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**ABSTRACT**

In connection with its jurisdiction over biomedical research and development at higher education institutions, the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigations met a second time to hear testimony on abuses in the indirect cost recovery practices at universities for federal research grants and contracts. The first meeting revealed extensive financial abuses at universities and ineffective oversight by the Navy. This meeting further examined the indirect cost abuses and sought testimony on why universities negotiate for top dollar when dealing with the American taxpayer, but give preferable treatment to foreign governments and others. It also examined the status of the actions taken to prevent these abuses and bolster the partnership between the Federal Government and universities in stimulating research. Testimony and prepared statements were delivered by Joseph S. Cohen, Audit Manager, General Accounting Office (GAO); Doreen S. Eng, Senior Evaluator, GAO; Rear Admiral William C. Miller, Chief, Office of Naval Research, U.S. Navy; Fred J. Newton, Deputy Director, Defense Contract Audit Agency; Richard Ogden, Regional Inspector General for Audit Services, Department of Health and Human Services (HHS); J. Dexter Peach, Assistant Comptroller General, GAO; Thomas D. Roslewicz, Inspector General for Audit Services, (HHS); and Gary M. Taiesnik, Director, Office of Grant and Contract Financial Management, HHS. (GLR)

# FINANCIAL RESPONSIBILITY AT UNIVERSITIES (Part 2)

## HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES ONE HUNDRED SECOND CONGRESS SECOND SESSION

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ON  
INDIRECT COST RECOVERY PRACTICES AT U.S. UNIVERSITIES FOR  
FEDERAL RESEARCH GRANTS AND CONTRACTS

JANUARY 29, 1992

Serial No. 102-118

Printed for the use of the Committee on Energy and Commerce



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# FINANCIAL RESPONSIBILITY AT UNIVERSITIES

WEDNESDAY, JANUARY 29, 1992

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,  
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. DINGELL. The subcommittee will come to order. Under Rules X and XI of the House of Representatives, the Committee on Energy and Commerce has specific jurisdiction over biomedical research and development, which includes research at universities. On March 13, 1991, this subcommittee held the first hearing on universities mischarging and overcharging the Federal Government for scientific research. At that hearing, the subcommittee learned that Stanford University had been charging the taxpayers for everything from luxury yachts to enlarging the bed of the president, all in the name of Federal research.

On May 9, 1991, in the second hearing of this subcommittee, Government auditors testified about other universities charging the taxpayers for executive jet services, trips to the Grand Cayman Islands for the wife of a university president, a trustees' retreat at Palm Springs, and outrageous legal fees to defend the universities in the Federal Government investigations of wrongdoing at universities, again all in the name of furthering Federal research.

A fair amount has been accomplished since those hearings in the spring. Government audit agencies have investigated these problems aggressively. And several universities have worked to clean up the problems. The subcommittee has also broadened its focus to include new inquiries into other matters which have been disclosed as the investigation has gone forward.

First, the Defense Contract Audit Agency [DCAA] has started audits at virtually all of the 38 major research universities under the aegis of the Office of Naval Research. Many of these audits are now complete. The findings are in a word stunning.

In addition, the DCAA has initiated audits of nonprofit research institutions like the National Academy of Sciences. These audits have also discovered serious overcharging. It is also a fact that the Inspector General of the Department of Health and Human Services has completed audits of 14 of their largest universities and selected close to 260 additional schools for consideration.

As a result of these audits, tens of millions of dollars have been saved or been returned to the Treasury of the United States. Hun-

dreds of millions of dollars in expenditures are being questioned or will be questioned by the Government. At Stanford alone, DCAA has raised questions on about \$231 million. This does not include 1989 and 1990. These years could drive that figure well above \$300 million.

At MIT, DCAA has questioned approximately \$20 million for 1990 alone and is in the process of auditing 1987 through 1989.

The following are a few examples from recent audit findings of what some of our major universities have done in the way of charging the Federal Government for: "necessary" costs of doing Federal scientific research.

Carnegie Mellon University incurred \$44,000 of travel costs for European summer study in Egypt and Turkey, including a cruise on the Nile River.

Syracuse University included charges of \$11,295 for a St. Patrick's Day party and \$8,855 for summer dances.

MIT included charges of \$3,406 for limousine rentals to bring university board members to their meetings and \$23,012 for hotel rooms, meals, and alcohol for the Biology Department's spring retreat held for faculty, lab personnel and grad students.

Pennsylvania State University included \$15,000 in its indirect cost claims for advertisements at the Hershey Amusement Park.

These are some of the things which concern the subcommittee. As a result, our concerns have continued. In our hearings last March, the committee discovered that Stanford was waiving all overhead charges for foreign governments, including the Government of Japan. Why an American University would waive charges against foreign governments for research done while charging overhead costs against the American Government is a matter of some curiosity to me. Perhaps we will find an answer that will justify this. I look forward to it.

We will learn today from the HHS Inspector General that most of the universities that they have audited were offering reduced or concessionary rates to a number of foreign governments and other non-Federal entities. Apparently this event and these circumstances are not peculiar to one school. Again, the subcommittee is curious why these universities negotiate for top dollar, plus more, when dealing with the American taxpayers, but give preferable treatment to foreign governments and others.

Second, some schools have accepted responsibility, have conducted credible self-audits, have returned or saved millions of dollars of misused taxpayers' funds. These schools and their officers deserve accommodation and credit, and I am sure the American taxpayers are grateful for those efforts.

But a number of universities and organizations representing major universities and research efforts, including some who tried to sweep problems under the rug early last year, are calling foul. They argue that this recent round of audits and tough negotiations indicates that the Federal Government is now somehow welching on what has been a productive 50-year partnership between the universities and the Federal Government. Nothing is further from the truth. That argument is just plain nonsense.

This subcommittee has been enormously supportive of moneys for research. The chairman of this subcommittee and the members

have individually supported research in large amounts, and we have been extremely active in trying to see to it that funding of research programs is maintained at an adequate level in order that not only may science have proper support, but the university efforts in the area of science may continue to prosper for the good of us all, as they have since World War II.

However, it is important. The partnership has been productive between the Federal Government and the colleges and universities. It has been invaluable to the Nation. But I know no where in the understandings that have been achieved as these events went forward in which a university has achieved any agreement on the part of anyone that it could burden taxpayers with irrelevant, improper, and in a number of cases, illegal charges in the name of science.

We think that science is a precious activity by human beings, and the benefits of it are extremely important. We recognize that the colleges and universities of this country are a great national treasure and will be our purpose to see that they prosper, they flower, they grow, they are successful in carrying out their basic missions, both in terms of educating our young and in terms of moving forward the cause of science and the expansion of human knowledge. But that does not include some of the things into which this committee has been inquiring in recent times.

The third item of concern: The subcommittee's probe has now been extended to cover additional Government programs. The subcommittee is now in the process of auditing some Environmental Protection Agency's Superfund contractors with a hearing to be scheduled in March. It is interesting to note that in that instance, the overhead costs are beginning to make the colleges and universities look like very small potatoes.

The subcommittee is also directing audits of the Department of Energy's weapons facilities contractors. Audits of additional contractors, including defense contractors examined by the subcommittee's activities in the mid-1980's can be expected. Here again, we are seeing serious overbilling of the American taxpayers for activities that have nothing to do with the goals or objectives of the basic programs.

What is becoming plain again is that the philosophy of the Government during the 1980's, as exemplified in the practices of the executive branch, were to let the good times roll, to not audit, to disregard the responsibility that the Federal Government had to the taxpayers, and in so doing, to send a signal to people, good and bad, to opportunists and scoundrels and to honest citizens that the Federal Government was going to let anybody steal anything they wanted to without any particular attention to auditing or anything else.

It is noteworthy that consistently not only has this committee found a lack of attention by auditing agencies, but we have found that auditing agencies were starved by the Government and by the programs. We have found a curious consequence in which Government programs were audited after payment was made. No rational businessman, no rational citizen, would permit the conduct of his business in that sort.

In short, to conclude, the subcommittee has been dismayed to discover the depth and breadth of indirect cost abuses at universities and elsewhere. We will continue to inquire into these matters. We feel that those items of misbehavior, in part, were stimulated by active disregard of Government with its responsibility to see to it that auditing went forward properly and vigorously.

We are grateful that we have the assistance of the General Accounting Office, which we believe is a fine institution, and which has been of enormous help to this committee in trying to protect the taxpayers against the kind of wrongdoing that has flourished during the 1980's. We are grateful for the actions taken by relevant Government agencies who will be testifying here today.

One of our purposes will be to see to it that the process maintains the supervision that is required so that proper continued audits may not only retrieve moneys improperly taken from the Government and the taxpayers, but also may achieve something else, and that is policies and practices inside the Federal Government where the American taxpayer can be satisfied that he is protected, rather than assuming that his Government is going to sit idly by and watch people dissipate the resources of the all of the people of the United States.

One more word about the partnership between the Government and the research universities. This is an important partnership. It is one which is calculated to stimulate research, and to invigorate and to cause the universities to grow and prosper. That is the policy of the Federal Government, and it is one which I endorse. It is too important, however, to be threatened by the kind of misbehavior in which this inquiry is going; and it is my suggestion that those who would scrutinize this committee with regard to its attitude might understand we believe that this kind of research program, this kind of cooperation between the Government and the colleges and universities can only prosper if it is conducted honestly and properly on both sides.

The Chair announces that our first witnesses are a panel composed of Mr. J. Dexter Peach, Assistant Comptroller General; and Ms. Eng and Mr. Cohen. Ladies and gentlemen, if you will please come forward, we will be delighted to receive your testimony.

As you very well know, it is the practice that all witnesses appearing before the committee testify under oath. Do you, Ms. Eng, you, Mr. Peach, or you, Mr. Cohen, have any objections to testifying under oath?

The Chair advises you that copies of the rules of the subcommittee, rules of the committee and rules of the House are there before you at the committee tables. They are there to inform you of your rights and the limitations on the powers of this committee. The Chair asks, as it must under the rules, do you or any of you desire to be advised by counsel during your appearance here?

Mr. PEACH. No, Mr. Chairman.

Mr. DINGELL. Very well. Then if you will each please rise and raise your right hand.

[Witnesses sworn]

Mr. DINGELL. You may each consider yourself under oath, and we are happy to recognize you for such statement as you choose to give.

**TESTIMONY OF J. DEXTER PEACH, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DOREEN S. ENG, SENIOR EVALUATOR, AND JOSEPH S. COHEN, AUDIT MANAGER**

Mr. PEACH. Thank you, Mr. Chairman. I would like to have my entire prepared statement entered into the record and then proceed with a summary of that statement.

Mr. DINGELL. Without objections, so ordered.

Mr. PEACH. Just for your identification, the people accompanying me at the table, Ms. Eng is from our San Francisco regional office and has been principally responsible for the work that was done at Stanford and at the University of California, Berkeley, and Mr. Cohen is from our Boston regional office and has been principally responsible for the work done at MIT and at Harvard Medical School.

We are pleased to be here to discuss the results of our work on whether selected universities charged excessive indirect research costs to the Government. We began examining this area in response to your request to look at indirect costs charged by Stanford.

Our testimony today focuses on three additional institutions you asked us to visit: The Harvard Medical School, the Massachusetts Institute of Technology, and the University of California at Berkeley. Harvard Medical and Berkeley are under the cognizance of the Department of Health and Human Services and have predetermined rates set with HHS. MIT, like Stanford, is under the cognizance of the Office of Naval Research and thus has a fixed rate with a carry-forward provision with ONR.

We generally examined the most recent indirect cost proposal at each of the three schools reviewed. Our objective was to determine whether the types of mischarges and misallocations of costs we reported on last March were also occurring at schools other than Stanford. Our review was not intended to determine what the actual indirect cost rate should be for each of the three universities. At MIT, the Defense Contract Audit Agency, which has audit responsibility for all ONR cognizant schools, is currently in the process of auditing MIT's indirect costs for fiscal years 1986 to 1990. Therefore we primarily reviewed DCAA's ongoing audit work and results.

We identified numerous deficiencies in the cost allocation methods and charging practices at all three universities. In some cases, we found problems that the university, the university's external auditors, or the cognizant audit agency had already reviewed but had not questioned. For example, we found instances at all three schools in which costs that were unallowable under Circular A-21 were included in various cost pools, portions of which were allocated to Federal research.

Specifically, Harvard Medical's reviews of administrative accounts, as well as external audits that used sampling techniques, identified a total of \$1.8 million of unallowable and questionable cost. Of this total, \$254,000 was allocated to the Government. We reviewed the same sample of transactions and identified an additional \$894,000 in unallowable and questionable costs, of which

\$75,000 was allocated to the Government. This included costs for such items as alumni publications, extra pension costs for a non-Medical School dean, and excessive athletic facility costs.

MIT reviewed selected accounts for fiscal years 1986 through 1990 in response to a request from DCAA. For those 5 years, MIT identified about \$1.8 million in unallowable or inappropriate charges, of which about \$778,000 had been charged to the Government. These costs included charges for such items as floral designs, dues for airline airport clubs, artwork, overseas trips, receptions, dinners, and other party expenses. MIT recently repaid the Government for these overcharges.

At Berkeley, we identified about \$736,000 in unallowable or questionable transactions, \$66,000 of which was allocated to the Government. These included about \$300,000 for furniture and decorating items for the university's residence halls, items which should have been charged directly to other institutional activities. In addition, other unallowable or questionable items charged included alumni publications, Berkeley High's graduation, which was held at the university, and 150 football tickets for potential university donors.

As these examples show, charges similar to those we found at Stanford also occurred at the three universities we visited. While the magnitude of unallowable charges at each school may vary, the problem of unallowable costs being charged to the Government is systemic. This has been substantiated by the HHS office of Inspector General and by DCAA audits at other universities conducted over the last several months.

Although the problem of unallowable cost is serious, the allocation process has the greatest potential for significant overcharges to Federal research because the indirect costs being allocated often involve sizeable amounts such as building depreciation and utility costs. At all three schools, we found numerous problems with the allocation methods. These problems occurred because the universities either did not comply with or improperly applied the A-21 criteria. As a result, overallocations of indirect costs to the Government at the three schools we reviewed totaled over \$12 million.

Let me cite a few examples. OMB Circular A-21 requires that depreciation and use allowances for buildings and equipment, as well as operation and maintenance costs, be allocated on the basis of assignable square feet unless a more equitable method is justified by the university. To determine assignable square feet, all three schools conducted space surveys.

Proper assignment of space is critical because it is used to allocate a significant portion of indirect costs. We found problems with the space surveys at Berkeley and Harvard Medical. We did not independently review MIT's space survey because DCAA was in the process of reviewing it as part of its audit.

At Harvard Medical, many of the Federal and non-Federal research projects share the same space. HHS found that Harvard Medical allocated the space between and thus developed separate rates for both kinds of research, with a disproportionately higher share of costs being assigned to Federal research, a distinction that Harvard Medical officials could not support.

As a part of their ongoing negotiations with HHS, Harvard Medical agreed to combine Federal and non-Federal research into a

single rate. This resulted in a \$700,000 reduction in the indirect costs allocated to the Government.

At Berkeley, we found that inadequacies in training, instructions, and quality control measures resulted in numerous errors within the university's space survey. The most significant problem, involving coding and data errors, resulted in 7 percent of total campus space being coded as "unassigned." The subsequent allocation of costs did not recognize this unassigned space; therefore, 100 percent of space-related costs were allocated to only 93 percent of the space. This resulted in an overallocation of \$580,000 to the Government in Berkeley's proposal. Berkeley agreed that this was an error.

As you may recall from my previous testimony, Stanford's allocation process was largely driven by memorandums of understanding that had been accepted and approved by ONR. MIT, the other ONR school reviewed, also had several MOU's that affected its allocation methods. Interestingly, DCAA issued a report in early February 1991 stating it had reviewed all of MIT's MOU's and had determined that, "in all cases, the contractor was in compliance with the terms of the MOU's and that the basis for the MOU's are reasonable." This analysis was incorporated into DCAA's audit report of MIT's 1986 actual costs, which DCAA issued on February 28, 1991. After the March 1991 hearings on Stanford, DCAA withdrew its report and reopened its audit. As of this month, DCAA officials informed us they have identified \$4.8 million in questioned costs to the Government relating to several of the MOU's.

We had brought one of these MOU's to DCAA's attention. This MOU allowed MIT to amortize \$3.6 million in renovation costs to a leased building over a 6-year period. However, MIT had already exercised an option to purchase the building when the MOU was signed. Had the costs been capitalized and charged to research on the basis of the 2 percent use allowance that MIT uses for the rest of its owned buildings, MIT would have been able to claim only \$72,000 a year instead of the \$600,000 it claimed under the MOU. For the 6 years the MOU covered, this amounts to a difference of \$3.2 million, of which \$2.4 million was charged to the Government. DCAA agreed with our analysis which it will incorporate into its final report.

Much of the criticism toward the allocation practices at universities have been focused on MOU's. However, we found several other problems with the determination of allowable indirect costs at the three universities reviewed which were not specified in MOU's, but instead were spelled out in various accounting policies.

For example, we found a problem with MIT's capitalization policy. Under OMB Circular A-21, capital expenditures that materially increase the value or useful life of an asset are unallowable as direct or indirect cost, except that a portion may be claimed as depreciation. However, A-21 does not set a dollar threshold for capitalization. We found that MIT's capitalization policy only requires capitalizing additions and improvements when such items exceed \$3 million, as contrasted with Berkeley and Harvard Medical, whose thresholds were \$20,000 and \$50,000, respectively.

Such a policy allows MIT to claim significantly more costs in the present year than would have been allowed had they capitalized

such costs. For example, MIT expended \$3.6 million in fiscal year 1990 for 14 building projects that exceeded \$100,000 each, of which \$1.9 million was charged to Federal research. Had these items been capitalized and subject to the use allowance, only \$38,000 would have been charged to Federal research for that year.

Similarly, Berkeley routinely records standard office furniture as an expense, regardless of the cost. Circular A-21 sets a threshold of \$500 for capitalizing equipment, which includes office equipment and furnishings. Berkeley officials, however, informed us that the University of California policy requires recording all standard office furniture as an expense, which directly contradicts Circular A-21. While we could not quantify the actual overcharge to the Government resulting from this policy, it could be significant since the policy affects all nine University of California campuses. Four of these campuses are among the top 15 Federal research dollar recipients nationwide.

I should note that while we found numerous problems with Berkeley's indirect cost proposal, not all the problems we found were in Berkeley's favor, and this is somewhat different than what we found when we looked at Stanford, MIT and at Harvard where all the differences were in the university's favor.

Mr Chairman, the problems identified resulted from breakdowns in several key areas of the system dealing with indirect costs. First, Circular A-21 criteria were inadequate for determining the types of allowable costs and how these costs should be properly allocated among university functions. These inadequacies occurred because some principles in A-21 were vague, inconsistent or absent altogether.

Second, universities generally lacked adequate systems and controls to ensure that only allowable indirect costs were charged to the Government. Many university employees responsible for entering transactions in the accounting systems did not have adequate training in Federal cost principles and thus may not have recognized that they were recording transactions incorrectly.

Last, we believe that lax oversight practices by ONR and HHS were important contributing factors. At the schools we visited, we found instances in which both Agencies failed to adequately review their assigned universities' indirect cost proposals or claims to detect and remove unallowable or unallocable costs.

Since the March 1991 hearings first brought to light the problems we found at Stanford, all parties involved with the indirect cost process have been taking various actions to address the problems noted. Particularly noteworthy, OMB, recognizing the shortcomings of Circular A-21, issued a major revision to it in October 1991. This revision, which was the first in 5 years, further defines and limits allowable indirect costs. Among other things, the revision clarifies and disallows certain types of costs that had previously been paid to universities. Most significantly, Circular A-21 now limits reimbursement for administrative expenses to 26 percent, which OMB has estimated will reduce Federal reimbursements by \$80 million to \$100 million a year.

To conclude, Mr. Chairman, the steps that are being taken are appropriate interim steps. However, they alone are not sufficient to prevent future occurrences of the same types of abuses noted in

these hearings without a commitment of a substantial amount of resources, both by the universities and the cognizant agencies.

Furthermore, both the Congress and the administration have expressed concern about rising indirect costs and the impact these costs have on the Government's ability to fund a growing array of university research activities. Both of these are complicated issues that need to be addressed.

In view of these concerns we believe this may be an opportune time to re-examine the Federal approach to reimbursing universities for indirect costs. Both OMB and HHS have begun this process by establishing task forces to address this broader concern. A number of proposals have been offered, both for simplifying the process and for reducing overall expenditures for indirect costs through application of caps or fixed rates on the various categories of indirect costs.

As a part of our ongoing work, we are examining the range of indirect cost rates now being applied at universities to better gauge how the various proposals might effect the reimbursements of indirect costs at universities. We also plan to obtain the views of Government and university officials on the likely impacts and other implications that various approaches might have for simplifying the process and affecting Federal oversight responsibilities.

In this regard, Mr. Chairman, it is not clear to me at this point why we need two different agencies using different approaches for oversight of research grants. We also need to carefully evaluate what can be gained through more precise application of cost accounting principles and improved definitions of allowable costs and the application of OMB Circular A-133 audits, and evolving to a more simplified system that keeps the cost of administering it within bounds while at the same time protecting the Government's interest.

These are issues that we are going to try to deal with and provide some input to the committee as we continue our work and issue the report that we plan to have out within the next 2 to 3 months. Thank you, Mr. Chairman. That concludes my statement, and I and my colleagues will do our best to respond to your questions.

[Testimony resumes on p. 37.]

[The prepared statement and attachments of Mr. Peach follow:]

Statement of J. Dexter Peach, Assistant Comptroller General,  
Resources, Community, and Economic Development Division

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the preliminary results of our work on whether selected universities charged excessive indirect research costs, or "overhead" as it is commonly known, to the federal government. As you know, we began our work, in response to your request, by examining the indirect costs charged by Stanford University. The results of that work were widely publicized following hearings held before this Subcommittee on March 13 of last year.<sup>1</sup>

Our testimony today focuses on three other institutions: the Harvard Medical School (Harvard Medical), the Massachusetts Institute of Technology (MIT), and the University of California at Berkeley (Berkeley). We sought to learn whether the types of mischarges and misallocations of costs we reported to you in March were also occurring at these schools and, if so, to determine the causes and the types of actions that might be needed to correct them. We also looked at recent actions taken by the Office of Management and Budget (OMB) and others to deal with these specific kinds of problems. Finally, we considered further steps that might be appropriate on a broader scale to improve the system for reimbursing universities for indirect research costs.

In summary, we identified numerous deficiencies in the cost allocation methods and charging practices at the three universities. In some cases, we found problems that the university, the university's external auditors, or the cognizant audit agency had already reviewed but had not questioned. These problems occurred because (1) certain OMB Circular A-21 criteria were inadequate for determining which types of costs should be allowed or how costs should be properly allocated among the

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<sup>1</sup>Federally Sponsored Research: Indirect Costs Charged by Stanford University, (GAO/T-RCED-91-18, Mar. 13, 1991).



different university functions; (2) universities generally lacked adequate systems and internal controls to ensure that only allowable indirect costs were charged to the government; and (3) lax oversight practices by the cognizant federal agencies resulted in universities claiming excessive indirect costs.

Since the March 1991 hearings, all parties involved have taken steps to address the problems noted. For example, OMB issued a major revision to Circular A-21 in October that further limits the types and amount of indirect costs universities may claim. Some schools are adding modifications to their accounting systems to better segregate allowable from unallowable costs and have begun training programs for their employees on the federal cost principles. The cognizant agencies have increased their audit presence and taken other steps to strengthen oversight at universities.

While these actions may be appropriate interim steps, we believe that now is an opportune time to reexamine the federal approach for reimbursing universities for indirect costs. OMB is already beginning this process by leading a task force to further evaluate and possibly revamp the system for reimbursing indirect costs. The Department of Health and Human Services (HHS) also has under way a study of National Institutes of Health sponsored research costs at universities.

