

PERFORMANCE AUDIT
OF
STATEWIDE FEDERAL INDIRECT COST RECOVERY AND USAGE

June 2000

EXECUTIVE DIGEST

STATEWIDE FEDERAL INDIRECT COST RECOVERY AND USAGE

INTRODUCTION

This report, issued in June 2000, contains the results of our performance audit* of Statewide Federal Indirect Cost Recovery and Usage.

AUDIT PURPOSE

This performance audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency*.

BACKGROUND

Federal regulations allow grant recipients to recover indirect costs* from the federal grant funds received. Section 18.1460 of the *Michigan Compiled Laws* requires State agencies to determine an indirect cost rate or percentage and to recover indirect costs from federal grants they administer.

Agency indirect cost plans must include both the agency's indirect costs and Statewide indirect costs. Indirect costs are costs for central support services, such as accounting, purchasing, budgeting, payroll, and information systems, that are not readily assignable to any one program or function. Statewide indirect costs include the costs of central support services provided by the Department of

* See glossary at end of report for definition.

Management and Budget (DMB), Department of Treasury, Department of Civil Service, and Department of Civil Rights.

DMB contracts with a private consultant to prepare an annual Statewide Cost Allocation Plan (SWCAP), which is approved by the federal government. The SWCAP contains an allocation of the Statewide indirect costs to State agencies. DMB provides the approved SWCAP indirect costs to State agencies for allocation to their federal assistance programs.

For fiscal year 1997-98, State agencies recovered indirect costs totaling over \$25 million from federal grants.

AUDIT OBJECTIVES
AND CONCLUSIONS

Audit Objective: To determine if the State charges appropriate indirect costs for the federal grants it administers.

Conclusion: We concluded that the State was generally effective in charging appropriate indirect costs for federal grants. However, we noted reportable conditions* related to agencies without indirect cost plans and the updating of indirect cost rates (Findings 1 and 2).

Audit Objective: To determine if the State appropriately distributes the federal grant indirect cost reimbursements it collects.

Conclusion: We concluded that the State was moderately effective in appropriately distributing the federal grant indirect cost reimbursements it collects. We noted a reportable condition related to the distribution of indirect cost revenue (Finding 3).

* See glossary at end of report for definition.

Audit Objective: To assess the State's efficiency in developing its federal indirect cost allocation plans.

Conclusion: We concluded that the State was efficient in developing its federal indirect cost allocation plans.

AUDIT SCOPE AND
METHODOLOGY

Our audit scope was to examine the practices followed by selected State agencies for federal indirect cost recovery and usage. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our methodology included an examination of procedures and records related to indirect cost recoveries and usage for selected State agencies for fiscal year 1997-98.

To accomplish our first objective, we reviewed the methodologies of State agencies for charging indirect costs to federal grants. Also, we analyzed the agencies' indirect cost plans to determine whether the indirect cost rates and charges to federal programs were proper.

To accomplish our second objective, we reviewed the procedures followed by State agencies for distributing the revenue for indirect cost charges for federal grants. Also, we analyzed the funding sources for indirect costs used for the indirect cost rates of three agencies and the distributions of the related revenue.

To accomplish our third objective, we reviewed and analyzed the costs incurred by State agencies for preparing indirect cost plans.

AGENCY RESPONSES

Our audit report contains 3 findings and 4 corresponding recommendations. The Department of Corrections disagrees with the finding that applied to it. The Judiciary, Michigan Department of Transportation, Michigan Department of State Police, Department of Natural Resources, Department of Environmental Quality, and Department of Consumer and Industry Services agree with the finding that applied to them. DMB agrees with both findings that applied to it.

Ms. Janet E. Phipps, Director
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Ms. Phipps:

This is our report on the performance audit of Statewide Federal Indirect Cost Recovery and Usage. Our report letter is addressed to the Department of Management and Budget because it is centrally responsible for uniform accounting practices for all State agencies. Our report will also be distributed to the 11 other State agencies that were included within the scope of our audit.

This report contains our executive digest; description of program; audit objectives, scope, and methodology and agency responses; comments, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agencies' responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agencies develop formal responses within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us by the staff of the agencies visited during this audit.

