to bear a disproportionate burden of costs. (No federal project would ever bear less than an evenly divided share of the costs, and in some cases federal projects would bear a greater share.) Depending on how this allocation policy came to be adopted and the extent of its impact on federal projects, it could become the subject of a fraud investigation.

'Banking' or 'trading' costs. The HHS OIG's draft compliance guidance highlights the risk of "clearly fraudulent practices such as principal investigators on different projects banking or trading award funds among themselves." There are a number of circumstances in which such impermissible shifting of costs may occur. For example, "trading" may occur when one project is temporarily short of funds, and a principal investigator on another project agrees to allow costs on the first project to be charged to his or her unrelated federal project, usually with the understanding that the mischarge will be evened out later by charging federal project costs to the first project when its funding is refreshed. Circular A-21 states clearly that such practices are impermissible:

> Any costs allocable to a particular sponsored agreement under the standards provided in this Circular may not be shifted to other sponsored agreements in order to meet deficiencies caused by overruns or other fund considerations, to avoid restrictions imposed by law or by terms of the sponsored agreement, or for other reasons of convenience.

Such cost shifting practices do not occur by accident; they are always deliberate to some degree. For that reason, they are prime targets for federal fraud enforcement, especially where they result in a net overcharging of federal projects. Even where the impact on federal projects "evens out" over time (which theoretically would be the case in the "trading" situation), and there is no intent to overcharge any federal project, there can be no assurance that federal enforcement authorities will not investigate cost shifting practices as possible fraud.

Advance charging of costs. Ordinarily costs may be charged to a federal award only as the costs are incurred; they may not be charged in advance. On occasion a principal investigator who has funds available in his or her federal award toward the end of a budget period may improperly charge costs to the award in advance, usually out of a concern that it may not be possible to carry the excess costs over to the next budget period. Although in theory this practice would not in the end result in an overcharge to the project, there is no assurance that it would not be scrutinized by federal enforcement authorities.

Abusive cost transfers. Misallocation of costs can occur either as the costs are incurred, as in the case of "trading" or advance charging, or after the fact, through cost transfers from the benefiting project to an unrelated federal project. For example, when one project is in an over-run condition, the principal investigator may cause the excess costs to be transferred to an unrelated federal project that still has unexpended funds. This practice is impermissible under Circular A-21, and would clearly be viewed as fraudulent by the HHS OIG.

Direct charging of costs that are normally indirect (F&A) costs. A special form of cost misallocation is the direct charging to a federal project of costs that by their nature are indirect (F&A) costs. For example, most costs of clerical staff are considered F&A costs, and are charged to federal projects through application of the institution's F&A rate. If a principal investigator were to charge the cost of clerical staff to a federal award as a direct cost, in some circumstances such charges would be a form of double-billing — once as a direct charge and a second time through the recovery of F&A. (Indeed, it might be argued that there is triple-charging, since the F&A rate would also be applied to the direct cost of clerical staff salaries.) Although in some special situations Circular A-21 expressly permits direct charging of costs that are normally considered F&A costs, the appearance of double-billing sometimes makes it difficult to persuade federal investigators that the practice is permissible even in these situations.

Conclusion

Allegations of fraud in the allocation of costs — whether through "banking," "trading," abusive cost transfers, improper effort reporting, or other means — are at the heart of practically every research fraud case that has been filed against a university in recent years. Federal enforcement authorities acknowledge that cost allocation can be very complex, and with the possible exception of cases involving direct charging of F&A-type costs, they are unlikely to pursue fraud investigations simply because they happen to disagree with a reasonable cost allocation method chosen by an institution. They have little tolerance, however, for deliberate mischarging of costs to federal projects, even where the intention is to "even out" the mischarge at a later time. Universities are well advised, therefore, to re-examine their policies, procedures, and training in the cost allocation area, in order to minimize the risk of abusive practices. ✧