As part of our ongoing work, we are looking at various approaches and options that could limit additional rate increases, simplify the reimbursement process, or strengthen federal oversight of indirect costs. We plan to discuss these approaches in our upcoming report, which is scheduled for release in the spring.

Before I discuss our preliminary findings in more detail, let me provide some background on the federal process for negotiating indirect cost rates at universities.

BACKGROUND

OMB Circular A-21 establishes the cost principles universities must follow in determining the types of allowable costs and the methods of allocating such costs to federally funded research. Direct costs are those that can be specifically identified with a particular research contract or grant; indirect costs are those that cannot be so identified and thus are charged via an indirect cost rate applied to each agreement. Generally, allowable indirect costs are grouped into several cost pools that are then allocated to the various functions of the university, such as research or instruction. The indirect costs ultimately allocated to research are then used to determine the university's indirect cost rate. The actual rate allowed, however, is negotiated between the university and its assigned cognizant agency, which is responsible for negotiating the rate for all government agencies. Most schools are assigned to HHS; however, the Department of Defense, through the Office of Naval Research (ONR), has cognizance over 38 schools.

Harvard Medical and Berkeley are HHS-cognizant schools, and MIT, like Stanford, is an ONR-cognizant school. The type of indirect cost rate negotiated generally differs between HHS- and ONR-cognizant schools. ONR typically uses a fixed rate with a carry-forward provision. Under this approach, the university negotiates a provisional rate for billing the federal government in the year ahead. After the year is over, actual costs are audited and negotiated. Once a final negotiated rate is agreed upon, the difference between the amount received under the provisional rate and the amount finally negotiated is then carried forward and applied against future years' rates. As a result, ONR schools generally receive the full amount of their allowable, claimed indirect costs.

In contrast, HHS typically uses a predetermined fixed-rate scheme; that is, the agency negotiates a fixed rate with the school

for generally a 2- or 3-year period, on the basis of prior year incurred costs. Because this negotiated rate is not later audited or adjusted for actual costs, the schools following this approach may over-recover or under-recover their actual indirect costs.

MIT, like Stanford, has a fixed rate with carry-forward provisions with ONR, whereas Harvard Medical and Berkeley have predetermined fixed rates with HHS. MIT's fiscal year 1990 proposed rate, which is currently being audited<sup>2</sup>, is 62 percent. This means that, for every \$100,000 awarded to cover the direct costs of a research project,<sup>3</sup> another \$62,000 is added for indirect costs. Harvard Medical proposed a fiscal year 1991 rate of 96 percent; however, in April 1991, after unsuccessful negotiations, HHS imposed a rate of 63.5 percent, which Harvard Medical is currently appealing. Berkeley has a negotiated fiscal year 1990-92 rate of 49 percent.

We generally examined the most recent indirect cost proposal at each of the three schools reviewed. Our objective was to determine whether the types of mischarges and misallocations of costs we reported on in March were also occurring at schools other than Stanford and, if so, to determine the causes and types of actions that might be needed to correct them. Our review was not intended to determine what the actual indirect cost rate should be for each of the three universities. At MIT, the Defense Contract Audit Agency (DCAA), which has audit responsibility for all ONR-cognizant schools, is currently in the process of auditing MIT's

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<sup>2</sup>At the time of this writing, DCAA officials informed us they planned to complete the 1990 audit and issue a report about January 24, 1992.

<sup>3</sup>This formula is subject to certain exclusions. OMB Circular A-21 requires that the indirect cost rate be calculated on the basis of modified total direct costs (MTDC), rather than on the total contract or grant amount. MTDC excludes, for example, purchased equipment and any subgrants or subcontracts over \$25,000 each.

indirect costs for fiscal years 1986 through 1990<sup>4</sup>. Therefore, we primarily reviewed DCAA's ongoing audit work and results. Further information on the details of the work performed at each of these universities can be found in appendix I.

UNALLOWABLE AND QUESTIONABLE  
COSTS CHARGED TO FEDERAL RESEARCH

Our audit work, as well as that of others, has shown a number of instances at all three schools in which costs that were unallowable under Circular A-21 were included in various cost pools, portions of which were allocated to federal research. In addition, we identified other costs that appeared questionable for charging to the government.

Specifically, MIT reviewed its sensitive accounts for fiscal years 1986 through 1990 in response to a request from DCAA. For those 5 years, MIT identified about \$1.8 million in unallowable or inappropriate charges, of which about \$778,000 had been charged to the government. These costs included charges for such items as floral designs, dues for airline airport clubs, artwork, overseas trips, receptions, dinners, and other party expenses. MIT has since repaid the government for these overcharges. MIT reviewed additional transactions at DCAA's request, which DCAA officials will report on.

In addition, Harvard Medical's review of administrative accounts, as well as external audits that used sampling techniques, identified a total of \$1.8 million in unallowable or questionable costs; of this total \$254,000 was allocated to the government. These costs included those that were incurred at the central Harvard University level, as well as at the Medical School. We

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<sup>4</sup>At the time of this writing, DCAA officials informed us they planned to complete the 1990 audit and issue a report in late January, 1992. They are continuing to audit fiscal years 1986 through 1989.

reviewed the same sample of transactions and identified an additional \$894,000 in unallowable or questionable costs, of which \$75,000 was allocated to the government. These included costs for such items as alumni publications, extra pension costs for a non-Medical School dean, and excessive athletic facility costs.

I should note that we found several problems with the adequacy of the review by Harvard's hired auditors. For example, they did not use a random start to select their samples, nor did they properly handle credit (negative) items. In addition, they initially deleted certain unallowable costs from their statistical projections because Medical School officials informed them that these transactions were anomalies. We believe these costs should not have been deleted because, in statistical sampling, they serve as "proxies" for other unknown transactions in the universe. As a result, the auditor's sampling results were not accurately projected. Harvard officials have since agreed with our judgment that such costs should have been included in the projection.

At Berkeley, we identified about \$736,000 in unallowable or questionable transactions, \$66,000 of which was allocated to the government. These included costs that were incurred at the central University of California level, as well as at the Berkeley campus. These included about \$300,000 for furniture and decorating items for the University's residence halls, items which should have been charged directly to other institutional activities. In addition, other unallowable or questionable items charged included alumni publications; Berkeley High School's graduation, which was held at the University; and 150 football tickets for potential University donors.

As these examples show, charges similar to those we found at Stanford also occurred at the three universities we visited. While the magnitude of unallowable charges at each school may vary, the problem of unallowable costs being charged to the government is

systemic. This has been substantiated by the HHS Office of Inspector General and by DCAA audits at other universities conducted over the last several months.

Further examples of unallowable or questionable transactions charged by each of the three universities visited are identified in appendix II.

#### IMPROPER ALLOCATIONS OF COSTS TO FEDERAL RESEARCH

As we reported to you in March 1991, the allocation process has the greatest potential for significant overcharges to federal research because the allocation methods affect all indirect costs. At all three schools we found numerous problems with the allocation methods. These problems occurred because the universities either did not comply with or improperly applied the A-21 criteria. As a result, overallocations of indirect costs to the government totaled over \$12 million.

#### Space Allocations

OMB Circular A-21 requires that depreciation and use allowances for buildings and equipment as well as operation and maintenance (O&M) costs be allocated on the basis of assignable square feet unless a more equitable method is justified by the university. To determine assignable square feet, all three schools conducted space surveys. We found problems with the space surveys at two of the schools, Berkeley and Harvard Medical. Proper assignment of space is critical because it is used to allocate a significant portion of indirect costs. For example, the buildings, equipment, interest and O&M costs at Berkeley and Harvard Medical were 29 and 59 percent of their total proposed indirect research costs, respectively. We did not independently review MIT's space survey.

At Harvard Medical, many of the federal and nonfederal research projects share the same space, and HHS found that Harvard Medical allocated the space between, and thus developed separate rates for, both kinds of research. By doing so, a disproportionately higher share of space costs was assigned to federal research, despite the fact Harvard Medical officials could not support the basis for this distinction. As part of their ongoing negotiations with HHS, Harvard Medical agreed to combine federal and nonfederal research into a single rate. This resulted in a \$700,000 reduction in the direct costs allocated to the government.

At Berkeley, we found inadequacies in training, instructions, and quality control measures resulted in numerous errors with the university's space survey. The most significant problem, involving coding and data entry errors, resulted in 7 percent of total campus space being coded as "unassigned." The subsequent allocation of costs did not recognize this unassigned space; therefore, 100 percent of the space-related costs was allocated to only 93 percent of the space. This resulted in an over-allocation of \$580,000 to the government in Berkeley's proposal. Berkeley agreed this was an error.

### Special Studies

OMB Circular A-21 allows universities to allocate certain costs on the basis of a cost analysis study if the study demonstrates a more equitable distribution of costs. All three universities performed utility studies to attempt to justify higher allocations of costs to research. Basically, these studies measured actual utility consumption to calculate weighting factors that were then used to allocate utility costs. These weighting factors served to allocate proportionately more costs to space, such as research labs, which use more energy. DCAA found problems with MIT's utility study which it will report on in its 1990 audit.

report. Although we found no problem with the application of Berkeley and Harvard Medical's studies to utility costs, we did find several problems with their application to nonutility costs.

We found that both schools used their studies to allocate utility maintenance costs, which included such items as costs of elevator repairs, fire equipment inspections, and management and review efforts. Officials at Harvard Medical said their approach was justified because utility maintenance costs are higher in buildings that have higher utility costs. However, other factors, such as the age of the buildings and equipment, could have a greater effect on maintenance costs than utility consumption, and neither of the schools demonstrated a direct correlation between utility and utility maintenance costs.

Berkeley also allocated the cost of its energy conservation office using utility study factors. Likewise, Harvard Medical used the results of its utility study to allocate the depreciation costs for electrical, plumbing, heating, ventilation, and air conditioning equipment. Because none of these costs, including the utility maintenance costs, were included in the utility studies, they should not have been allocated on the basis of the utility study results. Since utility study factors weight costs more heavily toward research, using these factors for nonutility costs resulted in a higher proportion of costs being allocated to research without justification. By using these factors, Berkeley allocated an additional \$76,000 to federal research, while Harvard Medical allocated an additional \$174,000.

#### Memorandums of Understanding

As you may recall from our previous testimony, Stanford's allocation process was largely driven by memorandums of understanding (MOUs) that had been accepted and approved by ONR. MIT--the other ONR school we reviewed--also had several MOUs that

affected its allocation methods. Interestingly, DCAA issued a report in early February 1991 stating it had reviewed all 10 of MIT's MOUs and had determined that "in all cases, the contractor is in compliance with the terms of the MOUs" and that the bases for the MOUs are reasonable." This analysis was incorporated into DCAA's audit report of MIT's 1986 actual costs, which DCAA issued on February 28, 1991. After the March 1991 hearings on Stanford, DCAA withdrew its report and reopened its audit. As of this month, DCAA officials informed us that they had identified \$4.8 million in questioned costs to the government relating to several of the MOUs.

We had brought one of these MOUs to DCAA's attention. This MOU allowed MIT to amortize \$3.6 million in renovation costs to a leased building over a 6-year period. However, MIT had already exercised an option to purchase the building when the MOU was signed. Had the costs been capitalized and charged to research on the basis of the 2-percent use allowance that MIT uses for the rest of its owned buildings, MIT would have been able to claim only \$72,000 a year instead of the \$600,000 it claimed under the MOU. For the 6 years the MOU covered, this amounts to a difference of \$3.2 million, of which \$2.4 million was charged to the government. DCAA agreed with our analysis, which it incorporated into its final report.

While the two HHS schools we reviewed, Harvard Medical and Berkeley, did not have any written MOUs, HHS allowed some allocation methodologies that deviated from Circular A-21. These allowed methods could be considered "unwritten" MOUs. For example, A-21 requires depreciation and use allowance costs to be allocated on a building-by-building basis. However, Berkeley allocated its equipment costs by department and, in addition, did not sample all departments. Therefore, the allocations do not comply with A-21 requirements and would not necessarily be accurate even if they were in compliance. The HHS negotiator told us he was aware of this allocation method but did not consider it a problem because he

did not consider the equipment costs to be material. We believe the costs are significant, however, since about \$5 million in equipment costs were allocated to federal research, even though we could not determine what portion was affected by this method.

Additional examples of improper allocations noted are described in appendix III.

#### OTHER INDIRECT COST PROBLEMS

We found several other problems with the determination of allowable indirect costs at the three universities reviewed. For example, we found a problem with MIT's capitalization<sup>5</sup> policy. Under OMB Circular A-21, capital expenditures that materially increase the value or useful life of an asset are unallowable as direct or indirect costs, except that a portion may be claimed as depreciation. However, A-21 does not set a dollar threshold for capitalization. We found that MIT's capitalization policy only requires capitalizing additions and improvements when such items exceed \$3 million, as contrasted with Berkeley and Harvard Medical, whose thresholds were \$20,000 and \$50,000, respectively. Such a policy allows MIT to claim significantly more costs in the present year than would have been allowed had they capitalized such costs. For example, MIT expended \$3.6 million in fiscal year 1990 for 14 building projects that exceeded \$100,000 each, of which \$1.9 million was charged to federal research. Had these items been capitalized and subject to the use allowance, only \$38,000 would have been charged to federal research for that year.

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<sup>5</sup>Items which are capitalized are inventoried and depreciated over time. Only the annual depreciation is recorded as an expense each year. Items that are not capitalized are not recorded in inventory, and the full price is recorded as an expense in the period the item is purchased.

Similarly, Berkeley routinely records standard office furniture as an expense regardless of the cost. Circular A-21 sets a threshold of \$500 for capitalizing equipment, which includes office equipment and furnishings. Berkeley officials, however, informed us that University of California policy requires recording all standard office furniture as an expense, which directly contradicts Circular A-21. While we could not quantify the actual overcharge to the government resulting from this policy, it could be significant since the policy affects all 9 University of California campuses; 4 of these campuses are among the top 15 federal research dollar recipients nationwide.

I should note that while we found numerous problems with Berkeley's indirect cost proposal, in addition to those already mentioned, not all of the problems we found were in Berkeley's favor. Unlike the other schools we reviewed, Berkeley made some mistakes that actually ended up in the government's favor by allocating fewer costs to the government than it would have without these mistakes. These mistakes included, for example, minor calculation errors in the utility study, use of the wrong utility factors in the proposal, and misallocation of some operation and maintenance costs. While these serve to offset some of the dollar amounts that were in Berkeley's favor, of greater concern is the weakness in internal controls and other checks that should prevent or detect such errors.

#### CAUSES OF PROBLEMS NOTED

Mr. Chairman, the problems identified resulted from breakdowns in several key areas of the system dealing with indirect costs. First, Circular A-21 criteria were inadequate for determining the types of allowable costs and how those costs should be properly allocated among university functions. These inadequacies occurred because some principles in A-21 were vague, inconsistent, or absent altogether. For example, until OMB's recent revision to Circular

A-21, university officers' housing costs were not identified as unallowable charges to the government.

Second, universities generally lacked adequate systems and controls to ensure that only allowable indirect costs were charged to the government. Many university employees responsible for entering transactions into the accounting systems did not have adequate training in federal cost principles and thus may not have recognized that they were recording transactions incorrectly.

Last, we believe that lax oversight practices by ONR and HHS were contributing factors. At the schools visited, we found instances in which both agencies failed to adequately review their assigned universities' indirect cost proposals or claims to detect and remove unallowable and/or unallocable costs. For example, ONR officials were lax in performing their responsibilities by not always requesting audits on a timely basis and by entering into MOUs that resulted in improper over-allocations of indirect costs to the government. DCAA, which is responsible for auditing the ONR schools, was in many cases years behind in performing requested audits. For example, DCAA did not complete its audit of MIT's 1986 costs until February 1991, and it is currently re-auditing those costs as well as those for 1987 through 1990<sup>6</sup>. In addition, DCAA did not always review cost submissions for unallowable items in sensitive accounts, such as the President's House accounts. According to the HHS Director of the Division of Cost Allocation, HHS negotiators spend their limited time examining the broader allocation process rather than looking at individual cost transactions, and often negotiate reductions in universities' proposed indirect cost rates which he believes more than compensate for any unallowable costs not identified by their negotiators. As an example of the results of this process, Berkeley's proposed rate of 59 percent was negotiated down to 49 percent, equivalent to a

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<sup>6</sup>See footnote 4 on page 5.

reduction in indirect costs of about \$8 million. However, we found several allocation problems, as well as unallowable cost charges, at Berkeley which had not been identified by the negotiator.

#### ACTIONS TAKEN OR PLANNED

Since the March 1991 hearings first brought to light the problems found at Stanford, all parties involved with the indirect cost process have taken various actions to address the problems noted. The cognizant agencies (ONR and HHS) have acted to correct some of their past problems. ONR cancelled all but one of the MOUs at Stanford and as well as many at its other assigned schools and implemented new review procedures for entering into MOUs. These new procedures include requiring an audit and legal review of such agreements before they are made, to prevent the type of improper and inequitable MOUs we have discussed today and previously. In addition, ONR and DCAA, which have audit responsibility for ONR schools, are continuing to review Stanford's indirect costs for the past 10 years and to negotiate a final settlement for those years. Since the March 1991 hearings, DCAA and the HHS Office of Inspector General have increased their audit effort at other universities as well. DCAA has initiated reviews at all 38 ONR institutions and, in some cases, re-opened audits at schools where the audit report had already been issued, but final negotiations had not yet taken place. Likewise, HHS/OIG conducted reviews at 14 universities and assigned staff to assist in the negotiation reviews at others. However, these reviews are not full audits but instead focus primarily on reviewing administrative transactions and selected additional areas as determined by the audit team.

At the university level, HHS and DCAA reported to you in May 1991 that some institutions had begun their own reviews of indirect costs and would be returning millions of dollars to the government or reducing proposals or claims that had already been submitted. Since the March 1991 hearings, Stanford University has directly

repaid about \$1,351,000 to the government and has made additional adjustments to the carry-forward totalling \$596,000, for a total reduction to date of \$1,947,000. Similarly, MIT has repaid \$778,000 for unallowable or inappropriate expenses. Harvard Medical has made net reductions totalling \$248,000 to its proposed 1991 indirect cost rate since submitting its original proposal. Stanford and the three additional schools we reviewed have also started planning for or have already implemented modifications to their accounting systems to better segregate allowable from unallowable costs and have begun training programs to better educate their employees on the federal cost principles.

OMB, recognizing the shortcomings of Circular A-21, issued a major revision to it in October 1991. This revision, which is the first in 5 years, further defines and limits allowable indirect costs. Among other things, the revision clarifies and disallows certain types of costs that had previously been paid to universities. For example, we reported to you in March on costs such as flowers, sterling silverware, cedar closets and other expenses incurred for the Stanford University President's home. Circular A-21 had been silent on whether such costs were allowable. The new revision to A-21 now clearly disallows the housing and personal living costs of institutions' officers. More significantly, Circular A-21 now limits reimbursement for administrative expenses to 26 percent, which OMB has estimated will reduce federal reimbursements by \$80 million to \$100 million a year.

#### CONCLUSIONS

In conclusion, Mr. Chairman, the actions that have been and are being taken appear to be appropriate interim steps. However, they alone are not sufficient to prevent future occurrences of the same kinds of abuses noted in these hearings without a commitment of a substantial amount of resources, both by the universities and

the cognizant agencies. Furthermore, both the Congress and the administration have expressed concern about rising indirect costs and the impact these costs have on the government's ability to fund a growing array of university research activities. Both are complicated issues that need to be addressed.

In view of these concerns, we believe this may be an opportune time to reexamine the federal approach to reimbursing universities for indirect costs. Both OMB and HHS have begun this process by establishing task forces to address this broader concern. A number of proposals have been offered, both for simplifying the process and for reducing overall expenditures for indirect costs through application of caps or fixed rates on the various categories of indirect costs. As part of our ongoing work, we are examining the range of indirect cost rates now being applied at universities to better gauge how the various proposals might affect reimbursement of indirect costs at universities. We also plan to obtain the views of government and university officials on the likely impacts and other implications the various approaches might have for simplifying the process and affecting federal oversight responsibilities. We plan to include this information in our upcoming report.

This concludes my statement, Mr. Chairman. I would be glad to answer any questions.

OBJECTIVES, SCOPE, AND METHODOLOGY

We initially reviewed the indirect costs charged by Stanford University in response to a September 7, 1990, request from the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, to examine how universities charge and allocate indirect costs to federally sponsored research grants and contracts. After reporting our findings on Stanford to the Subcommittee on March 13, 1991, we subsequently expanded our review to three other institutions: the Harvard Medical School (Harvard Medical), the Massachusetts Institute of Technology (MIT), and the University of California at Berkeley (Berkeley). Our objective was to determine whether the types of mischarges and misallocations of costs we reported on in March were also occurring at schools other than Stanford and, if so, to determine the causes and types of actions that might be needed to correct these problems. Our review was not intended to determine what the actual indirect cost rate should be for each of the three universities.

At MIT, the Defense Contract Audit Agency (DCAA) is currently auditing incurred costs for fiscal years 1986 through 1990<sup>7</sup>. Therefore, we primarily reviewed DCAA's ongoing audit work and results. At Harvard Medical, we focused our review on its fiscal year 1991 proposal, which is based on actual 1989 costs. This proposal is still under negotiation and appeal with the Department of Health and Human Services (HHS), thus we also considered some of HHS' findings. In conjunction with its proposal, Harvard Medical had also hired an outside accounting firm to review its administrative accounts to identify and eliminate any unallowable or inappropriate transactions. We reviewed the accounting firm's results, as well as the firm's sampling methodology. Some of the

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<sup>7</sup>See footnote 4 on page 5.

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costs in Harvard Medical's proposal were actually incurred at the central Harvard University level, then allocated out to the various schools, such as the Medical School. Our findings reflect only the dollar effect from the Medical School; the true effect to the government would be somewhat higher since the government also pays for portions of costs at the other Harvard University schools conducting federal research.

We reviewed Berkeley's fiscal year 1990-92 proposal, which is based on actual 1988 costs. This proposal had already been negotiated and closed at a lower rate than Berkeley proposed--resulting in a difference of approximately \$8 million. Like Harvard Medical, some of the costs in Berkeley's proposal were incurred at the University of California (UC) level, then allocated to the nine UC campuses, including Berkeley. While our findings reflect the impact to the government at Berkeley, the true effect to the government would be higher since all of the central UC costs are allocated to each of the nine UC campuses, portions of which are paid for by the government through each school's indirect cost rates.

We discussed the information in this testimony with officials at the three universities and incorporated their views where appropriate.

We also looked at the oversight provided by the Office of Naval Research (ONR) and HHS, the two cognizant agencies responsible for negotiating indirect cost rates with the schools we reviewed. Since the March 1991 hearings first brought to light the problems found at Stanford, all parties involved with the indirect cost process have taken various actions to address the problems noted. We met with officials at the Office of Management and Budget (OMB), DCAA, ONR, and HHS to determine what actions they have taken to address these problems and what future actions are planned.

EXAMPLES OF UNALLOWABLE OR QUESTIONABLE  
COSTS CHARGED TO FEDERAL RESEARCH

In addition to the costs that have already been identified and withdrawn at MIT and Harvard Medical, our examination of selected accounts and transaction detail identified the following transactions at Harvard Medical and Berkeley in which unallowable or questionable costs were charged to the government:

UNALLOWABLE COSTS

-- Unallocable costs. Circular A-21 requires costs to be allocable to research in order to be allowable. In order to be allocable, the cost must either benefit a sponsored agreement, or be necessary to the overall operation of the institution. The universities charged many transactions to research that are clearly not allocable and thus not allowable. For example, Harvard Medical charged \$65,200 for shuttle bus costs for student ridership, \$38,000 to hire three doctors to teach courses in doctor/patient relations and clinical medicine, costs that should more appropriately be charged to instruction, and \$11,511 in extra pension costs for a nonmedical school dean. For these, \$21,928 was allocated to the government.

Berkeley charged \$500 to indirect costs for part of a visiting lecturer's temporary living expenses, of which \$88 was allocated to the government. In addition, Berkeley included transactions totaling over \$300,000 for various furnishings for the residence halls, items which should have been directly charged to other institutional activities and therefore not passed on to the government. For these items, \$49,256 was allocated to the government.