AUDITOR GENERAL

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Description of Program

Federal regulations allow grant recipients to recover indirect costs from the federal grant funds received. Section 18.1460 of the *Michigan Compiled Laws* requires State agencies to determine an indirect cost rate or percentage and to recover indirect costs from federal grants they administer. Section 18.1460 of the *Michigan Compiled Laws* also provides that revenue for indirect cost charges shall be credited to the respective State funds to offset State expenditures for which indirect costs were provided.

Agency indirect cost plans must include both the agency's indirect costs and Statewide indirect costs. Indirect costs are costs for central support services, such as accounting, purchasing, budgeting, payroll, and information systems, that are not readily assignable to any one program or function. Statewide indirect costs include the costs of central support services provided by the Department of Management and Budget (DMB), Department of Treasury, Department of Civil Service, and Department of Civil Rights.

DMB contracts with a private consultant to prepare an annual Statewide Cost Allocation Plan (SWCAP), which is approved by the federal government. The SWCAP contains an allocation of the Statewide indirect costs to State agencies. DMB provides the approved SWCAP indirect costs to State agencies for allocation to their federal assistance programs.

U.S. Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, contains the federal principles and standards for development of indirect cost plans.

For fiscal year 1997-98, State agencies recovered indirect costs totaling over \$25 million from federal grants.

Audit Objectives, Scope, and Methodology and Agency Responses

Audit Objectives

Our performance audit of Statewide Federal Indirect Cost Recovery and Usage had the following objectives:

1. To determine if the State charges appropriate indirect costs for the federal grants it administers.
2. To determine if the State appropriately distributes the federal grant indirect cost reimbursements it collects.
3. To assess the State's efficiency in developing its federal indirect cost allocation plans.

Audit Scope

Our audit scope was to examine the practices followed by selected State agencies for federal indirect cost recovery and usage. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our work was performed between May and September 1999 and included an examination of procedures and records related to indirect cost recoveries and usage for selected State agencies for fiscal year 1997-98.

To accomplish our first objective, we reviewed the methodologies of State agencies for charging indirect costs to federal grants. Also, we analyzed the agencies' indirect cost plans to determine whether the indirect cost rates and charges to federal programs were proper.

To accomplish our second objective, we reviewed the procedures followed by State agencies for distributing the revenue for indirect cost charges for federal grants. Also,

we analyzed the funding sources for indirect costs used for the indirect cost rates of three agencies and the distributions of the related revenue.

To accomplish our third objective, we reviewed and analyzed the costs incurred by State agencies for preparing indirect cost plans.

Agency Responses

Our audit report contains 3 findings and 4 corresponding recommendations. The Department of Corrections disagrees with the finding that applied to it. The Judiciary, Michigan Department of Transportation, Michigan Department of State Police, Department of Natural Resources, Department of Environmental Quality, and Department of Consumer and Industry Services agree with the finding that applied to them. DMB agrees with both findings that applied to it.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

INDIRECT COST CHARGES FOR FEDERAL GRANTS

COMMENT

Background: State agencies may recover indirect costs from federal grants by determining an indirect cost percentage to be applied to a direct cost base for each grant.

State agencies may also recover indirect costs by charging central administrative costs directly to federal grants based on an allocation plan.

For fiscal year 1997-98, 11 State agencies recovered indirect costs totaling approximately \$14 million from federal grants based on indirect cost rate charges. Eight of these agencies also charged some central service costs directly to federal grants. Two other State agencies used allocation plans to directly charge federal grants for all central service costs. We estimate that these 10 agencies collected over \$11 million of indirect cost as a direct charge to the federal programs. Thus, State agencies recovered indirect costs totaling over \$25 million, including Statewide indirect costs.

Audit Objective: To determine if the State charges appropriate indirect costs for the federal grants it administers.

Conclusion: We concluded that the State was generally effective in charging appropriate indirect costs for federal grants. However, we noted reportable conditions related to agencies without indirect cost plans and the updating of indirect cost rates.

FINDING

1. Agencies Without Indirect Cost Plans

Three State agencies that incurred administrative costs related to federal programs had not developed plans for recovering allowable indirect costs as required by State law.

Section 18.1460 of the *Michigan Compiled Laws* requires State agencies to recover indirect costs from federal grants and to report their indirect cost rates or percentages to the Department of Management and Budget (DMB). Section 18.1141 of the *Michigan Compiled Laws* provides that DMB shall provide for uniform conduct in operations applicable to all State agencies. U.S. Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, allows grant recipients to recover indirect costs from the federal grant funds received.