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- Other costs. Harvard Medical charged \$89,300 for a portion of the university's athletic facilities' costs, even though Harvard Medical also included the subsidized cost of employee memberships in a local health club. It also charged \$42,200 for recruiting a new faculty member, which included paying the points and mortgage payments on a condominium, and \$4,950 resulting from duplicate printing bills paid. For these three items, Harvard Medical allocated \$29,629 to the government.
- Legal Fees. Circular A-21 states that for costs to be allowable they must, among other things, be given consistent treatment through application of those generally accepted accounting principles appropriate to the circumstances. One such principle includes the matching of costs to the benefitting time period. Harvard Medical incurred \$564,069 in legal fees in negotiating a 3-year union contract, most of which was paid in the proposal year. Rather than allocating these expenses over the term of the contract, the University recorded the expenses in the proposal year, thus inflating the proposal for the future years. Only one-third of the legal fees should be allowed in the proposal year, while the excess costs of \$275,891, should be disallowed from the proposal. Of the excess, \$9,656 was allocated to the government.
- Alumni Activities. Circular A-21 specifically disallows costs incurred for alumni activities; yet Berkeley spent \$10,000 in postage costs for the "CalReport," an alumni publication. Berkeley also charged its subscription to Harvard Magazine, Harvard's alumni publication, to indirect costs. Similarly, Harvard Medical spent \$65,401 for

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special alumni mailings. For these transactions, these schools allocated over \$4,000 to federal research.

- Public Relations Activities. Circular A-21 disallows costs incurred for general public relations activities. Berkeley donated \$500 for a community festival, \$1,594 to send representatives to a University of California at Los Angeles (UCLA) convocation and to a California State University at Los Angeles (Cal State-L.A.) inauguration. It also spent \$2,907 on three events for high school students, and \$290 to send representatives to two dinners sponsored by special interest groups. For these activities, Berkeley allocated over \$900 to the government.
- Travel Expenses. Harvard Medical charged \$7,330 for governing board travel costs on two trips, one examining issues related to election of university officials and the second to study investment and divestment in South Africa. The University of California (UC) charged \$2,600 for UC's former president and his wife to fly first class to attend a dedication of student housing named after him. Since these individuals are not UC employees and there is no necessary benefit to either Berkeley or the other eight schools in the UC system, the entire trip is unallowable. The portion of cost allocated to the government for these two trips was \$315.

Circular A-21 specifies that the difference between first-class air accommodations and less than first class is unallowable except under specific circumstances. UC charged \$1,494 for an individual to fly first class to a meeting, without justification for the first-class travel. In addition, UC charged \$14,881 for chartered aircraft on 5

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trips, 4 of which originated and ended within California. Four of the trips involved only one passenger, the fifth two passengers, and no justification was provided for the chartered aircraft for any of the trips. For these, the government charges, applicable only to Berkeley, was \$365.

- Fund-raising Activities. Circular A-21 states that costs of organized fund-raising and similar expenses incurred solely to raise capital or obtain contributions are unallowable. Berkeley spent \$3,300 to purchase 150 football tickets to give to potential donors, \$580 of which was allocated to the government. Harvard Medical also spent \$8,296 in preparing a history on endowed professorships. For this, \$290 was allocated to federal research.
- Advertising Expenses. OMB Circular A-21 specifies that the only advertising costs allowed are those necessary to meet the requirements of a sponsored agreement, such as recruiting personnel, procuring goods and services, and disposing of surplus materials. At Berkeley, we found three transactions totaling \$912 for advertising for scholarship applications, a sexual harassment workshop, and graduate division office hours. Of this total, \$160 was allocated to the government for these expenses.
- Entertainment and Miscellaneous Expenses. Circular A-21 states that costs incurred for amusement, social activities, and entertainment are unallowable. Harvard Medical charged \$7,336 for events sponsored by Harvard Neighbors, a social organization, of which \$257 was allocated to the government. In Berkeley's student services pool, we found charges totaling \$931 for an

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undergraduate retreat and for room rental and catering for a student party. We also found an expense of \$850 for a desk which should have been capitalized. Since only a small portion of student services at Berkeley is allocated to the government, \$45 was allocated to the government for these items.

QUESTIONABLE COSTS

-- Officers' Housing Costs. Since March, when we testified on the excessive costs associated with Stanford University's President's university-owned residence, much attention has been given to this area by all parties concerned. OMB's recent revision to Circular A-21 now makes such costs unallowable. While these costs were not specifically unallowable at the time the proposals we reviewed were prepared, some of the costs charged do appear inappropriate. For example, part of the costs that MIT repaid included \$174,000 in costs charged to the president's house account for such items as liquor purchases, flowers, and art, for which the government paid \$120,492. Berkeley charged \$155,415 to the account for its chancellor's residence, of which \$27,260 was allocated to federal research. These charges included, for example, linens, floral arrangements, and other household items.

Harvard's auditors found about \$114,000 in unallowable costs associated with the president's residence, of which \$4,000 was allocated to federal research. These costs were included in the proposal reductions we discussed earlier. In addition, we found three transactions totaling \$20,229, for the president's travel, car, and publication of the

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President's Report, which is distributed to members of the community. For these, federal research was allocated \$708.

-- Dues and Memberships. Harvard Medical spent \$2,875 for dues and memberships to various organizations, such as the Association of American Universities, for which the government was allocated \$101.

-- Other costs. Harvard Medical included legal fees for 12 legal matters, such as fees incurred in the sale of property in New York and defending a sex discrimination suit brought against the Harvard Business School, in its indirect cost proposal. These items totalled \$246,925, for which \$8,642 was allocated to the government.

Berkeley charged at least \$19,512 to indirect costs for numerous events at its faculty club, many of which were unallowable for reimbursement by the government. These events included several luncheon meetings for intercollegiate athletics and lunch and breakfast meetings regarding public relations, public ceremonies, and alumni affairs. While some of the faculty club meetings may have been considered allowable, many were not. In charging these meetings to the cost pools, Berkeley had not attempted to distinguish between those events that might be allowable and those that clearly were not allowable. As a result, all faculty club events were charged to indirect costs, and \$3,422 of this was allocated to the government.

EXAMPLES OF IMPROPER ALLOCATIONS OF  
COSTS TO FEDERAL RESEARCH

We also found problems similar to the allocation problems discussed in our testimony, in other areas:

- Distribution Base. Indirect cost pools are allocated to each of a university's benefitting functions in what is called a step-down process. For an example, some cost pools, such as building depreciation, are allocated to both indirect cost pools and direct functions, such as research and instruction. Amounts that are allocated from one indirect cost pool to another indirect cost pool are called cross-allocations.

Circular A-21 states that cost pools are to be allocated to functions on a modified total direct cost (MTDC) basis. However, Harvard Medical uses what it calls an "accumulated modified total cost base" for allocating costs. This method, which is not prescribed by Circular A-21, increases the cost base of each pool at each level in the step-down process, which serves to compound the relative portion of costs allocated to research. HHS has disallowed this method in its negotiations with Harvard Medical, which we concur with. We found this approach resulted in an additional allocation to the government of \$663,000, but Harvard Medical did not adequately justify the approach's equity.

- Equipment Depreciation/Use Allowance. Berkeley charges depreciation on certain classes of its equipment and use allowances on others. We found errors in its depreciation calculations that resulted in \$6,700 overallocated to

## APPENDIX III

## APPENDIX III

federal research. In addition, we found inaccuracies in the equipment data base that Berkeley used to calculate its indirect costs; we also found that it did not reconcile with the equipment inventory. For the errors in the equipment inventory, \$136,000 had been overallocated to the government.

We also found that the equipment values included in Berkeley's inventory did not reconcile with the dollar amounts included in Berkeley's accounting records. This was because assets were recorded in the equipment inventory on the basis of the purchase order amount, whereas assets were recorded in the accounting records on the basis of the invoice amount. We could not determine what effect this might have on charges to the government.

- Operation and Maintenance (O&M) costs. We found several problems in the way Berkeley allocated its O&M costs. For example, certain costs were allocated on the basis of total costs rather than on assigned space, as Circular A-21 specifies; and certain costs were erroneously allocated to departments that do not benefit from those costs. As a result of this, a net total of \$287,000 was actually underallocated to the government.
  
- Utility Study. At Berkeley, we found that wrong utility factors from its utility study were used in preparing its proposal. We also found minor miscalculations used to arrive at the factors in the utility study itself. Had these errors not occurred, an additional \$96,000 would have been allocated to the government.

## APPENDIX III

## APPENDIX III

- Library Pool. Berkeley allocated most of its library costs on a basis inconsistent with A-21, without conducting a special study or otherwise providing adequate justification. As a result, its proposal allocated \$3.5 million more to the government than would have been allowed had the university used the standard Circular A-21 method. HHS did not accept Berkeley's allocation of library costs in negotiating the indirect cost rate.
  
- Other allocation errors. We found that Berkeley also made other misallocations of costs because of a programming error. This resulted in \$24,000 overallocated to the government.

Mr. DINGELL. The committee is grateful to you for your invaluable assistance to us. As you very well know, the Chair has enormous respect for the General Accounting Office, and you have served this subcommittee and this country well on the missions to which you have been assigned by the subcommittee, and we are very appreciative of your presence today.

The Chair recognizes first the distinguished gentleman from New York, Mr. Lent, for questions.

Mr. LENT. Thank you, Mr. Chairman. I want to join the chairman in thanking Mr. Peach for his testimony and for all of the work that the GAO has done in this particular area.

Mr. Peach, in your testimony, you state that now is an opportune time to reexamine the Federal approach for reimbursing universities for these indirect costs. My question is: Is there any theoretical basis for reimbursing these universities for more than the marginal, indirect costs of doing research for the Federal Government, assuming that these costs can be identified?

Mr. PEACH. At least the basis that I would go back to, and the basis we have been operating under is Circular A-21, and you asked about a theoretical basis forgoing beyond that. But the basis generally established in A-21 relate to reasonable costs that are incurred directly related to the operation of the university and the research, and an equitable distribution of costs between the Government and the university.

Mr. LENT. Well, in other words, the question rephrased, and I guess your answer would be the same is: Should the taxpayers bear more than the extra burden imposed on the universities because those universities happen to do research work for the Federal Government? And I think your answer is, they need not be or should not be.

Mr. PEACH. Certainly in the case of the types of cost, if I move for more theoretical and we look at the types of costs that have been identified as a result of the audits that have been done, it shows a consistent abuse in charging costs that even are clearly unallowable under the circular, a number of other costs that are questionable when you apply the principles of being reasonable costs that relate to the ongoing business of the university, and also a number of special studies used to support allocations of substantial amounts of costs which don't result in an equitable distribution of the costs that they are involved with.

Mr. LENT. Now you mention the different types of indirect costs negotiated by these two agencies, ONR and HHS, a fixed rate with a carry-forward provision in the case of ONR, and a predetermined fixed rate scheme in the case of HHS. Did you also notice any difference in the philosophy as between these two agencies? Was ONR more inclined to compensate universities for their costs, and was HHS more inclined to try to negotiate the lowest overhead rate possible?

Mr. PEACH. Well, the difference, I would describe as a full cost basis, as opposed to a cost-sharing basis. Those were the principles that were being applied. ONR is operating on a basis of reimbursing you for the full cost that you are claiming, whereas HHS is operating off of a negotiated basis where they will negotiate a rate for a fixed period, usually 2 years into the future.

The university will make a proposal as to what they think their rate should be. It is examined for some period of time by HHS, and then they negotiate a rate that they think is a reasonable rate. It is not subject to audit afterwards once they have negotiated the rate. Whereas in the case of ONR, they will agree on a provisional rate, on which the university will be reimbursed for a year, and then they will come in and audit what the actual claims are; and they will carry forward any additional costs that they can claim above that additional rate. And it is designed to reimburse them for their full costs.

Mr. LENT. So that the ONR rates tend to be more fully documented than do the rates charged by HHS; but on the other hand, the HHS rates tend to be generally lower?

Mr. PEACH. They are more fully documented with—the average rate for an ONR school is 59 percent; the average rate for an HHS school is about 50 percent. So there is a considerable amount of difference in those rates.

Mr. LENT. Thank you, Mr. Peach. I see my time is up. Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman.

Mr. Peach, last year Mr. Milton Socolar, General Accounting Office, often testified before this subcommittee regarding the situation at Stanford. At that time, Mr. Socolar said that he is not in a position to determine whether Stanford was in a unique situation regarding the problems associated with its indirect costs or whether it was just a part of a larger problem.

Based on your further audit work at MIT, Harvard, and Berkeley and at other schools, would you say that the situation found at Stanford was typical, or was it unique?

Mr. PEACH. Mr. Chairman, I think we are certainly in a position now to say that the problems are systemic. If you, for example, take the controls over areas like general administrative expenses, our work at the three schools has shown the same pattern we found at Stanford. And we also know now that HHS's work and DCAA's additional work at a number of other universities show the same types of problems in the charging off of those expenses.

In addition, now that we have been to other schools and also have looked at memorandums of understanding, special studies used to support allocations, we again see the same pattern of it resulting in an inequitable allocation of costs to the Government. So I would say clearly the problems are systemic.

Mr. DINGELL. I think it is important that that be on the record, because we don't want to be singled out as picking on one school or university where we have a situation that is widespread and involves a broad spectrum of participants in Federal grant programs.

Now, Mr. Peach, to what extent did the General Accounting Office find specifically unallowable costs being billed to the Government at MIT, Harvard, and Berkeley?

Mr. PEACH. Well, Mr. Chairman, I will cite an example that may be one way to give you an idea of what the specifics are. If I was to refer to my overall statement, the longer statement that I have, on page 5, we have an example pointing out that MIT took a look in its sensitive accounts in response to a request from DCAA to look at that, and for a 5-year period identified about \$1.8 million in un-

allowable costs, \$778,000 being charged to the Government. The items that were included in those costs were things like floral designs, airline airport clubs, artwork, overseas trips, receptions, dinners, and party expenses. Those are all the areas for which MIT has now agreed to reimburse the Government.

Mr. DINGELL. Now, I believe we ought to address one question. Is it fair to say that the allowable, questionable costs are attention getters; but in reality, the problem is deeper and broader, and that is that the allocations practices significantly alter the cost arrangements? Is that a fair statement?

Mr. PEACH. Yes. I would agree very much with just the way you separated those. The unallowable costs, and the questionable ones like the president's home and other issues like that, are things that will clearly get a lot of attention. But there is also very large money involved in these special studies, these memorandums of understandings, which cover these big areas of utilities costs, depreciation, and library expenses. And if they resulted in an inequitable allocation, you can be talking millions of dollars.

Mr. DINGELL. So while they may attract a considerable amount of attention and while they are a significant problem, that there are other elements of the problem which are extremely important to which we have to devote our attention?

Mr. PEACH. That is correct, Mr. Chairman.

Mr. DINGELL. One mechanism, as you have indicated, for the shifting of the allocation processes are the memorandum of understanding. At Stanford, for example, the MOU's resulted in a shift of \$20 to \$30 million to the taxpayers. What did you find regarding MOU's at these three universities and at others?

Mr. PEACH. All right. Let me ask Mr. Cohen to talk about the problem that we found with one of the MOU's that we identified specifically at MIT, which was quite a sizeable problem.

Mr. DINGELL. If you please.

#### TESTIMONY OF JOSEPH S. COHEN

Mr. COHEN. Thank you, Mr. Chairman.

MIT, like Stanford, being an ONR school, did have a number of memoranda; 10, specifically. One of the ones which I think is particularly straightforward and easy to explain involved a building on which MIT had signed a lease and had already exercised an option to purchase. This was a new building to the university and one which they were planning to devote fully to research. They had to spend \$3.6 million to put this building in condition for it to serve as a research laboratory.

This information was made available to the Government, to ONR and to DCAA, and they agreed, in the form of a memorandum of understanding, to allow this \$3.6 million in renovation costs to be amortized over 6 years, 1984 to 1989, or 1985 to 1990, as the case may be. They had already, as I said, agreed to purchase this building; and as a purchased building, MIT would have been obligated to use its own policy of depreciating or taking a use allowance of 2 percent a year, \$72,000 in this case.

So during this 6-year period, after factoring in what the Federal Government paid, MIT actually charged the Federal Government

\$2.4 million more than would have been allowed under the use allowance.

Mr. DINGELL. Now, ladies and gentlemen, at MIT, what did you find in terms of the appropriateness of the MOU's, as well as the impact of the MOU's?

Mr. PEACH. Well, the one that Mr. Cohen just described was one that we came across directly and were able to define an impact and attach a dollar value to it. That was one that we also referred to DCAA. DCAA was in the process, while we were there, of also examining and going into the other MOU's. And they currently have done work to try to define what they think the total scope of the finding is there.

They suggested their problems with at least 8 of the 10 MOU's from DCAA's work, and the most recent figure they are talking about for the 1 year, was in the range of between \$4.5 and \$5 million associated with that.

Mr. DINGELL. Could we note here, for the record, that of the schools we have been discussing, only MIT had MOU's, and that HHS schools do not use these devices?

Mr. PEACH. They do not use those devices. Sometimes they have—some of the HHS schools, on occasion, have what they call special studies that are provided, but not memorandums of understanding.

Mr. DINGELL. Do they tend to function the same way as MOU's?

Mr. PEACH. Well, in this case, you get a signed document; I think the special studies, on the other hand, if they are looked at and agreed to, we consider them as being unwritten MOU's.

Mr. DINGELL. Now, Mr. Peach—

Mr. PEACH. They work the same way, in effect.

Mr. DINGELL. I am sorry. Mr. Peach, the Government audit agencies tend to focus on the existence of MOU's in their risk assessments to determine which universities seem to be at high risk. During your reviews, didn't you find that while MOU's are a problem, there are a number of other hidden agreements or not formalized agreements that can have major cost shifts in the allocation process?

Mr. PEACH. Yes, we did. One example that I cited and referred to relates to the policy on capitalization that we found at MIT. Their capitalization policies require an expense to be above \$3 million before they would capitalize it. Whereas at the other two schools we visited, it was \$50,000 and \$20,000. And we just applied and looked at projects where they had spent at MIT over \$100,000 that should have been capitalized and should have been amortized in the year in which they were expended.

And in that particular case, it resulted in a substantial amount of money that was inappropriately charged off in a year. I think \$1.9 million was the total that I was looking for.

Mr. DINGELL. Mr. Peach, can you tell us what you found regarding these informal agreements or arrangements at each of the three schools that we are discussing?

Mr. PEACH. All right. Let me ask—let me ask the people that have done the work directly to describe examples of those types of problems that we found at the schools.

Mr. DINGELL. That would be very appropriate.

## TESTIMONY OF DOREEN S. ENG

Ms. ENG. As an example, at Berkeley we were looking at how they were allocating their equipment depreciation and use allowances costs, and A-21 specifically requires that it be done on a building-by-building basis.

What we found at Berkeley is that they were doing it on a department-by-department basis, which would have been OK if they had done a 100 percent sample; but they didn't. They only did a partial sample. So what happened, if you had a department that wasn't sampled and say that department had 50 percent research salaries, 50 percent instruction salaries, since they didn't actually sample the physical space, they did it on salaries and wages, and so the space would be allocated 50-50, even though there may be a very different proportion that was used for instruction or research, but they had no way of knowing.

We did ask HHS about this method. They said they knew about it, that they were using it, but they felt that it was simpler, and it was OK. We could not quantify the amount, because the only way would have been to do an actual physical sample of all the buildings ourselves. But it is just another example of an arrangement that was agreed to between the school and HHS, but was not documented.

Mr. DINGELL. You referred to one item at MIT, I believe, elsewhere in your discussions with the staff. You indicated that in one instance, MIT expended \$3.6 million in fiscal year 1990 for 14 building projects, that each exceeded \$100,000; \$1.9 million was charged to Federal research. Had these items been capitalized and subject to use allowance, only \$38,000 would have been charged to Federal research for that year. Is that a correct statement?

Mr. PEACH. That is correct, Mr. Chairman.

Mr. DINGELL. And again, you noted that at Berkeley and Harvard Medical School, the dollar thresholds were \$20,000 and \$50,000 respectively. At MIT, the dollar threshold was \$3 million. So that this, again, tended to shift the equation in favor of MIT in connection with their activities in this area; is that correct?

Mr. PEACH. Very much so. We thought \$3 million was a very high number to have for suggesting that you would be expensing things before you would capitalize them.

Mr. DINGELL. How did that number, \$3 million, creep in?

Mr. PEACH. I don't know whether Mr. Cohen has any insight on that or not.

Mr. COHEN. Yes, I have some. In the early 1980's, the Navy and DCAA pointed out to MIT that they didn't have a very clear capitalization policy. They asked MIT to prepare one, which they did. MIT prepared an initial draft of the capitalization policy, which didn't have any threshold.

It was brought to their attention by DCAA, I believe, that they needed a threshold. MIT proposed \$3 million as this threshold, allowing them to expense all building improvements and renovations below that amount; and that, in effect, was accepted by ONR and DCAA, and has been the policy at MIT since 1982.

Mr. DINGELL. Now, Mr. Peach, we have been discussing something here, and you and Mr. Cohen have been addressing it. What

can we say has gone wrong here? Is it a question of insufficient Government oversight in which we find a situation where universities have then moved aggressively into a vacuum created by that, or what is the situation?

Mr. PEACH. You are close to the way I would characterize it, Mr. Chairman. I would say you start off with A-21 guidance. It invited opportunistic interpretations by schools that used it as an opportunity to reach for all that they could receive in reimbursement, often not having very good controls or very good accounting systems at the schools, backed up by a lack of oversight by the Government agencies that were supposed to be protecting the Government's interest in this regard. All those things.

Mr. DINGELL. Mr. Peach, your colleague, Mr. Socolar testified last year that Stanford was aggressively going after every dollar it would lay hands on, and that the Government was not keeping a watchful eye. Do you have or do we have any reason to believe that MIT, Harvard, and Berkeley were engaged in similar behavior with their capitalization policies, their accumulated modified total cost base and an allocation of equipment costs by departments instead of by buildings?

Mr. PEACH. Certainly they were all aggressive. MIT and particularly Harvard Medical could be described, I believe, as being very aggressive in their reimbursement request policies. Berkeley was a little bit different in that it is the one school we went to where we found they were making errors both ways. There were errors and mistakes that were being made that worked in their favor, and there were also some errors they made that worked in the Government's favor. And it did look like on some occasions that they just didn't really have people who had a good, clear understanding of what they should be doing and how they should be applying the principles. At the other schools, all of the problems we found always worked in the university's favor. None worked in the Government's favor.

Mr. DINGELL. It would be fair to assume that we would expect that some mistakes would work in favor of the university rather than in favor of the Government.

Mr. PEACH. Yes.

Mr. DINGELL. Now, we have been hammering rather hard at several universities. Would it be fair to say, however, that there is a strong possibility that similar events were going on elsewhere and have not yet been fully developed in the course of the sundry audits?

Mr. PEACH. Yes. If you are referring, I think, both in terms of other universities, I am assuming you might also be referring to indirect costs as they are applied in other areas of Government activity where we are currently involved, at your request, in looking at some of the Superfund contractors at EPA. And we are also getting involved at your request and looking at some of the indirect costs at the major Department of Energy facilities.

Mr. DINGELL. And we are looking forward to a great outburst of generosity on the part of those people in returning moneys to the Federal Government.

Mr. PEACH. Right, right.

Mr. DINGELL. The Chair is going to recognize my good friend, Mr. Bliley, for questions.

Mr. BLILEY. Thank you, Mr. Chairman.

You described the fixed rate with a carry-forward provision as the system used by ONR; is that right?

Mr. PEACH. Yes.

Mr. BLILEY. I think they call it provisional rate, but it was a carry-forward, and it is designed for full cost recovery.

Mr. BLILEY. When is it used and when must the university refund inappropriate charges?

Mr. PEACH. Well, the rate is agreed upon year by year, and then it is subject to the claims made by the university, after an auditor review. And if there are additional costs that the university should be receiving, then that is carried forward to the next year; or if any problems occurred, that should also be carried forward and adjusted out into the preceding years. That is how the system is designed to work.

What, of course, occurred at Stanford and also at MIT and some of these other schools, as these issues have been brought up about improper, unallowable costs and they have been identified, they have caused the universities to take action to reimburse costs for those past years, many times going back in the 1980's for some years.

Mr. BLILEY. I see. But does not the use of this carry-forward encourage a university to include an inappropriate charge, knowing that the only remedy will be a lower rate in some future year?

Mr. PEACH. I don't think—I would have to say I don't think it is just exactly only the carry-forward. I mean, I think the whole system has been designed to be as lenient towards the universities in terms of trying to assure them as full a recovery of whatever costs they claim is as possible.

I think that is the way the system has been working up to the point that the oversight hearings that were begun by this committee, and the investigations have begun to shine a spotlight on that activity and say there is something questionable that is occurring here. And people then begin to line up and say, well, yes, there are some problems, there are some costs; let us go ahead and look at them and begin to reimburse you for some of those costs.

Mr. BLILEY. You stated that Harvard Medical School proposed for fiscal year 1991 overhead rate of 96 percent?

Mr. PEACH. That is correct.

Mr. BLILEY. But that HHS imposed a rate of 63½ percent?

Mr. PEACH. That is the rate HHS has proposed for reimbursing them. It is my understanding that Harvard Medical is challenging that.

Mr. COHEN. Right. They are using a provisional rate of 88 percent right now until this matter is resolved, which I think was their rate from the prior year. But HHS, in its unilateral determination, is saying the rate should be 63½ percent.

Mr. BLILEY. Well, is there any kind of an audit going on at Harvard?

Mr. COHEN. Well, we did some audit work at Harvard during a process where HHS and the Harvard Medical School were in the earliest stages of resolving this through the appeal process.

Mr. BLILEY. My reason in asking the question is if there is not some audit there, how will HHS be able to establish this 63½ percent under this appeal as the right thing and not indeed at what Harvard says at 96?

Mr. PEACH. The HHS process is a negotiated process. Harvard has come forth with their position in support of what they think justifies this rate that they asked for. HHS has looked at that and said, we think 63½ percent is as much as we should be giving you for your indirect costs, and then it gets into a negotiation kind of a process between someone having to resolve and look at the appeal that is brought forward by the university administratively in HHS. But it is more of a negotiating process as opposed to a process that is a result from a specific audit with a lot of specific costs.

Mr. BLILEY. What happens if negotiations break down and they can't reach an agreement? What happens then?

Mr. PEACH. Well, eventually the appeal has got to be resolved, and they have got to agree to a rate at which they will be reimbursed. I suppose the other thing, you say what happens if they come to a rate that HHS says this is all we are going to give you and Harvard is not satisfied with that, they could decide whether or not they want to do the research they have been doing.

Mr. BLILEY. I see.

Mr. PEACH. I suppose that would be an ultimate kind of solution to say, well, if that is all we get from indirect research costs, we can only get 65 percent reimbursement here, then we aren't going to do the research.

Mr. BLILEY. Well, HHS can take their research somewhere else, too; they would have that option.

Mr. PEACH. Right.

Mr. BLILEY. Is there any other school that has a rate that approaches 96 percent?

Ms. ENG. We have read that there are some schools that are close to that amount, but we ourselves have not looked at those schools. For example, we have seen in the press Howard University was somewhere over 100 percent.

Mr. BLILEY. Over 100 percent, and we haven't looked at it?

Ms. ENG. No. Because in terms of research dollars, it is not one of the top schools.

Mr. BLILEY. Oh, I see. Well, when you say it is not one of the top, how much do we spend out there?

Ms. ENG. I don't know. We did not examine that school, in particular.

Mr. BLILEY. It would seem to me that if we had 100 percent or over 100 percent for overhead costs, that we ought to look at it; I don't care what the figure is. You know, because if you don't look at it, then you say, well, some other school is doing research and saying, gee, we are only charging 25 percent; this school up here is charging 110 percent. We are chumps. Maybe we ought to go, you know, raise our sights a little bit. That is where I am coming from.

Mr. Chairman, I am happy to yield to you.

Mr. DINGELL. I want to commend the gentleman for his questions. There is one thing I think that will help us to understand this situation. In the case of the Navy, their audit programs are

directed at dealing with specific rules of behavior which are set forth; is that correct?

Ms. ENG. I am sorry. Could you repeat the question?

Mr. DINGELL. Yes. In the case of the Navy, their programs deal with specific patterns of behavior which are clearly defined in the rules and in the agreements; is that right?

Ms. ENG. As we understand them, yes.

Mr. DINGELL. And in the case of HHS, it is essentially more a negotiated process which is somewhat vague as to the underpinning and the rules upon which those agreements are based; is that a correct statement?

Mr. PEACH. Just to break in, Mr. Chairman, clearly there is not the kind of documentation there in the HHS. It is a negotiating process. Oftentimes there is clearly not that much documentation about how they got to their negotiating position, what they are going to suggest, what they are going to reimburse at. Sometimes there is some documentation, sometimes not a lot of specific documentation.

In the ONR approach, the schools submit what they think they have a right to recover and it is looked at in accordance with the circular and in accordance with any special agreements they have. And if they deem it to be allowable under that, then it gets reimbursed for that cost.

Mr. DINGELL. I hear what you are saying. Would I be fair in inferring that it is harder to deal with a situation? Let me describe what I understand you are telling me. You are saying that HHS is more aggressive in its negotiations and its handling of the agreements.

Mr. PEACH. They seem to be operating more on the idea we are willing to share your indirect costs up to a point.

Mr. DINGELL. Yes.

Mr. PEACH. And they will establish what that point is. It is not, we are going to reimburse you for everything you ask for, but we are willing to share up to a point; and we will negotiate with you on what that point is going to be. You make a representation, and if we think that is too much, then we will negotiate on the point.

Mr. DINGELL. The problem is, in the case of HHS, although they are more aggressive, they have less documentation, is that right?

Mr. PEACH. That is correct. I can back that up with kind of an example.

If you take Berkeley, Berkeley asked for a 59 percent rate. HHS and Berkeley accepted—ultimately a 49 percent indirect cost reimbursement rate. Now, we looked at Berkeley's original proposal that they made to back up that 59 percent rate, and in our quick look at it, we found at least \$4 million that could be knocked out of that—out of what they had requested that was inappropriate.

If you look at what HHS did just through their judgment in negotiation in reducing the rate from 59 percent to 49 percent, that accounted for about \$8 million, so they, in effect, through their negotiating practice, knocked out \$8 million. It wasn't as precise as when we looked at it, and we looked at precise costs, and said specifically we can add up by a quick look \$4 million that doesn't fit.

Mr. DINGELL. Now, ONR has a different approach. They tend to be more gentle and less aggressive, but they tend to require more in the way of documentation, is that right?

Mr. PEACH. There would be more in the way of documentation, but I would have to say our work at Stanford and at MIT calls into question the quality of the documentation in a number of instances, and their willingness to accept that documentation is a basis for saying, yes, we will reimburse you for those costs.

Mr. DINGELL. Thank you. I thank the gentleman for yielding to me.

Mr. BLILEY. Mr. Chairman, I yield back at this time.

Mr. DINGELL. Now, Mr. Peach, the university community has sought to portray the Government's questioning of costs at Stanford, MIT, and other colleges and universities as breaking a partnership that started some 50 years ago between the Federal Government and the universities, and the allegations are being made that the Government is now auditing under different rules and retroactively applying these rules into the 1980's. You have identified a number of expressly unallowable charges that you found in the billings of the universities to the Federal Government.

Did your auditors use any new definitions of what is allowable or not allowable or did you use the same definition of allowable and unallowable that has existed at the time these expenses were first incurred and negotiated and at the time the bills were submitted and presumably paid and are we to infer that those same standards are still in existence today?

Mr. PEACH. We didn't come up with any new rules, Mr. Chairman. We went right back to Circular A-21 as it existed for the period in time that we were looking at the costs, and we made our examination—our interpretation of what is provided in A-21—in ways that we felt were designed to protect the Government's interests, and, through doing that, identified unallowable costs, clearly not allowable under A-21. We also found a number of charges that we identified as questionable costs because we also felt they didn't meet the criteria as being reasonably related to the research activity of the university.

An example of those questionable costs, for example, which has caught a lot of attention, are things like president or executive homes at universities and their use which were charged off and which became a large issue at Stanford. And we put that not in an unallowable, but in the questionable category. We felt it was clearly questionable. It didn't meet the test. We were using A-21.

Mr. DINGELL. So we haven't changed the rules at all?

Mr. PEACH. No, we have not changed the rules at all.

Mr. DINGELL. Now, Mr. Peach, when you questioned some of the MOU at both Stanford and MIT, again in determining whether it was appropriate, valid, and equitable as regards the MOU, did you use any new standards or did you use the same standard that should have existed at the time that the universities were attempting to enter into the agreements?

Mr. PEACH. Again, I think we are using the same standards. A-21 provides that a university can come up with a special study or some other support if they believe the specific provisions provided in A-21 are not going to result in an equitable distribution. What

they also are required, in my judgment, to do under A-21 is in their study to provide something that does result in an equitable allocation to the Government as well as them. The ones that we identified, the MOU's that we identified—we felt did not meet that test of providing for an equitable distribution to both parties.

Mr. DINGELL. Now, it is also true for the informal agreements that depreciation versus expensing, the capitalization—so here, again, are you taking some new standard and applying it to the universities or are you maintaining the existing standards that should have been entered in place at the time the agreements were entered into?

Mr. PEACH. Again, I would think we are using A-21 as a guide, but in some cases, you know, we were then applying the test of reasonableness under A-21, such as in the depreciation expenses and whether those costs should be capitalized. That wasn't an MOU. It wasn't a special study. It was an accounting policy that the university had developed that we felt resulted in an inappropriate expensing.

Mr. DINGELL. Mr. Cohen, you were nodding. Did you have a comment?

Mr. COHEN. No, just agreeing.

Mr. DINGELL. I just think you and Ms. Eng are valuable resources, and the subcommittee wants you to feel comfortable in speaking to us.

Mr. COHEN. The only thing I would add is that when we looked at the \$3 million capitalization policy at MIT, we looked at the other universities where we were doing work, and we inquired of some independent public accountants whether they knew of other institutions that expensed everything up to \$3 million. This is a double check on us. They may be out there, but we could not find other institutions that had the same policy.

Mr. DINGELL. Ladies and gentlemen, you have indicated in your testimony this, and I quote, "At all three schools we found numerous problems with the allocation method. These problems occur because universities either did not comply with or improperly applied the A-21 criteria. As a result, overallocations of indirect costs to the Government totaled over \$12 million."

Mr. Peach, isn't it true that what has really happened here is that for years universities have overbilled the Government and that the Government now is just discovering it and attempting to recover or rather determine the amounts which were overbilled and then to recoup it on behalf of the taxpayers?

Mr. PEACH. I think that is essentially true. We believe what has occurred is an overbilling of the Government, and I think the issue now is what remedy is available to the Government in the face of that.

Mr. DINGELL. Now, Mr. Peach, how would you respond to the charge that the Government has changed the rules on the universities in mid-course and that the identification and attempted collection of the overcharges is unfair?

Mr. PEACH. Mr. Chairman, I don't think the rules have changed unless you want to call the beefing up of the circular after the initial inquiry started into this area as a changing of rules. Now, that is prospectively.

But in terms of looking at what has been happening before, again, I don't think the rules have changed. I think it is a shifting in the enforcement mentality. I don't think there was much enforcement of the rules going on until this committee began to dig into this area, and now there is a much more intensive effort at enforcing the rules that existed.

Ms. ENG. I would just like to add to that, just as a key note. When we talked about the MOU's at MIT, they had looked at them and actually issued a report the end of February, 1991, that said the MOU's were fine; they were reasonable. I think it was an unfortunate choice of words. I think their intention was that they had looked to see whether the MOU's had been properly complied with without using their judgment as to whether the MOU's themselves were reasonable, and it wasn't until after your March hearings that they realized that they needed to do that and pulled their report and reaudited those MOU's.

Mr. DINGELL. And found that the MOU's did not comply with the requirements of A-21?

Mr. PEACH. Yes. And I think it was a little bit more. If you want to say the depth of what was being done was saying, well, these costs are being charged in this fashion, yes, there is a memorandum of understanding here that covers how those costs are being charged without asking the other question: Does that memorandum of understanding covering how those costs are charged make sense?

Mr. COHEN. I could even be more specific. In the case we have already talked about today, the \$600,000 a year amortization of that leasehold improvement, DCAA would have said, OK, there is a contract, a memorandum of understanding that says MIT can include \$600,000 in its submission. They looked at the record. They saw that MIT had submitted in its paperwork \$600,000. As long as they didn't submit \$600,001 they accepted it. They never asked the other question: Is this \$600,000 reasonable? Should it have been 2 percent or \$72,000? That is the question that wasn't asked until March.

Mr. DINGELL. So what they essentially did was they never bothered to look at the memorandum of understanding. They simply said, if this complies with the memorandum of understanding, all is well?

Mr. COHEN. That is the way incurred costs audits were conducted, to the best of my knowledge, until March.

Mr. DINGELL. It might make for a quick and easy audit, but it doesn't necessarily make for good public policy or wise expenditure of public funds.

Mr. COHEN. I would agree.

Mr. DINGELL. Now, gentlemen and ladies, Mr. Peach, in your testimony, in the part entitled the causes of the problems, you made this statement, "Last, we believe, the lax oversight practices by ONR and HHS were contributing factors. At the schools visited, we found instances in which both agencies failed to adequately review their assigned universities' indirect cost proposals or claims to detect and remove unallowable and/or unallocable costs.

Focusing on ONR, do you believe that ONR officials have the right attitude toward guarding the taxpayers' money in conducting fair and adequate negotiations and reviews at their schools?

Mr. PEACH. Mr. Chairman, the way I answer that is: First, I would say no, I don't believe that attitude was there at the time this whole problem started. And I would say, you know, there is an important difference between having an attitude that I am here to make sure that you get all the costs that you think you are entitled to, and an attitude of I am here to protect the Government's interest while assuring that you also receive a fair and equitable reimbursement for your costs. I think there is a significant difference between those two attitudes.

The latter attitude is the attitude we ought to see out there consistently, but the former attitude was the attitude we were seeing before.

Mr. DINGELL. Thank you.

Now, Mr. Peach, one last question. You mentioned that—a number of actions that you believe may help protect the Government's interests on this issue in the future. However, the Government must first face forward to the universities and others who have been a major part of the problem and must identify the fact that the contracting officers, both at the colleges and universities and at the Government, appear to be a part of the problem. Is that correct?

Mr. PEACH. Yes. I mean, that is a part of the oversight, and it took two groups to make this problem.

Mr. DINGELL. So we have to address, then, the question of management actions that are needed to improve the way contracting officers protect the Government interests, is that right?

Mr. PEACH. That is right. We have got to instill that attitude of I am here to protect the Government's interests while assuring you get this fair and equitable reimbursement, but my first job is also to protect the Government's interest here.

Mr. DINGELL. Let's try to look at what has to be done here, just so we can see. I think it is very clear that we require, first of all, a careful review of the overall structure of the grants, the agreements, the MOU's, and the regulations—like A-21—to be sure that they protect the public interest, is that correct?

Mr. PEACH. That is correct.

Mr. DINGELL. We need to have also a careful review of the time and the fashion in which audits are made. Is that correct?

Mr. PEACH. That is correct. Certainly one of the things that I would just like this opportunity to elaborate on, Mr. Chairman, is the long delay that often occurs in getting audits to occur under the system we now have. I see that here not only in the university audits—I see that when we have looked at Superfund contractors in our work at EPA, I see that when I look at Department of Energy contracts where they are often dealing with backlogs of 6 to 10 years out there before there is any kind of closeout—it is almost too late to do anything if you find a problem when you have a delay that long. So it is a problem.

Mr. DINGELL. You are defining the fact, then, that there is an inadequate number of auditors improperly supported financially and from the standpoint of policy by the agencies that are supposed to

be seeing to it that these contracts are properly administered, is that right?

Mr. PEACH. That is right. There is a systems' issue here, too. If you take, for example, that ONR has 39 schools and HHS has 600-plus schools and would then try to apply the ONR approach and require the same kind of audit effort at the 600 schools as it related to the 39 schools, you are talking about substantial expansion of effort, which leads me to think that you at least have to consider ways that we might be able to simplify this system. But the key is going to be figuring out how to simplify but still provide enough controls there to make sure that there is adequate protection of the Government's interest.

Mr. DINGELL. So one of the reasons, then, that we are having so many problems with these contracts are that the sensible principles that you have just discussed have not been properly applied. Is that right?

Mr. PEACH. They haven't been applied.

Again, one of the points I made at the end of my statement, too, is I think we need to at least look at whether we should have two different systems that are dealing with schools right now, administered by two different agencies. I think that is an issue that has to be on the table.

Mr. DINGELL. As well as looking to see whether we have a sufficient number of auditors and a proper emphasis on seeing to it that the overall public interest is protected all the way from the contracting stage clear up through and past the point at which improper charges are collected back for the Government, is that right?

Mr. PEACH. That is right. Once any decision is made, if we want to make any adjustments or changes in the system, we have to make sure it is properly supported.

Mr. DINGELL. Very well.

The Chair recognizes the gentleman from Georgia, Dr. Rowland.

Mr. ROWLAND. Thank you, Mr. Chairman.

Mr. Peach, how much of a contributing factor to the problem is DCAA's backlog of audits?

Mr. PEACH. I think it is a factor in terms of how quickly you get at these issues, but at the same time I think you have to have this attitude change in terms of how much you are looking and how carefully you are looking in trying to apply the A-21 criteria in deciding whether costs are allowable or not. I don't think that has been done in the past, so I think we could also have been doing better audits, more intensive audits. It is not just the backlog.

Mr. ROWLAND. I see. Well, since provisional rates, guesstimates of cost, is not an efficient audit system critical to keep ultimate cost in line?

Mr. PEACH. Certainly if you look at the ONR system and you use these provisional rates, then it has to be backed up by an audit to decide what kind of adjustments you want to make going forward in the future years.

Mr. ROWLAND. The provisional rates are used, then. These provisional rates, should they be used while DCAA is making an assessment of the true situation?

Mr. PEACH. Again, under the system, things are fine. I am not sure that there is necessarily anything wrong with a provisional rate. It is based on what your experience has been in the years immediately preceding and agreeing with that rate. Of course, then, you are dealing with the submission that would be made by the school as to what they think their actual expenses that they should be reimbursed are and any differences between what they got under the provisional rate and what they are requesting and making a judgment from the audit as to whether or not they deserve more money or some adjustment should be made otherwise.

Mr. ROWLAND. Those provisional rates are based on preceding years?

Mr. PEACH. Yes, that is a part of the input. In other words, what level have we been at in preceding years? What kind of adjustment should be made to that?

Mr. ROWLAND. Do you think these are timely and reliable done this way?

Mr. PEACH. I might ask my colleagues if they have any idea. They work more closely at the schools.

Mr. COHEN. DCAA does some auditing of provisional rates. They do what they call forward pricing. They do some auditing of those rates, look at trends. Now they are doing, I think, more auditing of the forward pricing rates. It is not the same as auditing for actual costs.

Whatever rate—whenever you audit a future projection, it is only as good as the estimates are. Clearly, at the end of the year, there will be adjustments made. Allowable costs will either be higher or lower than the pricing rate.

Ms. ENG. I would add, too, that under the system that they have, they can't negotiate a final rate until the actual costs have been completed. For example, you can't negotiate a final 1991 rate until 1991 is over. So during 1991 they have to have a provisional rate at which to bill at during that period. So you can't get away from having a provisional rate.

Mr. ROWLAND. Who is responsible for initiating DCAA's audits, the provisional rates grants? Who initiates that?

Mr. COHEN. I would guess ONR would request the audit.

Mr. ROWLAND. They are not automatic, then? They have to be requested?

Ms. ENG. Right.

Mr. ROWLAND. I see.

Is the university responsible for reimbursing overages before DCAA does the audit?

Mr. PEACH. Well, the practices in the last few months, since all this attention has been brought on this area, have caused a number of universities to go in and scrub their accounts, as they would call it, identify unallowable costs and reimburse them even before the audit came in. Interestingly—

Mr. ROWLAND. They knew something was amiss?

Mr. PEACH. That is right. Interestingly, one of the items that I cited in my statement was that Harvard Medical School did that by bringing in a CPA firm to do a scrub of the accounts, identified some costs, and made a reimbursement. We went in and looked at the work that had been done and identified additional unallowable

costs that they had not identified which will result in still further reimbursement.

Mr. ROWLAND. OK, thank you. Thank you very much.

Thank you, Mr. Chairman.

Mr. DINGELL. Mr. Peach, Ms. Eng, Mr. Cohen, we thank you for your invaluable help to us this morning and throughout the inquiries that the committee may make into these matters. We look forward to a continuing warm and friendly relationship with you and with your Agency, and we again thank you and commend you for the outstanding service that you have provided on this matter. Thank you.

Mr. PEACH. Thank you, Mr. Chairman. We appreciate the opportunity to work with you.

Mr. DINGELL. Our next panel is a panel composed of Rear Admiral William C. Miller, U.S. Navy, Chief of Naval Research, Office of Naval Research; Mr. Fred C. Newton, Deputy Director, Defense Contract Audit Agency. Gentlemen, we are delighted you are with us today.

We thank you for being here, and we have a few preliminary words. You have both been before the committee before. You understand it is the practice of the committee to receive all testimony under oath. Gentlemen, do either of you have any objection to testifying under oath?

Admiral MILLER. No, sir.

Mr. NEWTON. No, sir.

Mr. DINGELL. Chairman, the Chair advises you it is your right to be advised by counsel if you so choose. Do either of you seek to be advised by counsel in your appearance here?

Admiral MILLER. No, sir.

Mr. NEWTON. No, sir.

Mr. DINGELL. For your information, to indicate to you your rights and the limits on the power of the committee, are copies of the rules of the committee--the subcommittee, and of the House which are there before you at the witness table.

Gentlemen, if you have no objection to being sworn, would you then please each rise and raise your right hand.

[Witnesses sworn.]

Mr. DINGELL. You may each consider yourself under oath, and we would be delighted to receive such testimony as you choose to give us today.

**TESTIMONY OF REAR ADM. WILLIAM C. MILLER, CHIEF, OFFICE OF NAVAL RESEARCH, U.S. NAVY; AND FRED J. NEWTON, DEPUTY DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY**

Admiral MILLER. Thank you, Mr. Chairman. I would like to enter my prepared statement into the record and summarize them for you here, if that is permissible.

Mr. DINGELL. Without objection, that will be done. You may consider yourself recognized for this time.

Admiral MILLER. Mr. Chairman and members of this subcommittee, I appreciate the opportunity to provide you a status report on actions taken by the Navy Department to make improvements in Government contract administration at universities. In late 1990

and early 1991, based upon information regarding business problems at Stanford University reported by a Navy administrative contracting officer, various Government agencies including the General Accounting Office, the Defense Contract Audit Agency, the Navy, and staff members of this subcommittee began investigations that revealed serious billing errors at Stanford, but more importantly highlighted the need for reform of the business process between the Government and all colleges and universities.

In reforming our business process, our overall objective is much broader than recouping previously misspent Federal dollars. As important as that activity is, I firmly believe that we must look to reform the system governing Federal support of university research, and that has been one of the principal foci of our efforts over the last 18 months.

To meet this objective, we have initiated and are continuing the following actions: We are identifying and rectifying contracting problems at universities under DOD cognizance. We are establishing and have established personal accountability for past problems, taking appropriate disciplinary action where appropriate, and establishing effective oversight to preclude further recurrence. And we are working both within the DOD and under OMB leadership to reform and strengthen the Government's administrative procedures at each of the schools assigned to DOD cognizance.