Our review disclosed:

- a. The Department of Corrections (DOC) and the Judiciary had not developed plans for charging indirect costs to their federal grant programs. We analyzed whether 17 State agencies that received General Fund appropriations for fiscal year 1997-98 had developed plans for recovering indirect costs from their federal grants. We determined that indirect cost charges were allowable for the federal grants of 13 of these agencies. Of these agencies, 11 (all but DOC and the Judiciary) had developed plans and were charging indirect costs to their federal grants. For fiscal year 1997-98, total federal expenditures for DOC and the Judiciary were \$6.4 million, and \$1.2 million, respectively.

- b. The Michigan Department of Transportation (MDOT) had not developed a plan for charging indirect costs to its federal grant programs. The financial activities of MDOT are accounted for in 10 transportation-related restricted funds. For fiscal year 1997-98, total federal expenditures for MDOT were \$683.9 million. An indirect cost plan would not likely result in any additional revenue to the State. However, it would increase the proportion of State restricted funds available for projects not subject to federal grant requirements. Prior to fiscal year 1998-99, indirect cost charges were not allowable for MDOT's largest federal program. MDOT was notified in September 1998 that this restriction was removed and indirect cost charges are allowable for all of its federal programs.

Recovery of federal indirect costs, in accordance with State law, would reimburse State General Fund/restricted funds currently used to subsidize the federal programs.

RECOMMENDATION

We recommend that DOC, the Judiciary, and MDOT develop plans for recovering allowable indirect costs from federal grants in consultation with DMB or establish that not charging federal indirect costs is in the best interest of the State.

AGENCY PRELIMINARY RESPONSE

DEPARTMENT OF CORRECTIONS

DOC disagrees with the finding. DOC informed us that it has maximized funding from federal grants through direct cost charges. DOC does not believe that charging indirect costs would be in the best interest of the State because it will not increase the amount of the federal grants and it would reduce the amount available for direct charges, such as program supplies and materials. This conclusion has been communicated to DMB each year.

JUDICIARY

The Judiciary agrees with the recommendation. The Judiciary's goal has been to maximize the use of federal funds to fund the direct cost charges for eligible projects. The Auditor General's audit report of State-Funded Judicial Operations for the two fiscal years ended September 30, 1998 indicates that approximately \$22,600 in indirect costs could have been charged to federal grants for fiscal years 1996-97 and 1997-98. Although charging indirect costs to grants can reduce the direct charges that can be billed to the grant because of the cap imposed by the terms of the grant, Judiciary staff have worked with DMB's indirect cost rate consultant, DMG-Maximus, to create an indirect cost plan for the Judiciary.

MICHIGAN DEPARTMENT OF TRANSPORTATION

MDOT concurs that, when a financial benefit exists, it will charge indirect costs to federal grants. MDOT informed us that it currently bills and receives, and has always billed and received, all available federal aid; therefore, the addition of indirect charges does not result in additional federal aid coming to the State.

While the report states that charging indirect costs would change the proportion of State restricted funds for projects not subjected to federal grant requirements, it should also be noted that this would decrease the number of projects done with federal funds.

MDOT contracted with DMG-Maximus to develop indirect cost rates. The contractor's final report was issued to MDOT on May 5, 1999. However, to use these rates to charge federal grants, MDOT would need Federal Highway Administration approval and major modifications to its automated billing system. MDOT would also need to routinely update these indirect rates. MDOT's plan is to charge indirect costs to federal grants only when it results in financial benefit to the State or when it is unable to bill and recover all available federal aid. Since MDOT builds its trunkline to federal grant standards, no financial benefit would result by substituting State dollars for federal dollars on individual projects.

DEPARTMENT OF MANAGEMENT AND BUDGET

DMB, through the Office of Financial Management, will continue to make its consultation available to these agencies.

FINDING

2. Updating of Indirect Cost Rates

The Michigan Department of State Police (MSP) had not updated its indirect cost rate using current allowable costs to ensure that indirect costs were fully recovered.