I will summarize for you some of the measures implemented to date in each of these areas. At Stanford University the reform issues can be broken into two segments: First, the need to audit costs billed to the Government for the years 1981 to 1991—that is the past years—to negotiate final indirect costs for those years, and, where appropriate, to obtain reimbursement for any inappropriately billed costs. Second, the establishment of a proper billing rate and review system for current years, 1992 and forward.

The Defense Contract Audit Agency, represented here at the table by my colleague, Mr. Fred Newton, has now issued final audits on actual costs at Stanford for all open fiscal years through 1988. This audit data is currently under review by the Navy's special university team established specifically to handle contract administration matters at Stanford. Audits of back years at Stanford to date contained a significant amount of questioned costs, and the Navy's special university team will work closely with DCAA auditors and Stanford officials to confirm the audit findings and negotiate final rates for those years. This will be a time-consuming process, but a very necessary activity to determine what costs will ultimately be removed from Government billings.

In addition to these audits, a separate audit and review is also underway on all memoranda of understanding—frequently referred to as MOU's—which have provided alternative allocations of costs to Government-sponsored research. The objective of this MOU review is to determine whether the MOU's comply with cost principles for university research set forth in OMB Circular A-21: if in compliance, whether the terms and conditions of the memoranda were followed by the university in its billing practices; and, finally, to determine if the memoranda resulted in an equitable assignment of costs to federally sponsored research.

Additionally, as appropriate, audit findings and other data are being coordinated with the Naval Investigative Service for their review and with the Department of Justice for their determination of possible violations of civil statutes.

Now, considering the more recent open years of 1989 and 1990, Stanford has submitted its incurred cost proposal for fiscal year 1989 in November of last year, and the 1990 proposal is scheduled for submission in May, 1992. Audits of actual costs for these years will determine if the Government has either under or overcompensated Stanford for its overhead costs during those years. The current year, 1991 and 1992 are under consideration by a special university team at present.

On 25 April, 1991 the special university team issued a unilateral determination cancelling all but one of the existing MOU's between Stanford and the Government from 1991 prospectively, into the future. At the same time, the special university team unilaterally reduced Stanford's fiscal year 1991 provisional indirect cost rate from the 74 percent to 55 percent, and these actions were made retroactive to the beginning of the university's fiscal year, which started September 1, 1990.

Subsequently, on November 14, 1991, Stanford University announced that it would not accept the Government's unilateral cancellation of the memoranda of understanding, which had been the primary factor in the reduction of the fiscal year 1991 rate. The University therefore filed an administrative appeal of the Government's action with the Armed Services Board of Contract Appeals. Stanford's position is that these MOU's were binding contracts and could not be cancelled unilaterally.

We are continuing action to resolve the MOU status, but the university's action in filing appeals adjusts the possibility that a lengthy legal process may ultimately be required to determine the validity of the Government's cancellation of these MOU's.

Stanford also has submitted a forward pricing proposal for its fiscal year 1992 rates. However, the supporting documentation and overall proposal are not yet considered adequate by DCAA for their making a rate recommendation to the ONR negotiators. This is a necessary precondition for conducting negotiations.

Accordingly, under the terms of OMB Circular A-21, the 55.5 percent rate for the previous year has been extended unilaterally as the provisional rate for fiscal 1992 pending submission and audits of an acceptable forward pricing indirect cost proposal from Stanford.

During fiscal year 1991, Stanford's provisional billing rate was reduced, as I said, from 74 percent to a final fixed rate of 55 percent. This resulted in a number of previously awarded contracts and grants at the University being overfunded. All affected Federal agencies were advised of the potentiality of excess funds having been obligated and were provided options for deobligating these moneys and reapplying them to other research efforts.

The amount of possible overfunding governmentwide, due to the reduction in Stanford's rate, is not yet available, as such calculations must be performed independently by each of the awarding or granting agencies.

For the Department of Navy, I can tell you that we currently estimate that approximately \$1.4 million in excess funds will result from this rate reduction, based on a total Navy obligation at Stanford last year of \$13.8 million.

The second objective in addressing reforms of our Federally funded research was to establish individual accountability for the problems identified. For that purpose, I established a personnel accountability panel of senior Navy military and civilian officials to conduct a formal fact finding inquiry.

Based on that panel's report to me, I determined that within the Department of the Navy, contracting abuses resulted principally from the failure of six civilian Navy employees to exercise proper oversight and to faithfully carry out their assigned duties. And in administrative proceedings, one of these employees was reduced in pay and grade level and reassigned out of the university business environment. A second employee chose to retire prior to imposition of a pending reduction in pay and grade and reassignment. Four others were disciplined administratively.

On the other side of the ledger, the Secretary of the Navy and I have personally congratulated and publicly recognized Mr. Paul Biddle, our Administrative Contracting Officer, who first called attention to these issues. Mr. Biddle was awarded the Navy Meritorious Civilian Service Award in a public ceremony held in September here in Washington.

The third objective in addressing the general indirect cost problems found was to ensure that management procedures for handling contract administration and overhead rate negotiation for schools across the country are sound and adequate. While there is no evidence of problems comparable to the magnitude found at Stanford, a thorough review of procedures and indirect cost rates is underway at each of the schools under DOD cognizance.

Actions now in progress include the following: Our internal administrative and procedural instructions have been strengthened and clarified so that these rules are made clear to everyone involved. Our procedures also now require additional safeguards for administrative contracting actions taken by our field representatives, such as Navy headquarter's approval is now required prior to the local contracting officer conducting his indirect cost of rate negotiations.

Formal coordination with all other interested Federal agencies is required prior to conducting rate negotiations with any university. Navy headquarter's legal approval is required to support all rate agreements. And a new reporting system on the status of all ongoing indirect cost rates has been implemented.

But I think even more important than these, all future memoranda of understanding agreeing to alternative allocations of indirect costs other than the standard procedures laid out in A-21 must be approved at the level of the Assistant Secretary of the Navy, the Department of the Navy's Service Acquisition Executive.

Currently, audit and legal review of all memoranda of understanding is underway at all schools under DOD cognizance, not just at Stanford. Additionally, the Office of Management and Budget is reviewing options for alternative methods of addressing tuition remission of graduate students involved in research, currently a

point of contention within the Federal Government, and OMB will establish a Government-wide policy on this issue.

I certainly agree with the position that GAO cited earlier today when they said we should have one system applied uniformly across all the schools. At schools other than Stanford, the MOU audit phase is complete, and the MOU legal review process is ongoing.

Now, of 55 MOU's existing in March of last year at these universities, 38 have been cancelled, and action on the others is still pending. MOU's were cancelled for a variety of reasons, some because the MOU's agreed to accounting methods that should have been incorporated into internal university procedures, some because the MOU's had actually expired or run their course, and others because the MOU's merely restated the provisions of OMB Circular A-21.

Generally speaking, MOU's at these schools do not yet appear to have had a significant cost impact in establishing the indirect cost rate or they have not been questioned by Government administrators or auditors.

In contrast, the MOU's at four institutions, California Institute of Technology, Massachusetts Institute of Technology, the National Academy of Science, and the University of Hawaii, are coming under more careful scrutiny because of their potential for significant dollar impact on indirect cost rates.

In April of last year, I personally wrote the president of every university or nonprofit institution under DOD cognizance, forwarding them a copy of the GAO report on federally sponsored research and asking them to ensure that costs paid by the taxpayers are proper and reasonable. To date, 12 of these schools, including Stanford University, have reviewed accounts submitted for past open years and have voluntarily withdrawn a total of \$8.4 million in indirect costs billed to the Government during the period 1985 to 1991. The amounts withdrawn represent a combination of specifically unallowable charges, other charges that had been improperly allocated to research, and charges which the University may itself still believe to be allowable but inappropriate for billing to sponsored research.

I am pleased that these schools, when apprised of the potential for problems in their billings, took prompt action to review past billings and to initiate reform of their own internal controls. I am also pleased that Stanford University, the National Academy of Sciences, Columbia University, and the Massachusetts Institute of Technology have refunded to the Treasury of the United States a total of \$3,692,000 to date from these amounts withdrawn.

Mr. Chairman, I will add that that is a correction or new data relative to my prepared remarks which referred to a potential refund from Columbia. We got the check from Columbia yesterday afternoon.

Lastly, I have written the other institutions to express my appreciation for their internal review of past year charges and to formally request a refund of their withdrawals identified to date. Audits of past open years at DOD cognizance schools, other than Stanford, are in process across the country by DCAA as addressed in the testimony of my colleague.

However, in brief, let me say that DCAA, in our opinion, is diligently working to ensure that unallowable charges are removed from the incurred cost submissions of all open years at DOD cognizant universities.

Additionally, DCAA has performed over 30 internal control audits at universities and nonprofit institutions which serve to assist Government administrators as well as the universities in identifying potential deficiencies in their own accounting systems and pinpointing areas for reform. In order to ensure that ONR is truly employing the right approach to its business operations, we have also taken positive action to conduct these operations much more out in the sunshine.

Formal management reviews have been instituted at all ONR business operations, not only at universities but for all forms of contracting. Reviewers include officials from the other military services, from Federal agencies, academia, the Naval Audit Service and industry. Begun in December 1991 and continuing through January, these reviews are providing policy and management visibility and detailed procedural checks into our annual business plans and practices.

The first review held on December 9, 1991, included Government representatives from the Department of Defense, the National Aeronautics and Space Administration, the Department of Health and Human Services, the National Science Foundation, the Industrial College of the Armed Forces, and university representatives from the University of California at San Diego, the University of Houston, and the University of Massachusetts.

Another change in the early stages of development is that the Office of Naval Research will fundamentally change its method of establishing indirect cost rates at universities. Presently, the primary responsibility is on the resident administrative contracting officer to negotiate and establish these rates.

In the future, a centralized, indirect cost branch will be established as the primary rate setting organization, supplemented by support from the resident administrative contracting officer. This reorganization is based upon the very successful experience that we had with the special university team approach used at Stanford University. Establishment of this branch, together with the headquarters' level reviews and approvals will enhance consistency and rate establishment nationwide and provide local resident representatives the in-depth, senior negotiation support they previously lacked.

In addition to actions instituted by the Department of Defense, I serve as a member of a task group working under the leadership of the Office of Management and Budget to recommend improvements to Circular A-21, cost principles for colleges and universities. Other changes have already been implemented, as previously mentioned in this hearing, and will assist in preventing future abuses in allocating costs to federally sponsored research by clarifying rule provisions and eliminating the need for some interpretations of cost allocability, but other more fundamental changes are now under interagency review as part of the OMB initiative.

Mr. Chairman, I believe that much has been accomplished, although I suspect the pace of conducting audits and negotiations at

schools across the Nation may seem slow to some. I, as well, would have preferred to be able to report to you today a completed list of final reform actions at each of our 39 schools. However, what I can report is that the process now ongoing does fully protect the interests of the American people in the recovery of any moneys which may have been improperly charged, either deliberately or erroneously, even though the recovery process may, in fact, prove lengthy. Lax oversight by Federal regulators or mischarging or overcharges by schools for their expenses should not and will not be tolerated.

Nevertheless, in carrying out needed changes we have an equally important responsibility to ensure that our reform measures do not simply correct existing abuses or penalize university management but rather that they provide a sound basis for effective Government oversight and the internal accounting controls necessary for continuing business process based on fairness and equity.

Mr. Chairman, I thank you for your patience. This completes my opening remarks.

[The prepared statement of Admiral Miller follows:]

STATEMENT OF  
REAR ADMIRAL WILLIAM C. MILLER, USN  
CHIEF OF NAVAL RESEARCH

29 January 1992

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to provide you a status report on actions taken by the Navy Department to make improvements in government contract administration procedures at universities. These actions have been taken in furtherance of Department of Defense responsibilities for administration of contractual matters at designated colleges, universities and non-profit institutions in accordance with OMB Circular 4-88.

In late 1990 and early 1991, based upon information regarding business problems at Stanford University reported by a Navy Administrative Contracting officer, various government agencies, including the General Accounting Office, the Defense Contract Audit Agency and the Navy, commenced investigations that revealed serious billing errors at Stanford and highlighted the need for reform of the business process between the government and all colleges and universities.

In reforming our business process, our overall objective is to correct any systemic problems or abuses, recover any monies improperly charged, and ensure that the future business process with universities contributes to the underlying federal policy supporting the conduct of scientific research at the nation's universities and to maintaining and upgrading the university research infrastructure. To meet this objective, we are currently engaged in the following actions:

1. identify and rectify contracting problems at universities under DoD cognizance.
2. establish personal accountability for past problems, take appropriate action, and establish effective oversight to preclude future reoccurrence.
3. reform and strengthen the government's administrative procedures at each of the schools for which the Office of Naval Research is assigned responsibility for contract and grant administration and indirect cost rate negotiation.

I will summarize measures implemented to date in furtherance of each of these objectives:

#### AT STANFORD UNIVERSITY

The reform issues at Stanford can be broken into two segments:

o First, the need to audit costs billed to the government for the years 1981-1991, to negotiate final indirect cost rates for those years, and where appropriate, to obtain reimbursement for any inappropriately billed costs.

o Second, the establishment of a proper billing rate and review system for current years, 1992 and forward.

#### **Open Years 1981-1988**

In December of 1991, the Defense Contract Audit Agency issued final audits on actual costs at Stanford for fiscal years 1981 to 1988, based on extensive transaction audits for 1987 and 1988. This audit data is currently under review by the Navy's Special University Team (SUT) -- established to handle contract administration matters at Stanford.

Audits of backyears at Stanford, to date, contain a significant amount of questioned costs, but it is important to note that no final conclusions have been reached on past year actual costs. The Navy Special University Team will work with DCAA auditors and Stanford officials to ensure the accuracy of audit findings. As there are a number of years involved, it will take considerable time to complete our evaluation of the amounts of indirect costs that should ultimately be removed from government billings.

In addition to these audits, a separate audit and review is also under way for the Memoranda of Understanding (MOUs) previously established at Stanford to provide alternative allocations of costs to government sponsored research. The objective of these MoU reviews is to determine: (1) whether the MoUs comply with the cost principles for university research set forth in Office of Management and Budget (OMB) Circular A-21; (2) if in compliance, whether the terms and conditions of the Memoranda were followed by the University in its billing practices; and finally, (3) to determine if the Memoranda resulted in an equitable assignment of cost to federally sponsored research.

Additionally, as appropriate, audit findings and other data are being coordinated with the Naval Investigative Service for their review and with the Department of Justice for their determination of possible violations of civil statutes.

#### Open Years 1989-1990

Stanford submitted its incurred cost proposal for fiscal year 1989 in November of last year, and the 1990 proposal is scheduled for submission in May 1992. Audits of actual costs for these years will determine if the government has either under or overpaid Stanford for its overhead costs during 1989-90.

#### Current Years 1991-1992

On 25 April 1991, the Special University Team issued a unilateral determination canceling 124 Memoranda of Understanding (MOUs) between Stanford and the government for 1991 and future years. At the same time, the SUT unilaterally reduced Stanford's FY 91 provisional indirect cost rate from 74% to 55.5%. These actions were made retroactive to the beginning of the University's fiscal year 1991 (FY-91), which started 1 September 1990. Subsequently, in August of last year, the SUT and Stanford agreed to convert the FY 91 unilateral provisional rate of 55.5% to a final negotiated fixed rate of 55.5% with provisions for a carry forward adjustment. Data provided by Stanford was deemed insufficient to raise or lower the unilateral provisional rate.

On 14 November 1991, Stanford University announced that it would not accept the Government's unilateral cancellation of the Memoranda of Understanding, which had been the primary factor in the reduction of its fiscal year 1991 rate. The University therefore filed an administrative appeal of the government's action with the Armed Services Board of Contract Appeals. Stanford's position is that these MoUs were binding contracts and could not be canceled unilaterally. We are continuing action to resolve the MoU status, but the University's action suggests the possibility that a lengthy legal process ultimately will be required to determine the validity of the Government's cancellation of these MoUs.

As best we understand today, Stanford's current plan is to submit an actual Incurred Cost Proposal for FY 91 in August 1992. Adjustments to the 55.5% rate established for FY-91, if any, will depend upon audit and negotiation of their proposal and the ruling of the Armed Services Board of Contract Appeals or civil courts.

#### **1992 Forward Pricing Proposal**

Stanford also has submitted a forward pricing proposal for its FY 1992 rates. However, the supporting documentation and the overall proposal are not yet considered adequate by Defense Contract Audit Agency for their making a rate recommendation to the SUT negotiators, as a necessary precondition for conducting negotiations. Accordingly, under the terms of OMB Circular A-21, the 55.5% rate for the previous year has been extended unilaterally as the provisional rate for fiscal year 1992 pending submission and audit of an acceptable forward pricing indirect cost proposal.

#### **DEOBLIGATION OF FUNDS**

During fiscal year 1991, Stanford's provisional billing rate was reduced from an initial rate of 74% to a final fixed rate of 55.5%. This resulted in a number of contracts and grants being potentially over funded. All affected federal agencies were advised of the potentiality for excess funds having been obligated, and were given the following options:

- deobligate the excess funds and reallocate the funds to research work at other universities.
- apply the excess funds to direct costs for research work on the existing grant or contract.
- use the excess funds to offset future incremental funding or renewal actions under existing contracts or grants.

The amount of possible over funding government-wide due to the reduction in the rate is not yet available, as such calculations must be performed independently by each of the awarding or granting agencies. For the Department of Navy, it is estimated that approximately \$1.2 million in excess funds will result from the rate reduction, based on total Navy obligations at Stanford of \$13.8 million. A portion of these funds is being applied to contracts or grants which will continue or be renewed. The remaining funds are being deobligated and returned for reallocation to research at other schools.

PERSONAL ACCOUNTABILITY

The second objective in addressing reforms of our federally sponsored research was to establish individual accountability for problems identified.

For that purpose, I established a Personnel Accountability Panel of senior Navy military and civilian officials to conduct a formal fact finding inquiry. Based on the Panel's report of 14 May 1991, I determined that within the Department of the Navy, contracting abuses resulted not from the OMB Cost Principles or from existing Navy procedures and policies, but rather from the failure of six civilian employees within the Office of Naval Research to exercise proper oversight and to faithfully carry out their assigned duties.

In administrative proceedings, one of these employees was reduced in pay and grade level and reassigned out of the university business environment; a second employee chose to retire prior to imposition of a pending reduction in pay and grade and a reassignment. Four others were disciplined administratively, each receiving a letter of reprimand or caution.

The Secretary of the Navy and I also have congratulated and publicly recognized Mr. Paul Biddle, our Administrative Contracting Officer who first called attention to these issues. Mr. Biddle has been awarded the Navy Meritorious Civilian Service Award in a public ceremony held in September 1991 here in Washington.

REFORM AT ALL DOD COGNIZANCE SCHOOLS

The third objective in addressing the general indirect cost problems found was to ensure that management procedures for handling contract administration and overhead rate negotiation for schools across the country are sound and adequate. While there is no evidence of problems comparable to the magnitude found at Stanford, a thorough review of procedures and indirect cost rates is underway at each of the other schools. Actions now in progress include the following:

**Administrative.**

As noted, my Personnel Accountability Panel determined that the problems at Stanford were caused by personnel error and not by a lack of adequate procedures. Nevertheless, our internal administrative and procedural instructions have subsequently been strengthened and clarified, so that these rules are made clear to everyone involved. Our procedures also now require additional safeguards for administrative contracting actions taken by field representatives, such as:

- Navy headquarters approval now required prior to the local contracting officer conducting indirect cost rate negotiations.

- Formal coordination with all other interested Federal Agencies required prior to conducting rate negotiations with the University.

- Navy headquarters legal approval required to support all rate agreements.

- A new reporting system on the status of all ongoing indirect cost audits having been implemented, and

- All future Memoranda of Understanding agreeing to alternative allocations of indirect costs must be approved at the Assistant Secretary of the Navy level.

#### Review of Memoranda of Understanding.

Currently, audit and legal review of all Memoranda of Understanding (MoUs) is underway at all schools under DoD cognizance. Additionally, the Office of Management and Budget is reviewing options for alternative methods of addressing tuition remission of graduate students involved in research, currently a point of contention within the federal government, and will establish a government-wide policy on this issue. At schools other than Stanford, the MoU audit phase is complete and the MoU legal review process is ongoing. Of 55 MoUs existing in March at these universities, 38 have been canceled to date. MoUs were canceled for a variety of reasons--some because the MoUs agreed to accounting methods that should have been incorporated into internal university procedures, some because the MoU's had expired, and some because the MoU's merely restated the provisions of OMB Circular A-21.

Generally speaking, MoUs at these schools do not yet appear to have had a significant cost impact in establishing the indirect cost rate, or they have not been questioned by government administrators or auditors.

In contrast, the MoUs at four institutions--California Institute of Technology, Massachusetts Institute of Technology, National Academy of Sciences, and the University of Hawaii--are coming under careful scrutiny because of their potential for significant dollar impact on indirect cost rates.

#### Voluntary review of cost proposals by Universities.

In April of last year, I personally wrote the President of

every university or non-profit institution under DoD cognizance, forwarding them a copy of the General Accounting Office report on Federally sponsored research, and asking that they ensure that costs paid by the taxpayers are proper and reasonable. To date twelve of these schools, including Stanford University, have reviewed accounts submitted for past open years and voluntarily withdrawn a total of \$8,431,657 in indirect costs billed to the government during the period 1985 to 1991. The amounts withdrawn represent a combination of specifically unallowable charges; other charges that had been improperly allocated to research; and charges which the University may itself still believe to be allowable, but inappropriate for billing to sponsored research.

I am pleased that these schools, when apprised of the potential for problems in their billings, took prompt action to review past billings and to initiate reform of their internal controls. Stanford University, the National Academy of Sciences and the Massachusetts Institute of Technology (MIT) have refunded \$2,265,071.00, \$168,723.00, and \$778,261.00, respectively. An additional refund of \$480,185 from Columbia University is pending receipt. Lastly, I have also written the other institutions to express my appreciation for their internal review of past year charges and, without waiving any future government rights, to formally request a refund of their withdrawals identified to date.

#### **University Audits.**

Audits of past open years at DoD cognizant schools, other than Stanford, are in process at schools across the country by the Defense Contract Audit Agency (DCAA), as addressed as part of the testimony of my colleague, Mr. Fred Newton of the Audit Agency. However, in brief, let me say that DCAA is diligently working to ensure that unallowable charges are removed from incurred cost submissions for all open years. Additionally DCAA has performed over 30 internal control audits which serve to assist government administrators as well as universities officials in identifying potential deficiencies in their accounting systems and pinpointing areas for reform.

#### **Fiscal year 1992.**

Because of the greater scope of ongoing audits at universities, only eight FY-92 forward pricing rate negotiations have been completed to date. All other DoD-cognizant schools are currently working under provisional FY-92 or previously negotiated rates.

#### **Business Reviews.**

Formal management reviews have been instituted of all ONR business operations, not only at universities, but for all forms of

contracting. Reviewers include officials from other federal agencies, academia, the Naval Audit Service, and industry. Begun in December 1991 and continuing through January 1992, these reviews are providing policy and management visibility and detailed procedural checks into our annual business plans and practices. The first review held, December 9, 1991, included government representatives from the Department of Defense (DoD), the National Aeronautics and Space Administration (NASA), the Department of Health and Human Services (DHHS), the National Science Foundation (NSF), Industrial College of the Armed Forces, and university representatives from the University of California (San Diego), the University of Houston, and the University of Massachusetts (Lowell Research Foundation).

#### **Indirect Cost Rate Branch.**

Another change in the early stages of development is that the Office of Naval Research will fundamentally change its method of establishing indirect cost rates at universities. Presently, the primary responsibility is on the resident Administrative Contracting Officer (ACO) to negotiate and establish these rates. In the future, a centralized indirect cost Branch will be established as the primary rate setting organization, supplemented by support from the resident ACO. This reorganization is based upon the experience gained with the Special University Team approach used most recently at Stanford University. Boston, Massachusetts, has been tentatively selected as the office location because ONR already has a regional office there, and approximately 30 of the 39 schools for which DoD has responsibility are located in the eastern half of the United States.

Establishment of this Branch, together with headquarters level reviews and approvals, will enhance consistency in rate establishment nationwide, and provide local resident representatives the in-depth, senior negotiation support they previously lacked.

#### **OMB CHANGES**

In addition to actions instituted by the Department of Defense, I serve as a member of a task group working under the leadership of the Office of Management and Budget to recommend improvements to Circular A-21, Cost Principles for Colleges and Universities. Some changes have already been implemented that will assist in preventing future abuses in allocating costs to federally sponsored research, by clarifying rule provisions and eliminating the need for some interpretations of cost allocability.

The recent rule change having the greatest cost impact thus

far limits a university's General and Administrative (G&A) rate to a maximum of 26%. While this new rule will not directly affect those universities whose G&A rates are below the cap level, it is expected that this rule change by fiscal year 1993 will result in approximately a \$10.8 million dollar reduction in overhead costs charged to the Department of Defense, and approximately a \$100 million dollar reduction in annual indirect cost expenditures for the federal government as a whole. These savings estimates have already been reflected in the formulation of future year Military Department and Defense Agency budgets.

Mr. Chairman, this completes my update on business reform measures, as well as a status report on our ongoing scrub of open years at schools under DoD cognizance.

Much has been accomplished, although I suspect the pace of conducting audits and negotiations at schools across the nation may seem slow to some. I, as well, would have preferred to be able to report to you today, a completed list of final reform actions at each of our 39 schools. However, what I can report is that the process now ongoing does fully protect the interests of the American people in the recovery of any monies which may have been improperly charged, either deliberately or erroneously --- even though the recovery process may prove lengthy.

Lax oversight by federal regulators, or mischarging or overcharges by schools for their expenses should not and will not be tolerated. Nevertheless, in carrying out needed changes we have an equally important responsibility to ensure that our reform measures do not simply correct existing abuses or penalize university management, but rather that they provide a sound basis for effective government oversight and the internal accounting controls necessary for a continuing business process based on fairness and equity.

I believe that we have taken effective measures to improve government oversight, and together with DCAA, we are identifying needed internal control measures at each DoD cognizant University.

Thank you, Mr. Chairman. I would be pleased to answer any questions that you or other Subcommittee members may have.

Mr. DINGELL. Thank you very much, Admiral, for a very helpful submission to the subcommittee. We are grateful.

Mr. Newton, we are happy to welcome you back at this time.

#### TESTIMONY OF FRED J. NEWTON

Mr. NEWTON. Thank you, Mr. Chairman and members of the subcommittee. I have submitted a formal statement which I request be placed on the record so I might just highlight in the oral testimony.

Mr. DINGELL. Without objection, so ordered. We will recognize you for such statement as you choose to give.

Mr. NEWTON. Thank you.

I will describe the status of activities of the Defense Contract Audit Agency in auditing costs of Government-sponsored university research. My comments will specifically address the findings at those universities where DCAA has completed its audits. In addition, I will provide an overall assessment of the actions to correct the causes of university cost problems and describe initial findings at a major nonprofit research organization.

There are three universities which have attracted most attention. With reference to them, I provide the following information:

Stanford University is where the exposure of major overbillings to the Government began, and Stanford continues to hold by far the largest amount which should be refunded. We have completed audits of costs billed for the years 1981 through 1988. We issued 28 audit reports on the various elements of costs of that period. It is our opinion that Stanford owes the Government \$231 million for excessive amounts billed during that period. This amount does not include the \$1.3 million refunded last year.

At the Massachusetts Institute of Technology, we have completed the audit of costs billed for fiscal year 1990. It is our opinion that MIT owes the Government \$19 million for excessive amounts billed in that period.

At Pennsylvania State University, we have completed the audit of costs billed for fiscal years 1986 and 1990. It is our opinion that Penn State owes the Government \$6.4 million for excessive amounts billed in that period.

The nature of audit findings at these and the other universities at which we have conducted audits will be described in the remainder of my statement.

DCAA has completed many audits of internal controls and of incurred and projected costs. A schedule showing the status of cost-incurred audits at the universities where we have audit cognizance is submitted as Appendix 1. While there is still a lot of audit work to be done, I believe we have reached a point where overall conclusions may be drawn regarding both the significance of the cost impact and whether the corrective actions in process may be expected to prevent recurrence of the problems.

Our audits of universities' internal controls have disclosed three common deficiencies: (1) inadequate employee awareness and training regarding the regulations and procedures applicable to federally sponsored research; (2) inadequate written policies and procedures to guide employees in cost accounting for Government con-

tracts and grants; and (3) absence of systems to identify and segregate unallowable costs.

The universities have acknowledged these deficiencies and have established corrective action plans. The plans appear adequate to correct the problems cited. We are carefully examining their implementation.

Audits of direct and indirect cost claims have been completed at 22 universities. These audits cover 54 university fiscal years. Audits are in process at 20 universities covering 49 fiscal years. We hope to complete these audits during the current Government fiscal year.

Appendix 2 is a schedule of the \$336 million of unallowable costs identified during the recent period of intense scrutiny of university costs. This schedule only reflects those actions where audits are complete.

The audits completed indicate cost allocability and allowability problems similar to those previously brought to the attention of the subcommittee. Since the costs were incurred before the significant attention given to the universities this past year, they should not be viewed as reflecting continuing university actions.

Examples of audit findings include:

At Syracuse University, the University voluntarily removed \$362,000 of entertainment costs from various 1990 indirect expense pools. However, the auditor found an additional \$57,000 of entertainment costs. Of this amount, \$11,295 was for a Saint Patrick's day party, \$8,855 was for dinner dances, and \$3,718 was for convocation and commencement activities.

The Massachusetts Institute of Technology included the following unallowable item in its 1990 indirect cost claim: \$23,012 for the Biology Department's spring retreat held for faculty, lab personnel, and graduate students. The costs were for hotel rooms, meals and alcohol. The University did not provide any evidence demonstrating a technical purpose for the retreat.

Pennsylvania State University included \$15,000 for sponsorship of the Hershey Amusement Park in its 1990 indirect cost claim. The sponsorship agreement is for promotion of Penn State's Hershey Medical Center through various billboards and signs.

DCAA has completed audits of all of the nonstandard allocations having significant cost impact which were the subject of Memorandums of Understanding, commonly referred to as MOU's. These alternate allocations are deviations from the standards for allocating costs to Government contracts. While the MOU's are documents of agreements signed by the Government contracting officers and university officials, we have acted upon a legal opinion from Office of Naval Research counsel in assessing whether the agreements are valid. The criteria provided by counsel are quoted in my detailed statement.

We have recommended that 74 percent of the nonstandard allocations be terminated because they produce inequitable allocations of cost to Government contracts and grants and, consequently, do not comply with applicable regulations.

In virtually all of the circumstances, the universities also did not comply with the OMB Circular A-21 requirement that nonstandard

allocations must be supported by cost analyses studies at least every 2 years.

An example of the results of DCAA's audits of nonstandard allocations is: The Massachusetts Institute of Technology allocates library costs using a single recovery rate of 49 percent for all library costs based on a 1983 cost-analysis study. MIT did not provide the contracting officer updated library studies in fiscal year 1988 or 1990, as required by the circular.

Our analysis of the library cost recovery indicates that a single research recovery rate is not equitable because the cost of the libraries do not closely correlate with the distribution of research by a school. For example, the Architecture, Humanities, and Management school libraries incur about 50 percent of the total library costs, but these schools conduct only about 4 percent of the total on-campus research. We developed individual research recovery rates for each school library to support audit recommendations for equitable cost allocations.

The cost impact to the Government of the excessive allocation is \$2.6 million in 1990.

The allocation methods and criteria prescribed in OMB Circular A-21 as the standards for cost allocation are very good accounting practices. By this, I mean that they generally result in objective and equitable allocations of cost. The concepts are sound, whether applied in the university environment or in any other environment where a reasonably accurate measure of costs is desired.

Unfortunately, Stanford attacks the Circular A-21 utility cost allocation standard without providing a reasonable alternative. They would have the Government accept utility cost allocations which totally disregard their own meter records of actual utility usage in favor of a very old report from a consultant who purportedly studied utility usage in a few buildings and recommended weighted square feet for cost allocations. That weighting resulted in charges to the Government in excess of allocations based on usage records. The overbillings amount to about \$2 million per year.

As the level of Government oversight activity has increased, so has the level of university activity. Many universities have hired additional personnel or engaged external consultants to bolster their positions. In many cases, this has resulted in revisions to cost claims, removing expressly allowable costs.

We are pleased to see this voluntary effort and the amounts removed from the claims. However, we are concerned about the cost of retroactively doing what should have been done before the claims were submitted. We do not believe the costs should be charged to the Government, and we intend to question any such costs billed to the Government. Whether we are successful in sustaining these disallowances remains to be seen. We expect to be challenged.

For example, Stanford University's Director of their Office of Government Cost and Rate Studies said in a October 28, 1991, letter to the DCAA audit manager that their 1992 rates would include \$8 million in costs to respond to deficiencies cited by DCAA to prepare cost studies and to otherwise respond to Government requests. This seems patently unreasonable to me. It is also ironic in view of the fact that they have declined DCAA offers to conduct

joint analyses of unallowable costs during the past 10 years as a means of reducing costs to both Stanford and the Government.

Columbia University has hired two independent accounting firms to assist it in reviewing indirect cost claims for unallowable costs for fiscal year 1986 through 1990. Columbia representatives have indicated that they do not intend to charge the cost of this review to the Government.

We have experienced some significant improvement in relations between university representatives and our auditors. Some positive actions are cited in my complete statement.

My overall assessment of the actions to correct the causes of university cost problems may be summarized as follows:

There has been a large amount of Government funds distributed both to the universities and within the universities where the academic environment and the importance of the research has overshadowed the usual prudence associated with the use of such funds. This environment caused a failure to give appropriate attention to the more stringent controls expected to be associated with public funds. A number of significant actions appear to be correcting the lack of attention to appropriate controls. Your hearings have certainly brought into clear focus the need for corrective action.

University managers across the Nation have initiated internal reviews of their systems and revised personnel assignment responsibilities. Implementation actions observed to date have been a great improvement over prior practices.

Many universities have come forward with voluntary refunds or deletions from open settlement claims of significant amounts they admit were inappropriately billed to the Government.

The applicable regulation, OMB Circular A-21, has been significantly revised and improved to make cost-allowability provisions more explicit, to establish more definitive cost controls, and to make it clear that unallowable costs which have flowed through the billing process are to be refunded when discovered, not treated as an element of carryforward provisions.

The Cost Accounting Standards Board has published for public comments proposals which would make some of their regulations applicable to universities.

Oversight organizations have heightened the awareness of their personnel toward the need to deal with universities that are in the business of Government-sponsored research as they would with other businesses in Government contracting. In DCAA, we have reviewed and revised audit guidelines, assured that appropriate risk assessments are made, and established audit programs and assigned personnel commensurate with those risk assessments.

While the work of correcting all the university cost problems will take considerably more time, I believe the recoveries and recommended additional recoveries of Government funds show that the effort is worthwhile. The newly experienced cooperation and attention towards systems improvement will likely result in much more acceptable conditions for Government-sponsored research at universities.

Before concluding my statement, I would like to point out that lessons learned in the university environment are being pursued elsewhere. For example, attention is now being focused upon non-

profit organizations involved in Government-sponsored research and other contracted activities.

At the National Academy of Sciences, DCAA auditors have encountered some significant accounting system problems and unallowable billed costs similar to those observed at universities. The Academy is a nonprofit organization, exempt from Federal income taxes, which operates as a collection of scientists engaged to perform research studies requested and paid for by Federal agencies. The majority of research done is for the Department of Transportation, NASA, Department of Energy, and DOD. The Academy charged about \$143 million to the Government for research in its fiscal year 1990.

The National Academy of Sciences has been submitting indirect cost submissions that have not been properly reconciled by the Academy to its general ledger. The DCAA auditor asked for a reconciliation of costs claimed, costs billed and costs recorded in the general ledger for open Government contracts and grants in the period 1986 through 1990. The Academy engaged expert assistance and spent 4 months attempting to reconcile the 1988 indirect costs claimed to the accounting records. A reconciliation and explanation was provided to DCAA this past week. The auditors are currently reviewing this reconciliation.

The reconciliation difficulties raised concern that the Academy's accounting system may not be acceptable for accounting for costs on Government contracts and grants.

Audit effort at the National Academy of Sciences will obviously continue to have our attention. In the meantime, we are surveying our audit offices to identify other nonprofit organizations having significant Government contracts or grants subject to audit. We will assure that organizations identified in this survey receive expedited and effective audits.

Mr. Chairman, members of the subcommittee, this concludes my statement. I will be pleased to answer any questions.

[Testimony resumes on p. 99.]

[The prepared statement and attachments of Mr. Newton follow.]

STATEMENT OF  
FRED J. NEWTON  
DEPUTY DIRECTOR  
DEFENSE CONTRACT AUDIT AGENCY

Mr. Chairman and Members of the Subcommittee:

I will describe the status of activities of the Defense Contract Audit Agency (DCAA) in auditing costs of government sponsored university research. My comments will specifically address the findings at those universities where DCAA has completed its audits. In addition, I will provide an overall assessment of the actions to correct the causes of university cost problems and describe initial findings at a major nonprofit research organization.

There are three universities which have attracted most attention. With reference to them, I provide the following specific information:

1. Stanford University is where the exposure of major overbillings to the government began, and Stanford continues to hold by far the largest amount which should be refunded. We have completed audits of costs billed for the years 1981 through 1988. We issued 28 audit reports on the various elements of costs of that period, all of which have been made available to Stanford for comment. The number and magnitude of deficiencies and exceptions reported is such that it is not reasonable to expect a studied

response yet from Stanford. It is our opinion that Stanford owes the government \$231 million for excessive amounts billed during that period. This amount does not include the \$1.3 million refunded last year. As discussed later in my testimony, it is our opinion that the government should retroactively cancel the Memorandums of Understanding with Stanford. A substantial portion of the overbillings cited here result from Stanford's inappropriate deviations from OMB Circular A-21 standards for cost allocation. While we are continuing some work on more current years, the issues as reported in these concluded audits need to be resolved because they significantly impact considerations in subsequent periods.

2. At the Massachusetts Institute of Technology (MIT), agreement was reached between the government and the university to focus audits on fiscal year 1990 before going back into the older open years, 1987 through 1989. We have completed the audit of costs billed for fiscal year 1990 and have made the findings available to MIT for comment. The number and magnitude of deficiencies and exceptions is such that it is not reasonable to expect a studied response yet from MIT. It is our opinion that MIT owes the government \$19 million for excessive amounts billed in that period. This reflects the government's participation in total costs questioned of \$23 million.

3. Similarly at Pennsylvania State University, agreement was reached between the government and the university to focus audits on fiscal year 1990 before going back into the older open years, 1987 through 1989. We have completed the audit of costs billed for fiscal years 1986 and 1990 and have made the findings available to the university for comment. University representatives have expressed disagreement with many of our recommendations, but they have not yet submitted any explanations or data which cause the audit recommendations to be revised. It is our opinion that Penn State owes the government \$6.4 million for excessive amounts billed in that period. This reflects the government's participation in total costs questioned of \$22 million.

The nature of audit findings at these and the other universities at which we have conducted audits will be described in the remainder of my statement.

DCAE has completed many audits of internal controls and of incurred and projected costs. A schedule showing the status of cost incurred audits at the universities where we have audit cognizance is submitted as Appendix 1. While there is still a lot of audit work to be done, I believe we have reached a point where overall conclusions may be drawn regarding both the significance of the cost impact and whether the corrective actions in process may be expected to prevent recurrence of the problems.

Our audits of universities' internal controls have disclosed three common deficiencies:

1. Inadequate employee awareness and training regarding the regulations and procedures applicable to federally sponsored research.
2. Inadequate written policies and procedures to guide employees in cost accounting for government contracts and grants.
3. Absence of systems to identify and segregate unallowable costs.

The universities have acknowledged these deficiencies and have established corrective action plans. The plans appear adequate to correct the problems cited. We are carefully examining their implementation.

We have been providing audit recommendations to contracting officers on estimated 1992 costs for pricing new awards to universities. Our recommendations reflect our opinion on the improper allocations and unallowable costs observed in the audits of costs incurred. Substantial savings may be expected as these recommendations are implemented. Cost estimates are only as good

as the cost accounting practices to accumulate data used for projections. Consequently, we expect systematic corrective action for estimates to be an integral part of implementing good practices for costs incurred.

Audits of direct and indirect costs claims have been completed at 22 universities. These audits cover 54 university fiscal years. Audits are in process at 20 universities covering 49 fiscal years. We hope to complete these audits during the current government fiscal year.

Appendix 2 is a schedule of unallowable costs identified during the recent period of intense scrutiny of university costs. This schedule only reflects those actions where audits are complete. This appendix separately identifies those costs voluntarily removed by universities following their reviews. The applicable OMB Circular A-21 provisions are referenced for identification of the nature of the costs.

The audits completed indicate cost allocability and allowability problems similar to those previously brought to the attention of the Subcommittee. Since the costs were incurred before the significant attention given universities this past year, they should not be viewed as reflecting continuing university actions. Examples of audit findings include:

1. Carnegie Mellon University incurred \$44,000 of travel costs for a European summer study in Egypt and Turkey. The expenses included a cruise on the Nile River. The auditor questioned these costs as unallocable to organized research in accordance with OMB Circular A-21.C.4. Furthermore, A-21 states that travel costs are allowable only when they are directly attributable to specific work under a sponsored agreement or are incurred in the normal course of administration of the institution. The government participation is \$11,000. In addition, the auditor questioned \$287,000 of commencement and convocation costs in the university's 1987 and 1988 indirect cost claim. These costs are expressly unallowable per OMB Circular A-21. The government participation in these costs is \$76,000.

2. At Syracuse University:

a. \$833,000 of interdepartmental service costs were included in the 1990 indirect cost claim. The university department receiving the service was charged for that service; however, the department providing the service also recorded the costs. This resulted in double counting the expense. The government participation is \$22,000.

b. The university voluntarily removed \$362,000 of entertainment costs from various 1990 indirect expense pools. However, the auditor found an additional \$57,000 of entertainment costs. Of this amount \$11,295 was for a St. Patrick's Day party; \$8,855 was for dinner dances; and \$3,718 was for convocation and commencement activities.

3. The Massachusetts Institute of Technology (MIT) included the following unallowable items identified as recreation expense in its 1990 indirect cost claim:

a. \$3,406 for limousine rental to bring the university board members to their meetings.

b. \$23,012 for the Biology Department's spring retreat held for faculty, lab personnel, and graduate students. The costs were for hotel rooms, meals, and alcohol. The university did not provide any evidence demonstrating a technical purpose for the retreat.

4. Pennsylvania State University included \$15,000 for sponsorship of the Hershey Amusement Park in its 1990 indirect cost claim.

DCAA has completed audits of all of the nonstandard allocations having significant cost impact which were the subject of Memorandums of Understanding (MOUs). These alternate allocations are deviations from the standards for allocating costs to government contracts. While the MOUs are documents of agreement signed by the government contracting officers and university officials, we have acted upon a legal opinion from Office of Naval Research Counsel in assessing whether the agreements are valid. The criteria provided by Counsel are as follows:

"Memoranda of Understanding may be retroactively challenged by the Government if the facts so warrant. Facts which would support a challenge are: 1) where the Memorandum of Understanding was inconsistent with substantive provisions of OMB Circular A-21, Cost Principles for Educational Institutions, or other applicable substantive law or rule; or 2) where subsequent events provide evidence that the facts or costs reported to support the MOU are materially different from facts and costs actually in place or incurred in performance of the agreement. Each MOU must be examined individually in light of these factual considerations."

We have recommended that 74 percent of the nonstandard allocations be terminated because they produce inequitable allocations of costs to government contracts and grants and, consequently, do not comply with applicable regulations. In virtually all of the circumstances, the universities also did not comply with the OMB Circular A-21 requirement that nonstandard allocations must be supported by cost analysis studies at least every two years.

Some examples of the results of DCAA's audit of nonstandard allocations are:

1. The Massachusetts Institute of Technology (MIT) allocates library costs using a single recovery rate of 49 percent for all library costs based on a 1983 cost analysis study. MIT did not provide the contracting officer updated library studies in fiscal year 1988 or 1990 as required by Circular A-21.

Our analysis of the library cost recovery indicates that a single research recovery rate is not equitable because the costs of the libraries do not closely correlate with the distribution of research by school. For example, the Architecture, Humanities, and Management school libraries incur about 50 percent of the total

library costs but these schools conduct only about 4 percent of the total on-campus research. We developed individual research recovery rates for each school library to support audit recommendations for equitable cost allocations.

In addition, we questioned the allocation of campus library costs to Lincoln Labs. Lincoln Labs is a federally funded research and development center located 20 miles from the main MIT campus and has its own library. Our analysis indicates that the main campus library facilities are not significantly used by Lincoln Labs personnel.

The cost impact to the government of the excessive allocation is \$2.6 million in 1990.

2. Pennsylvania State University has a MOU which changed the capitalization threshold for moveable equipment from \$500 to \$1,000 effective for fiscal year 1990. The MOU is not in compliance with Circular A-21 which sets the requirement for capitalization as "property having a useful life of more than two years, and an acquisition cost of \$500 or more per unit." The cost impact to the government in fiscal year 1990 is

\$480,000. This MOU has been cancelled but the university continues to capitalize only equipment costing \$1000 or more.

The allocation methods and criteria prescribed in OMB Circular A-21 as the standards for cost allocation are very good accounting practices. By this, I mean that they generally result in objective and equitable allocations of costs. The concepts are sound whether applied in the university environment or in any other environment where a reasonably accurate measure of costs is desired.

Yet, university managers, particularly at Stanford, persist in alleging that the Circular A-21 allocation standards are inequitable. Their allegations are made in the context of attempting to justify departures from the Circular A-21 allocation standards so that deviations may be used to allocate a larger portion of their costs to government contracts and grants. Let me give you a frequently cited example.

The president of Stanford University repetitively cites utility costs as being improperly allocated by Circular A-21 provisions. He comments that utility costs are obviously different for laboratories than for classrooms and then explains that Circular A-21 requires utility costs to be allocated to all

square footage equally. Thus, as he alleges, two buildings of equal square footage should be allocated equal shares of utility costs.

The interpretation given to Circular A-21 allocation standards is wrong. Circular A-21 says that utility costs of buildings used exclusively in the conduct of a single function shall be assigned to that function. Thus, two buildings with dissimilar functions should not be lumped together for utility cost allocation.

Unfortunately, Stanford attacks the allocation standard without providing a reasonable alternative. They would have the government accept utility cost allocations which totally disregard their own meter records of actual utility usage in favor of a very old report from a consultant who purportedly studied utility usage in a few buildings and recommended weighted square feet for cost allocations. That weighting resulted in charges to the government in excess of allocations based on usage records. The overbillings amount to about \$2 million per year.

Other items observed in our audits reflect misinterpretations of the OMB Circular A-21 regulations. For example, Section J.36 of Circular A-21 allows the charging of tuition remission as a compensation cost of students performing necessary work provided (i) there is a bonafide employer-employee relationship, (ii) the

tuition remission is reasonable compensation for the work performed, (iii) and the practice is to similarly compensate nonsponsored and sponsored activities. At MIT, the amount of tuition remission given to graduate students when related to hours worked exceeds the average compensation of full time researchers by 12 percent. We believe this is unreasonable. The excess in fiscal year 1990 amounts to \$7 million. The subject of tuition remission is currently being studied by the OMB Task Force as part of their review of Circular A-21 guidelines.

As the level of government oversight activity has increased, so has the level of university activity. Many universities have hired additional personnel or engaged external consultants to bolster their positions. In many cases, this has resulted in revisions to cost claims, removing expressly unallowable costs. We are pleased to see this voluntary effort and the amounts removed from the claims. We are concerned about the costs of retroactively doing what should have been done before the claims were submitted. We do not believe the costs should be charged to the government and we intend to question any such costs billed to the government. We will cite the following reasons for recommending disallowance in our reports to the contracting officers:

1. The costs are directly associated with the unallowable expenses to which the effort is directed and should be so allocated.