OMB Circular A-87 requires governmental units desiring to recover indirect costs from federal awards to prepare an indirect cost proposal and related documentation to support those costs. OMB Circular A-87 provides that either a fixed or predetermined indirect cost rate may be developed based on estimated costs. A fixed rate is calculated annually and differences between estimated and actual costs are carried forward as adjustments of rates of future years. OMB Circular A-87 also provides that a predetermined rate is not subject to adjustment and should typically be used for 2 to 4 years.

In addition, OMB Circular A-87 provides that an indirect cost rate should be developed by dividing the total allowable indirect costs by an equitable distribution base. OMB issued guidelines for developing state and local indirect cost rates. These guidelines provide that all allowable indirect costs for an agency should be included in the pool used to calculate an indirect cost rate.

MSP received initial approval of a fixed indirect cost rate of 7.4% in May 1989 for use in fiscal year 1988-89, based on actual costs for fiscal year 1986-87. For subsequent fiscal years, MSP has annually requested an extension of the 7.4% rate and obtained approval from its federal cognizant agency. MSP has continued to use the 7.4% as an estimated rate and has not calculated any adjustments for the differences between the costs used for the initial rate and actual costs for subsequent fiscal years.

The documentation of MSP's 1989 indirect cost rate disclosed that MSP did not include all allowable indirect costs in the indirect cost pool used to determine the rate. MSP included only indirect costs for salaries and wages to calculate the 7.4% rate. This methodology is not consistent with the current OMB guidelines for developing indirect cost rates and the methodologies used by other State agencies that develop indirect cost rates.

MSP's indirect cost rate and the charges of indirect costs for federal grants would be significantly higher if MSP updated its rate using current allowable costs. Based on all allowable indirect costs for fiscal year 1995-96, we estimated that MSP's indirect cost rate would be 10.7%. Based on an indirect cost rate of 10.7%, MSP's total indirect cost charges for federal grants for fiscal year 1997-98 would have increased by approximately \$120,000.

RECOMMENDATION

We recommend that MSP update its indirect cost rate using current allowable costs to ensure that indirect costs are fully recovered.

AGENCY PRELIMINARY RESPONSE

MICHIGAN DEPARTMENT OF STATE POLICE

MSP agrees with this recommendation. MSP is in agreement that its federal indirect rate should be updated and it intends to comply with the recommendation by developing an updated indirect rate consistent with federal requirements.

DISTRIBUTION OF INDIRECT COST REIMBURSEMENTS

COMMENT

Audit Objective: To determine if the State appropriately distributes the federal grant indirect cost reimbursements it collects.

Conclusion: We concluded that the State was moderately effective in appropriately distributing the federal grant indirect cost reimbursements it collects. We noted a reportable condition related to the distribution of indirect cost revenue.

FINDING

3. Distribution of Indirect Cost Revenue

State agencies did not distribute indirect cost revenue to the respective funding sources of the costs recovered as required by Section 18.1460 of the *Michigan Compiled Laws*.

Eleven State agencies annually determined indirect cost rates for charging federal grants for the State's costs of administering the grants. These rates were applied to certain direct grant expenditures and the resulting amounts were billed to federal grants. For fiscal year 1997-98, the State's revenue from billings to federal grants based on indirect cost rates was approximately \$14 million.

Section 18.1460 of the *Michigan Compiled Laws* provides that revenue for indirect cost charges shall be credited to the respective State funds to offset State expenditures for which indirect costs were provided.

We analyzed the funding sources for costs used to compute three departments' indirect cost rates for fiscal year 1997-98 and their subsequent distributions of the related indirect cost revenue receivables. We determined that significant portions of the indirect cost pools for the departments had been funded by charges to special revenue funds or restricted revenue sources. Our analysis also disclosed

that the methods used to distribute the revenue for the indirect cost charges varied among the three departments:

- a. The costs in the indirect cost pool for the Department of Natural Resources (DNR) were funded 44.0% by General Fund appropriations, 24.5% by special revenue funds, and 21.3% by restricted revenue sources. The other 10.2% of the costs in the indirect cost pool consisted of Statewide costs allocated from the Statewide Cost Allocation Plan (SWCAP). The indirect cost revenue for DNR for fiscal year 1997-98 was \$1,912,422. Of this amount, \$496,579 (26%) was distributed to the General Fund and \$1,415,843 (74%) was distributed to two DNR special revenue funds.
- b. The costs in the indirect cost pool for the Department of Environmental Quality (DEQ) were funded 42.3% by General Fund appropriations, 6.1% by special revenue funds, and 33.5% by restricted revenue sources. The other 18.0% of the costs in the indirect cost pool consisted of Statewide costs allocated from the SWCAP. The indirect cost revenue for DEQ for fiscal year 1997-98 was \$3,811,464, and all of this revenue was credited to the General Fund.
- c. The costs in the indirect cost pool for the Department of Consumer and Industry Services (CIS) were funded 25.5% by General Fund appropriations, 7.3% by special revenue funds, and 44.7% by restricted revenue sources. The other 22.5% of the costs in the indirect cost pool consisted of Statewide costs allocated from the SWCAP. The indirect cost revenue for CIS for fiscal year 1997-98 was \$1,137,880, and all of this revenue was credited to the General Fund.
- d. The Statewide costs allocated from the SWCAP included in the indirect cost pools had been funded in part by sources other than the General Fund. Approximately 28% of the allocated SWCAP costs had been funded by various special revenue funds and restricted revenue sources. However, State agencies credited all of the revenue for charges for the SWCAP costs to the State's General Fund.

To comply with statutory requirements and ensure that indirect cost revenue is consistently distributed, guidelines should be established to State agencies to equitably distribute indirect cost revenue to the respective funding sources for the costs.

RECOMMENDATIONS

We recommend that State agencies distribute indirect cost revenue to the respective funding sources of the costs recovered as required by Section 18.1460 of the *Michigan Compiled Laws*.

We also recommend that DMB assist agencies in establishing appropriate approaches for allocating recovered indirect costs.

AGENCY PRELIMINARY RESPONSE

DEPARTMENT OF NATURAL RESOURCES

DNR agrees with item a.

DEPARTMENT OF ENVIRONMENTAL QUALITY

DEQ agrees that indirect revenue was transferred to the General Fund. This was done based on past practice and guidance. DEQ is willing to comply with statutory requirements for distribution of indirect revenue. DEQ will initiate discussions with DMB, as resolution of this issue will require guidance from DMB outlining the appropriate methodology.

DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES

CIS agrees with item c. CIS is in the process of developing proper methodology to apply indirect cost revenue to its respective funding sources for the costs.

DEPARTMENT OF MANAGEMENT AND BUDGET

DMB agrees with these recommendations. The DMB Office of Financial Management will revise its guidance on how departments should account for the recovery of federal revenue associated with indirect costs. DMB will comply by December 31, 2000.

EFFICIENCY OF INDIRECT COST PLANS

COMMENT

Audit Objective: To assess the State's efficiency in developing its federal indirect cost allocation plans.

Conclusion: We concluded that the State was efficient in developing its federal indirect cost allocation plans.

We reviewed the costs for developing indirect cost allocation plans for 12 State agencies for fiscal year 1997-98. The total cost to prepare these plans was \$248,512 and resulted in the collection of indirect cost totaling over \$25 million.

Seven agencies contracted for the development of their plans at a total cost of \$101,312. Two agencies used predetermined estimated indirect cost rates to charge federal grants and did not incur any costs. The plans for two agencies were developed by agency staff at a total cost of approximately \$7,200.

The Family Independence Agency (FIA) maintained a public assistance cost allocation plan, as required by federal regulations. Under this plan, FIA directly allocated administrative costs to federal grants based on time studies, caseload statistics, and other allocation methods.

FIA's plan is also used to directly charge federal programs for their portion of administered programs. For fiscal year 1997-98, the total cost for allocating costs to federal grants under FIA's allocation plan was approximately \$140,000. Based on FIA's size, its complexities, and federal requirements, FIA's costs are reasonable.

Glossary of Acronyms and Terms

CIS	Department of Consumer and Industry Services.
DEQ	Department of Environmental Quality.
DMB	Department of Management and Budget.
DNR	Department of Natural Resources.
DOC	Department of Corrections.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes.
FIA	Family Independence Agency.
indirect costs	Costs incurred for a common or joint purpose that benefit more than one program or function and are not readily assignable to any one program or function.
MDOT	Michigan Department of Transportation.
MSP	Michigan Department of State Police.
OMB	U.S. Office of Management and Budget.

performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.
reportable condition	A matter coming to the auditor's attention that, in the auditor's judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.
SWCAP	Statewide Cost Allocation Plan.