2. The government has previously reimbursed the universities for administrative expenses sufficient to assure compliance with applicable regulations. Their failure to do so and the resultant managerial inefficiency which caused these incremental costs to be necessary is unreasonable.

3. The costs are not of a type generally recognized as ordinary and necessary for the conduct of the university's business or the performance of sponsored research.

Whether we are successful in sustaining these disallowances remains to be seen. We expect to be challenged. For example, Stanford University's Director of their Office of Government Cost and Rate Studies, said in a 28 October 1991 letter to the DCAA audit manager that their 1992 rates will include \$8 million in costs to respond to deficiencies cited by DCAA, to prepare cost studies, and to otherwise respond to government requests. This seems patently unreasonable to me. It is also ironic in view of the fact they have declined DCAA offers to conduct joint analyses of unallowable costs during the past 10 years as a means of reducing costs to both Stanford and the government. Other

universities, specific examples being the California Institute of Technology and the University of Denver, have informed DCAA auditors that they intend to claim similar costs.

Columbia University has hired two independent accounting firms to assist it in reviewing indirect cost claims for unallowable costs for fiscal years 1986 through 1990. Columbia representatives have indicated that they do not intend to charge the costs of this review to the government.

We have experienced some significant improvement in relations between university representatives and our auditors. For example, at Stanford, financial and internal audit management changes have resulted in a tone of cooperation and a strong desire to get the inherited mess behind them. They have removed time consuming barriers to auditor access to records and have made commitments to be cooperative with our auditors as they measure the dollar impact of improper allocation methods.

Some positive actions at other universities are seen in the following examples:

1. The DCAA auditor at the University of Hawaii identified some significant cost accounting and internal control problems. DCAA management met with the university officials and developed an action plan to resolve the issues. The University provided a positive and constructive response. This included revising allocation methods to conform with Circular A-21.

2. Audits disclosed that Cornell University provides its former president rent-free use of a university-owned house. Cornell is currently reviewing its indirect expenses and have indicated it will submit revised indirect cost claims for 1986 through 1988. Cornell representatives have advised that they will remove costs associated with the former president's house in the revised claims.

My overall assessment of the actions to correct the causes of university cost problems may be summarized as follows:

There has been a large amount of government funds distributed both to the universities and within the universities where the academic environment and the importance of the research has overshadowed the usual prudence associated with the use of such funds. This environment caused a failure to give appropriate attention to the more stringent controls expected to be associated

with public funds. A number of significant actions appear to be correcting the lack of attention to appropriate controls:

1. Your hearings have certainly brought into ~~clear~~ focus the need for corrective action.

2. University managers across the nation have initiated internal reviews of their systems and revised personnel assignment responsibilities. Implementation actions observed to date have been great improvement over prior practices.

3. Many universities have come forward with voluntary refunds or settlements from open settlement claims of significant amounts they admit were inappropriately billed to the government.

4. The applicable regulation, OMB Circular A-21, has been significantly revised and improved to make cost allowability provisions more explicit, to establish more definitive cost controls, and to make it clear that unallowable costs which have flowed through the billing process are to be refunded when discovered, not treated as an element of carryforward provisions.

5. The Cost Accounting Standards Board has published for public comments proposals which would make some of their regulations applicable to universities.

6. Oversight organizations have heightened the awareness of their personnel toward the need to deal with universities who are in the business of government sponsored research as they would with other businesses in government contracting. In DCAA, we have reviewed and revised audit guidelines, assured that appropriate risk assessments are made, and established audit programs and assigned personnel commensurate with those risk assessments.

While significant progress has been and will continue to be accomplished, there are some obstacles of concern to the auditors:

1. Where we are performing audits at universities having both DoD and non DoD contracts, it is imperative that the non DoD agencies be prepared to pay for their share of the audits. For example about half of the costs we are auditing at Stanford are allocable to Department of Health and Human Services (HHS) sponsored research. HHS has advised that they do not have sufficient funds to support their share of the audits. Because our appropriation includes funds for only the DoD requirements, we may have to reschedule some of the audits until HHS is able to pay for their share. The budget shortage for fiscal year 1992 audits is about \$1 million. We are working through government channels to resolve this condition.

2. Some of the universities have withdrawn cost claims and deferred submissions pending their internal reviews of the claims. While we welcome this self governance action, it obviously detracts from our being able to conduct an audit. There must be a claim available to audit. We are meeting with university managers, and in some cases scheduling interim tests or joint audits, to resolve this condition.

While the work of correcting all the university cost problems will take considerably more time, I believe the recoveries and recommended additional recoveries of government funds show that the effort is worthwhile. The newly experienced cooperation and attention toward systems improvement will likely result in much more acceptable conditions for government sponsored research at universities.

Before concluding my statement, I would like to point out that lessons learned in the university environment are being pursued elsewhere. For example, attention is now being focused upon nonprofit organizations involved in government sponsored research and other contracted activities.

At the National Academy of Sciences, DCAA auditors have encountered some significant accounting system problems and unallowable billed costs similar to the those observed at

universities. The Academy is a nonprofit organization exempt from federal income taxes which operates as a collection of scientists engaged to perform research studies requested and paid for by federal agencies. The majority of research done is for the Department of Transportation, NASA, Department of Energy, and DoD. The Academy charged about \$143 million to the government for research in its fiscal year 1990.

The National Academy of Sciences has been submitting indirect cost submissions that have not been properly reconciled by the Academy to its general ledger. The DCAA auditor asked for a reconciliation of costs claimed, costs billed, and costs recorded in the general ledger for open Government contracts and grants in the period 1986 through 1990. The Academy engaged expert assistance and spent four months attempting to reconcile the 1988 indirect cost claim to the accounting records. A reconciliation and explanation was provided to DCAA this past week. The auditors are currently reviewing this reconciliation.

The reconciliation difficulties raise concern that the Academy's accounting system may not be acceptable for accounting for costs on government contracts and grants. Other evidence in support of this is that the Academy does not accumulate a record of billings by fiscal period, overhead expenses are accumulated on a consolidated basis even though four

overhead rates are used for billings on government contracts and grants, and there is no system for identifying and segregating expressly unallowable costs. Our auditors are making an assessment of these deficiencies. Regarding the expressly unallowable costs, the Academy recently engaged the large CPA firm, Price Waterhouse, to perform a sample of three accounts in about ten cost centers. As a result of this review, the Academy refunded \$168,723 to the government. An acceptable test should include all accounts. Of course, this procedure would not be necessary at all if the Academy had established procedures to comply with the applicable regulations in the first place.

Audit effort at the National Academy of Sciences will obviously continue to have our attention. In the meantime, we are surveying our audit officer to identify other nonprofit organizations having significant government contracts or grants subject to audit. We will assure that organizations identified in this survey receive expedited and effective audits.

Mr. Chairmen and Members of the Subcommittee, this concludes my statement. I will be pleased to answer any questions.

Status of Incurred Cost Audits  
at Universities  
January 1992

<u>Institution</u>	<u>Last Year Report Issued</u>	<u>Audits In Process</u>	<u>Audits Not Started</u>		<u>Submission Withdrawn/Revised Dates</u>	
			<u>Submission On Hand</u>	<u>Submission Not Received</u>	<u>Withdrawn</u>	<u>Resubmitted</u>
1 Alaska, University of	1987	1988 thru 1990		1991		
2 Brown Univ	1987	1988		1989 thru 1991		
3 California Inst Tech	1986	1987 thru 1990		1991	1987-90 5/1/91	1987-90 8/30/91
4 Carnegie Mellon Univ	1988	1989 thru 1991				
5 Colorado School of Mines	1987		1989	1990, 1991		
6 Columbia Univ	1985	1986 thru 1989		1990, 1991	1986-89 10/4/91	1986-89 11/25/91
7 Cornell Univ (Main)	1985	1986 thru 1988		1986 thru 1991	1986-88 3/22/91	
8 Cornell Univ (Medical)	1986	1987	1988 thru 1990	1991		
9 Dayton, University of	1990			1991		
10 Denver, University of	1988			1989 thru 1991	1989-90 9/24/91	
11 Emmanuel College	1986	1987 thru 1990		1991		
12 Georgia Inst of Tech	1986	1987 thru 1989	1990	1991		

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Status of Incompletes & Audits  
 as of December 31, 1991

<u>Institution</u>	<u>Last Year Report Issued</u>	<u>Audits In Process</u>	<u>Audits Not Started</u>		<u>Submission Withdrawn/Revised Dates</u>	
			<u>Submission On Hand</u>	<u>Submission Not Received</u>	<u>Withdrawn</u>	<u>Resubmitted</u>
13 Hawaii, University of	1988	1989, 1990		1991		
14 Illinois - Chicago	1989			1990, 1991		
15 Illinois - Urbana	1989	1990		1991		
16 Lake County, College of	1989	1990, No government business after 1990			1990 9/3/91	
17 Mass Inst of Tech (a)	1990	1987 thru 1989		1991		
18 New Mexico Institute of Technology	1989		1990	1991		
19 New Mexico State Univ	1990			1991		
20 New Mexico, Univ of	1989			1990, 1991		
21 Notre Dame, Univ of	1990			1991		
22 Penn State Univ	1990	1987 thru 1989		1991		
23 Polytechnic Univ	1984	1989 thru 1990		1989 thru 1990	1989 4/91	1989 9/30/91
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**Status of Incurred Cost Audits  
at Universities  
January 1992**

<u>Institution</u>	<u>Last Year Report Issued</u>	<u>Audits In Process</u>	<u>Audits Not Started</u>		<u>Submission Withdrawn/Revised Dates</u>	
			<u>Submission On Hand</u>	<u>Submission Not Received</u>	<u>Withdrawn</u>	<u>Resubmitted</u>
25 Rhode Island, Univ of	1985	1986 thru 1987		1988 thru 1991		
26 Rice Univ	1990			1991		
27 Rochester, Univ of	1987	1988		1989 thru 1991		
28 Smithsonian Astrophysical Observatory (c)	1988	1989, 1990		1991		
29 Smithsonian Institution (c)	1988	1989, 1990		1991		
30 Southeastern Society for Electrical Engineering Education	1990			1991		
31 Stanford University (b)	1988		1989	1990, 1991		
32 Stevens Institute of Technology	1985	1986 thru 1989		1990, 1991		
33 Syracuse University	1990			1991		
34 Virginia Institute of Marine Sciences	1989		1990, 1991			
U. Virginia Medical Institute Research Lab	1990		No government contract after 1990			

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**Status of Incurred Cost Audits  
at Universities  
January 1992**

<u>Institution</u>	<u>Last Year Report Issued</u>	<u>Audits In Process</u>	<u>Audits Not Started</u>		<u>Submission Withdrawn/Revised Dates</u>	
			<u>Submission On Hand</u>	<u>Submission Not Received</u>	<u>Withdrawn</u>	<u>Resubmitted</u>
36 Kentworth Inst Tech	1986		1986 thru 1991			
37 William & Mary	1989		1990, 1991			
38 Wright State Univ	1990		1991			

**Notes**

- (a) Supplemental field work to be performed on FY 1986
- (b) Stanford submitted an inadequately supported FY 1989 claim on 27 November 1991. The condition was reported to OHR on 20 December 1991. On 26 December 1991, DCAA was informed that the supporting documents would be available middle or late January 1992
- (c) The Smithsonian is included because their awards include provisions making OMB Circular A 21 applicable

**SUMMARY SCHEDULE OF UNALLOWABLE COSTS  
COSTS INCURRED  
REPORTS ISSUED OCTOBER 1990 - JANUARY 1992**

		(Note 1)			TOTAL
A-21 REF	TYPE OF COST	VOLUNTARY DELETIONS (\$ 000)	COST QUESTIONED (\$ 000)	TOTAL (\$ 000)	IMPACT TO GOVERNMENT (\$ 000)
<b>BASED ON REASONABLENESS</b>					
C 3	REASONABLE COST	0	5 017	5 017	4 225
C 5	CREDITS	22,617	6,450	29,077	14 729
C 7	LIMIT ON ALLOWANCE	754	0	754	154
<b>EXPRESSLY UNALLOWABLE</b>					
J 1	ADVERTISING	97	18	115	23
J 2	BAD DEBTS	426	25	451	251
J 4	COMMENCEMENT COSTS	330	55	385	113
J 6	SPECIAL COMPENSATION	0	147	147	113
J 7	CONTINGENCY PROVISIONS	0	421	421	302
J 8	DEANS	220	0	220	164
J 9	DEPR. AND USE ALLOW.	0	2,002	2,002	1,661
J 10	DONATED SERV. & PROP.	0	325	325	100
J 11	EMP. MORALE	71	407	478	359
J 12	ENTERTAINMENT	2,136	1,657	4,393	1,499
J 14	FINES AND PENALTIES	24	38	62	13
J 15	FRINGE BENEFITS	140	401	541	411
J 16	INSURANCE	40	3,582	3,622	3,202
J 17	INTEREST, FUND RAISING, ETC.	22,223	6,342	28,565	9,281
J 19	LOSSES ON CONT.	0	469	469	394
J 21	MATERIAL	0	25	25	25
J 22	MEMBERSHIPS, ETC.	98	403	501	363
J 26	PROFESS. SERVICE	76	225	301	121
J 29	PUBLIC INFO	417	414	831	327
J 32	RECRUITING	92	31	123	92
J 33	RENTAL COST	0	528	528	445
J 36	SCHOLARSHIP	0	1	1	0
J 39	SPEC. SERVICE	6,819	7,725	14,544	9,023
J 40	STUDENT ACTIVITY	0	1,618	1,618	43
J 42	TRANSPORTATION	1	0	1	0
J 43	TRAVEL	11	191	202	87
<b>BASED ON ALLOCABILITY (Note 2)</b>					
C 4	ALLOCABLE COSTS	399,336	56,193	455,531	1,117,774
F 1	DEPRECIATION	2,901	28,030	30,931	23,943
F 2	OPER. AND MAINT.	244	29,578	29,822	24,354
F 3	GEN. ADMIN. AND EXP'S.	2,217	35,329	37,546	12,480
F 4	DEPT. ADMIN.	0	44,300	44,300	36,296
F 5	SPONSORED ADM.	26	0	26	15
F 6	LIBRARY EXP.	(404)	56,755	56,351	47,412
F 7	STUDENT ADMIN.	0	28,770	28,770	24,251
--	OTHER	769	18,974	19,743	7,944
<b>TOTAL</b>		<b>462,291</b>	<b>336,448</b>	<b>798,739</b>	<b>349,463</b>

(1) DATA SUPPLIED BY INSTITUTIONS

(2) MOST OF THESE COSTS ARE ASSOCIATED WITH THE MEMORANDUM OF UNDERSTANDING ISSUED WITH THE STATEMENT FOR DCAA COMMENTS.

Mr. DINGELL. Mr. Newton, Admiral Miller, the Chair thanks you both for very helpful testimony and for the very valuable assistance you have given to this committee as we have proceeded through this investigation. The Chair wishes to commend you both.

The Chair is going to recognize members for questions now commencing with my good friend from Georgia, Dr. Rowland.

Mr. ROWLAND. Thank you, Mr. Chairman.

Mr. Newton, you said in your statement that DCAA has just completed its audit of MIT for 1990 and that there was a total of \$23 million that was in question and that \$19 million were excessively billed to the Government, is that correct?

Mr. NEWTON. Yes, sir.

Mr. ROWLAND. My understanding is that MIT has 4 open years, 1987 through 1989, as well as 1991, that hasn't been audited yet; is that correct?

Mr. NEWTON. Yes, sir. We have the years audits 1987 through 1989. We have not received a submission for the university for 1991.

Mr. ROWLAND. Well, if your 1990 findings are indicative, we could be talking about a substantial sum at MIT; couldn't we?

Mr. NEWTON. I would expect so; yes, sir.

Mr. ROWLAND. Could you provide the subcommittee with some examples of the problems that were found at MIT?

Mr. NEWTON. Yes, sir; I can. In the audit of fiscal year 1990, we found a condition where there are problems with what is called tuition remission. This is, in effect, compensation being made to graduate students in lieu of paying the money where the university will forego the requirement for them to pay certain tuition money. That is referred to as tuition remission.

We did an analysis of the tuition remission amounts for research being performed by graduate students, and we compared that with the amount being paid to the regular researchers of MIT, and we found that by dividing the hours worked into the amount being paid, coming up with the average amounts being paid, we found that through tuition remission the student researchers were being paid 12 percent more than the full time researchers. We considered that unreasonable. This amount is reflected in a total of about \$7 million in fiscal year 1990.

Another example at MIT that may be of interest to you is that the university had established in its contingency provisions account a reserve for unbudgeted positions in their medical department. In other words, these are positions that they did not fill, but they set up the reserve so they would have the money to do so, and charged the Government \$352,000.

Mr. ROWLAND. The Government paid for positions that weren't filled; is that what you are saying?

Mr. NEWTON. Yes, sir. Yes, I am. Another example of problems at MIT is that they have a building at 175 Albany Street that was treated as an operating lease, meaning that they wrote off all the costs to the overhead in that year, contrary to even a proper application of their own accounting policy, as well as the generally accepted accounting principles. This resulted in another \$100,000 excess charge to the Government. It included social events and weddings costs. It included one item I have noted here, an \$8,500

total for luncheons that we classified as entertainment. They have charged athletic department costs into the fringe benefit account. There are other examples that—would you like me to continue on?

Mr. ROWLAND. No. That is enough. Let me ask you about accounting at MIT. You seem to suggest there, in one of your examples, that they were not following good accounting procedures.

Mr. NEWTON. That is our opinion; yes, sir. We have considerable problems with some of the allocations; unfortunately, some that have been subject to the old memorandums of understanding.

The example I included in my statement, which I think is a good reflection of poor accounting, is the accounting for library costs. The university has lumped all of their libraries together, where, in fact, they have different libraries in each of their major departments. And by lumping them together, it has caused a very large amount of additional costs to be allocated to the Government than would have been had separate allocations been made for each of the libraries.

An example, I believe I cited, is that you have several departments there that make up 50 percent of the total consolidated pool of library costs, but yet they only have a very small percentage of the actual research being conducted there.

Mr. ROWLAND. Would you have an opinion as to whether or not following good accounting principles there, was intentional or unintentional?

Mr. NEWTON. Well, I have seen no evidence that would lead me to a conclusion that they set out to intentionally not follow good accounting practices. But, from the number of the situations and the direction that they all seem to take, which is against the Government and bringing in more revenue to the university, my speculation as an auditor is that perhaps some of the accounting treatments were devised as a means of increasing the revenue that would come to the university.

Mr. ROWLAND. Were they gaming the Government?

Mr. NEWTON. Were they gaming? I would have to say as to what their intent is or what they were thinking, I really don't know what they were thinking.

Mr. ROWLAND. Let me ask, let me just go to Admiral Miller. It is my understanding that the Army is open to criminal investigation at MIT. Can you tell me what allegations are against MIT and what the scope of the investigation is?

Admiral MILLER. First, I wanted to comment on your line of questioning with Mr. Newton. It is my impression, and certainly defer to Mr. Newton on questions of auditing, but in looking at what we have seen at universities across the board, I have formed a personal impression that universities do not have the same rigor in their accounting procedures as we have seen on the commercial side.

That is an across-the-board observation, and I would defer to Mr. Newton to confirm that, if he would.

Mr. NEWTON. I certainly would. I think that is a general condition that we are observing. Also, I have to say it is unfortunate. Here we are dealing with Government—that is, the Government is dealing with them as a business insofar as sponsoring research. I see no reason why more lax accounting procedures should be exist-

ing in that situation than we require in the industrial environment.

Mr. ROWLAND. I certainly think that a school that has as wonderful a reputation that MIT has would have an excellent accounting system.

Mr. NEWTON. I would expect so.

Admiral MILLER. I believe you will find many more excellent accounting systems in the near future than we have found over the past 10 years.

Going back to the question that you asked me about Naval Investigative Service inquiries; they have been alerted to the potential for mischarging and overcharges at the university, and they have been investigating that situation to see if some statute was broken.

Mr. Newton and I and our organizations tend to act as a team; and we are looking at the contractual sides of this, the business aspects. But when we, either of us, see the possibility of a criminal or civil proceeding, then we refer that to the appropriate investigating agency.

Mr. ROWLAND. Can you tell us the status of that?

Admiral MILLER. No, sir; I cannot.

Mr. ROWLAND. OK. Thank you very much.

Mr. Newton, let me come back to you for just a moment. DCAA found almost \$6 million in questioned costs at Carnegie Mellon for 1987 and 1988, including \$243,000 in questioned entertainment charges, \$200,000 in questioned interest and fund-raising charges, \$150,000 in questioned traveling charges, and \$2.8 million in questioned depreciation charges. Could you tell the subcommittee some of the specific problems behind these questioned charges?

Mr. NEWTON. Yes, sir. I can give you examples in a number of these cases. The entertainment, for example, included \$1,370 for a departmental get-together party; it included \$2,671 to Poppa J's for catering the winter ball. We have items, even some of the smaller items, such as refreshments included for nontechnical meetings. We have in the travel category the \$44,000 for a Nile River cruise, notwithstanding the explicit requirement of A-21 J-43E, which requires a specific prior approval for foreign travel. We have allocability problem noted. An example of that is \$7,300 for orchestra costs being allocated over to the Government. We have a \$1.5 million excess charge in depreciation regarding conversion from the university's application of use rates to depreciation accounting. And finally, a final example I can offer you here is that in what is called "other category" for allocability, we observed that where the university had a series of projects with 55 percent sharing arrangements with the Government, Carnegie Mellon didn't delete their share; and as a consequence, billed the Government \$1.3 million.

Mr. ROWLAND. Well, we also have, in addition to those 2 years, 1988—I mean 1989, 1990, 1991 that hadn't been audited; is that correct?

Mr. NEWTON. Yes, sir. That is correct.

Mr. ROWLAND. So, if your finding is almost \$6 million for 1987 and 1988 are carried forward, and you put in those other 3 years, the total questions at Carnegie Mellon could increase significantly; couldn't it?

Mr. NEWTON. I would expect so.

Mr. ROWLAND. Mr. Chairman, is my time about out?

Mr. DINGELL. The Chair thanks the gentleman.

Now, Mr. Newton, let's turn to Penn State University. DCAA questioned some \$22 million in fiscal year 1986 and 1990; is that correct?

Mr. NEWTON. Yes, sir.

Mr. DINGELL. Now, as I note in these charges that were questioned, there is some \$2.8 million in interest and fund raising; almost \$9 million in allocation costs and more than \$10 million in other allocability issues. Can you give the committee some of the specifics that would support these numbers, please?

Mr. NEWTON. Yes, sir. In the interest area, the nomenclature of the account here includes interest and fund-raising and some other contingencies, but what we have here as a major portion of this deals with refinancing bond interest. The university has gone through various refinancing gyrations, which have caused the cost of the financing to go up. In other words, if they had stayed with their original schedule of financing for the construction and other activities that they were involved in that were allowable activities, the interest would have been accepted.

But in this case they are refinancing and spreading payments out over a longer period of time. For that period in which more interest costs would be charged, we questioned that as being an unallowable practice.

We also found in that particular account a number of fund raising, solicitation type activities and so on. Under the category of professional services, there are various unallowable legal and other services, I might add that for that amount, Penn State University officials have concurred with our recommendation.

On the large item under allocable costs where we have some \$9 million, \$8,341,000 to be more precise, it includes items such as operating costs that are not allocable to the Government, like the president's house; \$102,000 is included for that. Another large item that we found allocability problems with is that the university made an error within their computer program for the calculation of depreciation. That reflects about a \$10 million error, \$10 million of excess billings to the Government; and again, the university has concurred with this finding.

Mr. DINGELL. Now, it would be fair to note that the \$22 million we are discussing is based on 1986 and 1990. It does not cover 1987, 1988 and 1989; is that correct?

Mr. NEWTON. Yes, sir.

Mr. DINGELL. Now, what would you anticipate then would be the results of Penn State for these 3 years?

Mr. NEWTON. I am not in a position to make an estimate without doing the audit effort that we would pursue. The reason why is, like I mentioned the computer error of \$10 million, I am not sure that that is not an isolated circumstance. Our auditors will have to do a comparison analysis of the various accounts for each of the years with the objective of identifying whether there are circumstances that we observed which would not be repetitive in another period. Likewise that comparative analysis, I would think, would identify unusual fluctuations in those other periods in which we

would have to do probes to see if there might be things that just existed in those years which should be unallowable.

Mr. DINGELL. It would not be illogical to assume, though, that these should be years into which we should be vigorously inquiring; would it?

Mr. NEWTON. Yes, indeed. I would expect there to be significant sums involved.

Mr. DINGELL. Can you give us any idea when you anticipate results at Penn State for the 3 years we have just been discussing, 1987, 1988, 1989?

Mr. NEWTON. We are presently scheduled to complete all of those audits in this Government fiscal year. In other words, we would hope to have them done by the summer.

Mr. DINGELL. Now, DCAA has also questioned about \$6 million at Syracuse University; is that correct?

Mr. NEWTON. Yes, it is.

Mr. DINGELL. Now, I gather that DCAA has questioned \$236,000 in entertainment, \$414,000 in public information, \$1,600,000 in student activities. Can you tell the committee what supports these numbers?

Mr. NEWTON. In the entertainment category, we have a number of deans' dinners; we have a St. Patrick's Day party and there are dinner dances that are included in that particular amount. The other categories, say the student activity, for example, there is \$1.4 million included for cheerleaders, the band, and something called Sour Citrus Society. We considered that unallowable.

Mr. DINGELL. Now, Mr. Newton, again I notice University of Hawaii was not included in the summary of information you provided the subcommittee. I gather that the DCAA has a number of audit activities ongoing at Hawaii and that you have a number of concerns at DCAA. Could you tell us the status of audit work there at the University of Hawaii and the concerns that you have identified to date?

Mr. NEWTON. The audit manager of our audits at the University of Hawaii has raised a number of system concerns that could, in fact, evolve into significant unallowable costs being identified in an audit report. But we have had meetings with the University of Hawaii, and in these meetings, the university representatives have taken on what I would say is an unusually cooperative attitude toward making sure that their systems are revised so that they do, in fact, comply with A-21 requirements.

We are working with them, observing to some extent what the university is doing themselves, and we would expect to be in a position later this year on making recommendations. We are not in the position to do that at this time because of the actions that they are taking.

Mr. DINGELL. Now, Mr. Newton, the DCAA has significant audit activity ongoing at the National Academy of Sciences. Can you tell us what the status of that work might be and the concerns that have been identified to date?

Mr. NEWTON. Yes, sir. The primary concern we have at this point is getting them to tie the billings they are sending to the Government into the general ledger. As I mentioned, when it requires an organization, whoever they are, to have to go out and bring in an

expert and spend 4 months, when all we are asking for is to reconcile between the billings to the Government and what they have on their general ledger, that is cause for concern.

But some other things that cause us to be concerned that we are looking into is that they don't accumulate the record of billings by fiscal period. Overhead expenses are accumulated on a consolidated basis, even though they have different rates used for billings on Government contracts and grants. And there is no system at all for identifying and segregating expressly unallowable costs. These issues are of considerable concern.

I might give you an example of the kind of problem we have with expressly unallowable costs there. They brought in the Big Six CPA firm, Price Waterhouse, to perform a sample of three accounts in about 10 cost centers. As a result of this review, the academy refunded \$168,723 to the Government. We believe an acceptable test, though, should include all accounts. Of course, this procedure would not be necessary at all if the academy had established procedures to comply with the applicable regulations in the first place. So we are working with them systematically right now, and I think we will be identifying amounts later on in this year.

Mr. DINGELL. Thank you.

Now, Admiral Miller, the Navy, I note, has a criminal investigation going at the University of Hawaii. I understand that this includes the University of Hawaii shifting costs across grants as funding limits were reached. Can you tell us what the scope of the criminal case is at the University of Hawaii and what allegations are being examined? Now, I don't want you to jeopardize any criminal processes in your response.

Admiral MILLER. Well, I appreciate your concern, Mr. Chairman, and in fact, I am not authorized to discuss ongoing investigations. I would have to refer that question to the Naval Investigative Service.

Mr. DINGELL. Very well.

Mr. Newton, according to Stanford, in your testimony you state, "It is our opinion that Stanford owes the Government \$231 million for excessive amounts billed during 1981 to 1988;" is that correct?

Mr. NEWTON. Yes.

Mr. DINGELL. Mr. Newton, can you tell the subcommittee about the depth and breadth of DCAA audit work that went into this determination?

Mr. NEWTON. Yes, sir. We did a very detailed amount of testing of the years 1987 and 1988; a very comprehensive examination of the specific transactions. We went through the various allocation methods and tested whether the results were, in fact, in compliance with the specific requirements of Circular A-21. As I have mentioned, the findings in that analysis caused us to question some of the allocation methods that had previously been sanctioned by the MOU's.

After we concluded our reviews of the years 1987 and 1988, we then went back for the years 1981 through 1987 and did extensive comparative analyses. We did not do as comprehensive transaction testing in those years, but rather we did comparative analyses, and we would do probes of transactions where we would see fluctua-

tions amongst the accounts. Otherwise we would assume that there would be comparability.

When we reached the point where we had decided that we could make a comparison of certain amounts, then we would project our findings from the averages of 1987 and 1988 back to those prior years. We believe that this analytical approach is an adequate audit procedure in the circumstances. It serves as the basis for our opinion in those years.

Mr. DINGELL. Having said that, is it your opinion that based on the audits that Stanford owes the Government about \$231 million? Is that a fair statement?

Mr. NEWTON. That is correct.

Mr. DINGELL. Admiral Miller, what would your judgment be on that matter, sir, please?

Admiral MILLER. The audits that we now have in hand will be made available to Stanford. What we don't know yet is which of the audit findings they will concur in and which they will dispute. If they dispute those audit findings, then it will be incumbent upon Stanford to provide facts, evidence, justification for their position. That procedure has not yet occurred, and therefore I would rather not give you a judgment at this time. I certainly do appreciate the effort and advice that DCAA has given us these past years.

Mr. DINGELL. Now, Admiral, we discussed possible criminal investigations at other universities. I gather that there is also one going on at Stanford. What answer would you want to give us if I were to ask you to comment on that, if you please?

Admiral MILLER. I would be unable to comment on that investigation, except to confirm that both the Naval Investigative Service and the Department of Justice have ongoing investigations on the Stanford campus.

Mr. DINGELL. Very well. Now, Admiral, when you were here last year, you called Paul Biddle a hero for his actions last year. I note that Stanford has now named him man of the year in the Stanford Review. Would we be unfair, you and I, in assuming that Paul Biddle remains a hero in the Stanford situation?

Admiral MILLER. I think that would be a fair assessment. I recently had the opportunity to read that article in the Stanford Review. Mr. Biddle sent me a copy of it. And I found it very interesting and an enlightened view.

Mr. DINGELL. Well, Admiral, when the Stanford situation became known in the winter of 1990, you formulated a senior team to go into Stanford to determine the depth and the breadth of the problems, what went wrong and how it happened. Is that correct?

Admiral MILLER. That is correct.

Mr. DINGELL. Now, Mr. Newton testified today that the situation at MIT involves a potential of \$20 million in 1990 alone, and there are a number of open years. We have had MOU's in operation that never should have been agreed to. The GAO told us that there were hidden agreements that dramatically affected the taxpayers as well. What are the plans with regard to formulation of special teams of senior ONR officials to be sent in to MIT as you did at Stanford?

Admiral MILLER. Mr. Chairman, we have near-term plans and long-term plans. In the near term, we are managing all of our indi-

rect costs from headquarters, right now, in close coordination with headquarters at DCAA. We are not allowing it to go to the field as it had in previous years. We think this is a necessary interim step; the magnitude of the problems we have found requires very close supervision, even at my level, on a regular basis on what is going on and what negotiations are ready to start and what is our position.

In the longer term, we believe that our experience at Stanford in forming a high level team of negotiators to help the local resident representative has proven very fruitful, and that is the basis for the reorganization plans that I mentioned in my opening statement. I will say that I am withholding actual implementation of that plan, because I have also called in the Naval Audit Service. I wanted an outside agency, someone besides my own organization to assess the situation. The Naval Audit Service has completed assessing my headquarters. They are now out looking at our field operations, and I expect their report in April of this year. So I am withholding my own plan until I get their advice. Unless they convince me otherwise, I intend to consolidate and have a single very senior negotiating team, with the individual administrative contracting officers serving as members of the team at their university. This team of senior negotiators, and senior attorneys will be provided centrally; something that hadn't been done in the past.

Mr. DINGELL. It is very clear that in the number of colleges and universities, you do have the same problem that you had at Stanford to a greater or lesser degree, and we do not know at this particular time. Would I be fair in assuming that this kind of concentrated approach of having teams go in there is in order?

Admiral MILLER. Well, we have addressed it differently. I believe additional concern is very valid and called for, but we have not addressed it in terms of forming a tiger team to go out because I agree with Mr. Peach from the GAO when he said that this is a systemic problem. And so our solutions have tended to be systemic rather than having a fire brigade go out.

What we have done is put much more emphasis on our own procedures and have redone our entire procedures to give much more visibility at headquarters to what is going on in the field. We have also instituted very rigorous training for all of our field operatives and implemented our rotation policy at all of the universities.

Since this matter first came to light, two-thirds of our administrative contracting officers have moved in their responsibilities. So we have new eyes looking at each event. We don't have the same one evaluating the university that was there 2 years ago. And I think the new eyes, the new training, and the more rigorous administrative procedures are the appropriate systemic solutions.

Mr. DINGELL. Well, I agree. The thing—the thing is, I don't want the record to leave anybody with the impression that you propose not to pursue these other schools vigorously, using whatever mechanisms are necessary.

Admiral MILLER. That would be an incorrect perception. We are going to pursue it, and are pursuing it in coordination with DCAA. In fact, DCAA's audits of all open years at all universities, plus, as I said, the audit of internal controls—that is how a university accounts for their own costs—have been cited here with regard to

some universities and nonprofit institutions. I think this gives us more or less confidence in how a university is accounting for costs and, therefore, whether we ought to believe the proposals that we are getting from that university.

Mr. DINGELL. And I don't want you to think that these comments are critical. I want you to do the best job you can. I want you to paddle your own canoe in the way that you deem most appropriate to get you up the rapids. You referenced, I believe, some comments made by GAO here where they said, lastly, we believe lax oversight practices by ONR and HHS were contributing factors. What you are saying is essentially that you are reviewing the prior practices; trying to—

Admiral MILLER. No, sir. Back when I talked to you in this subcommittee in March of last year, I said essentially the same thing; that over the decade of the 1980's, ONR had not done a good job for the taxpayer in the administration of indirect costs at colleges and universities. And in fact, at that time, I had just begun accountability procedures that eventually led to the reassignment of the senior executive that was in charge of ONR's entire system for accounting for direct costs.

Mr. DINGELL. You told the subcommittee staff earlier this week that you plan to have a Naval Audit Service review conducted of how you staff the universities and whether you need more seasoned people with different backgrounds to deal with the universities; is that correct?

Admiral MILLER. That is correct.

Mr. DINGELL. Can you describe what you are doing about that particular problem?

Admiral MILLER. That is the Naval Audit Service Review. I told you that we expected to get an outside look at our own organization. That report will be available to me in April, and I am looking forward to it.

Mr. DINGELL. So what you are trying to do is to correct your concerns about the capability of the current system to adequately protect the Government's interests.

Admiral MILLER. Both organizationally and from a performance standpoint.

Mr. DINGELL. Gentlemen, I have to leave here. I want to commend you both, Admiral Miller and Mr. Newton, for the fine work that you are doing. And we very much appreciate your cooperation with this committee as we conduct our investigations, and we very much appreciate the vigor with which you are addressing your concerns and our concerns in this matter. So as I leave, gentlemen, I want you to go with my personal thanks and appreciation for each of you and what it is that you are doing.

I am going to ask my good friend, distinguished gentleman from Georgia, Dr. Rowland, to preside over the subcommittee in my absence.

Mr. ROWLAND [presiding]. Well, we have known about the situation at Stanford for about 18 months. Why have you not put together a senior team as in the Stanford situation to go out to other problem universities, like MIT, Penn State and Hawaii, to better face and more quickly correct the problems there?

Admiral MILLER. As I stated, we agree with the GAO assessment that the real problem is generally systemic. That is, the system for administering Federal research needs healing. The part that we control for DOD cognizance schools, that is those schools that the team of DCAA and ONR are overseeing, we have gone out and looked at systemic solutions, looked at better training and selection, methods for people, as well as reorganization plans to get more experienced negotiators representing a consolidated Federal position and not just an ONR position. And we have instituted a requirement that before a local contracting officer initiates his negotiations with a university, he not only has to get DCAA's advice but also the advice of other Federal agencies that fund research. For example, the Department of Health and Human Services might have a very distinct interest in how rates are negotiated at that particular university; and so we call in their advice.

But I think the overall approach is both near-term and far-term. We want a correction of the system rather than a fire brigade approach.

Mr. ROWLAND. Well, you still have the same eyes and ears at those universities, most of them.

Admiral MILLER. Yes, sir. In fact, at most of them we have new eyes and ears through our rotation policy. Approximately two-thirds of all of the administrative contracting officers in the field have changed their responsibility in the last 18 months. We have them moved. They are now looking at new schools; I want them to tell me what is different and question everything out there.

In fact, when we had them in town, we had a conference last quarter of all of our field representatives to bring them in for training and to make sure that their perspective was correct. I personally talked to them and told them of the great importance of their responsibility and that their commission in the field is directly from me. They are out there representing me as the head of the contracting activity. If ever they find anything that they don't understand or have the least question about and are not getting the proper response, I want them to pick up the phone and call me directly.

Mr. ROWLAND. You are comfortable with what is going on right now then?

Admiral MILLER. I am comfortable with where we are today. I recognize we have a lot of work ahead of us. We are at the stage now where we are rolling up our sleeves. We and DCAA are grinding out years of backlog of work.

Mr. ROWLAND. So are your ACO's calling you now about the problems?

Admiral MILLER. They have not called me, but I have also cleaned out the pipe of the chain of command between the ACO's and me. So I think they are finding a much more responsive system into which to express their concerns.

Mr. ROWLAND. Can you assure the subcommittee that all of those 14 ACO's not only have the capability but also the willingness to protect the Government's interest when it comes to protecting financial dealings with these universities?

Admiral MILLER. I am under oath, and I cannot state what is in anybody's head except my own. All I can do is tell you that we

have gone to great lengths to ensure that they have the proper training, I have personally gone out to talk to them individually and collectively to ensure that they know the standard by which they should be conducting their business and the standard by which they will be evaluated.

Mr. ROWLAND. So you can personally vouch for them.

Admiral MILLER. I can personally vouch that we have provided it. Absent getting inside their heads, I can't give you any better vouch than that.

Mr. ROWLAND. And going back, you are pretty comfortable with what is going on?

Admiral MILLER. Yes, sir.

Mr. ROWLAND. We are more than a year where the ACO was not doing his job handling their universities, and you haven't sent any kind of team from Washington to any place other than Stanford. How can you be assured that some of your current ACO's are not operating like the former ACO at Stanford operated?

Admiral MILLER. We have looked at that question and the question of whether other administrative contracting officers ought to be disciplined, but we have not found the same collection of circumstances at the other universities that we found at Stanford. Let me cite a couple of examples. At Stanford we had more than 100 of these MOU's that were in existence and that hadn't been agreed to. We see nothing like that elsewhere. The next greatest count is 10 at a university. At Stanford we had a much greater potential vulnerability in terms of dollars at risk.

But I think more importantly, we have concluded that it was a systemic problem; and that is why the disciplinary action that was meted out was focused at the leadership of the organization. It was focused on the senior executive service leader. In the civilian world and the civil service, he is the equivalent of a flag officer; and he is no longer working in that area at all, and he is no longer at his former pay grade.

The proposed reduction in grade and pay of the individual who had been an administrative contracting officer at Stanford resulted principally because he had progressed to a position of leadership and oversight of other administrative contracting officers. In my view, as the person who would have imposed the discipline, he had exceeded his level of competence; and I was going to reduce him back to the level at which I thought he could perform.

So it was touching the systemic problems and holding responsible the individual responsible for the system of costs, and also taking action where I no longer had confidence in the performance of one of my leadership.

Mr. ROWLAND. Since Paul Biddle so easily and readily identified the problems with his predecessor at Stanford, why wouldn't you use his services and help identify problems with other ACO's and universities around the country?

Admiral MILLER. I am not ready to relieve Stanford of the pressure of having Paul Biddle there on the case. I think he is performing an outstanding service to the country in keeping the pressure on. I think our potential liability there is such that I want Paul Biddle on that campus routing around as only Paul Biddle can.

Mr. ROWLAND. Well, once he has finished his business there, would you use him at other universities?

Admiral MILLER. As part of my reorganization, we are going to look into changing around responsibilities for all the universities. Right now we are looking into consolidating into fewer residencies, as we call them. We have 14 offices around the country. My current plan is that we would consolidate to eight and reassign them; also we are going to have this centralized team. But nobody has been assigned to a job yet. I haven't hooked names to jobs. Mr. Biddle certainly would be considered for any job for which he has the talent and the expertise.

Mr. ROWLAND. Let me ask you this, Mr. Newton, one last question about the backlog at DCAA. That has to be a concern.

Mr. NEWTON. Yes, it is.

Mr. ROWLAND. Tell me what is going on with reference to trying to bring that backlog situation under control.

Mr. NEWTON. We are doing the best we can with the resources available through the use of risk assessment procedures, attempting to identify contractors and which contractor years to focus the resources on, toward being able to eliminate the more risky elements of the backlog.

To do this we have worked with the contracting activities to identify situations where they have a large number of contracts in a given year at a given location. We have attempted to assign our resources so that we might be able to get a large number done with the people we have.

We have been making progress on it. At one time, it looked like we were going into a never-ending situation where we had about, what I would call over 3,000 audits. Audits here are being measured by contractor fiscal year. We had about 3,000 of these audits coming into the in-basket, if you will every year. We were putting out only about 1,100 audits. That didn't look too good.

But then we had increases in resources. We had the risk assessments that we applied. We have turned the backlog growth around. Now we are doing more than what is coming in. This has occurred in the last two Government fiscal years; and as I say, we are seeing progress that we hope to continue.

Mr. ROWLAND. Well, under our present budgetary constraints, certainly there is a lot of problems that have been created for agencies. Can you tell me what has happened to yours under the President's budget?

Mr. NEWTON. We presently have a budget of \$378 million. That amount will not cover the payroll for the employees we presently have onboard, which is around 6,100 people. However, the Comptroller of the Department of Defense has indicated, in fact just this past week, that he is going to conduct a review of the staffing and the budget of our Agency within the next 2 weeks with prospects of seeing if there possibly might be some reprogramming of additional funds for the Agency. We are looking forward to that review.

Mr. ROWLAND. OK. Thank you very much, Admiral Miller and Mr. Newton. We really do appreciate your testimony very much.

Mr. NEWTON. Thank you.

Mr. ROWLAND. The next panel is Mr. Thomas Roslewicz and Mr. Gary Talesnik. I ask you gentlemen to take the witness stand,

please. They are accompanied by Mr. Richard Ogden. Is Roslewicz the correct pronunciation?

Mr. ROSLEWICZ. Roslewicz.

Mr. ROWLAND. It is customary to be sworn under the rules of this subcommittee. There is a copy of the rules of the subcommittee there, and the rules of the Energy and Commerce Committee. Do either of you have any objection to being questioned under oath?

Mr. ROSLEWICZ. No, sir.

Mr. TALESNIK. No, sir.

Mr. OGDEN. No, sir.

Mr. ROWLAND. Do either of you desire counsel?

Mr. ROSLEWICZ. No, sir.

Mr. TALESNIK. No, sir.

Mr. OGDEN. No, sir.

Mr. ROWLAND. Rise then and raise your right hand.

[Witnesses sworn.]

Mr. ROWLAND. You may consider yourselves under oath now. I ask that you proceed in any manner that you choose at this time with your prepared statement.

**TESTIMONY OF GARY M. TALESNIK, DIRECTOR, OFFICE OF GRANT AND CONTRACT FINANCIAL MANAGEMENT, DEPARTMENT OF HEALTH AND HUMAN SERVICES, AND THOMAS D. ROSLEWICZ, DEPUTY INSPECTOR GENERAL FOR AUDIT SERVICES, HHS, ACCOMPANIED BY RICHARD OGDEN, REGIONAL INSPECTOR GENERAL**

Mr. TALESNIK. Thank you, Mr. Chairman. I am Gary Talesnik, the Director of the HHS Office of Grant and Contract Financial Management. I submitted a prepared statement, which I would like to have inserted in the record.

Mr. ROWLAND. Without objection.

Mr. TALESNIK. I will just summarize. I appreciate the opportunity to appear before the subcommittee today to assist in your review of indirect costs. As we indicated when we testified before the subcommittee last May, this is a very important matter to our Department. Indirect costs represent almost a third of the total costs of the Department's research grants, and we are the cognizant Agency for the audit and indirect cost negotiation for most of the universities in the country that receive Federal research funds. We obviously have a very large stake in making sure that the system works effectively.

Much has been done since the hearing in May to try to improve the system. Actions have been taken to strengthen both of the policies that govern how indirect costs are determined, as well as improved enforcement. I would like to briefly outline the specific steps that have been taken in recent months to try to deal with those problems, some of which have been discussed in the prior testimony. But I would like to go over them and just kind of summarize.

First, to strengthen indirect cost policy, a number of major changes have been made to the basic ground rules of indirect costs in OMB Circular A-21. These changes, among others, tighten and clarify the rules of unallowable costs, require senior university offi-

cial to certify that their indirect cost proposals do not include any unallowable costs, and impose an across-the-board limit on the amount of university administrative costs the Government will pay.

The new rules were issued this past October and generally went into effect immediately on October the 1st. The one exception to that is the limits on administrative costs, which became effective at the start of each institution's next fiscal year.

Second, indirect audits of indirect costs are being made by both Federal and non-Federal auditors. As noted in Mr. Roslewicz's testimony, the HHS Inspector General has recently completed special audits of 14 major universities to identify unallowable costs in their indirect cost pools, and I am pleased to report that most of those audits have now been resolved; and the vast majority of the costs that were questioned have been sustained in the audit resolution process.

The IG has also conducted a number of audits in collaboration with the indirect cost negotiators to assist and support the negotiation process. Additionally, we are expecting to see a substantial increase in the coverage of indirect costs by non-Federal auditors under new audit guidelines issued by OMB last fall. These guidelines specifically require coverage of indirect costs as part of the organization-wide audits conducted by CPA firms and other auditors under OMB Circular A-133.

Third, we have recently implemented several changes to our negotiation operations that we believe will strengthen our ability to negotiate reasonable and appropriate indirect cost rates with universities, as well as in many other types of organizations for which we are responsible. The most significant of these changes is a consolidation of our regional negotiation offices to broaden the level of technical expertise in each office. The consolidation was fully implemented at the start of the current fiscal year.

Finally, we are continuing to examine possible additional reforms to the indirect cost system through the collaborative efforts of the Director of NIH, the Inspector General, and the Assistant Secretary for Management and Budget. This is part of a Government-wide study of this subject being conducted under the leadership of OMB and the Offices of Science and Technology policy.

In summary, Mr. Chairman, the Department is committed to real and lasting improvements in this important and complicated area. Concrete steps are being taken to deal with the problems identified by the subcommittee and others, and we believe they will go a long way towards correcting those problems.

That concludes my prepared statement, Mr. Chairman. I would be pleased to respond to your questions.

[The prepared statement of Mr. Talesnik follows:]

STATEMENT OF GARY M. TALESNIK, DIRECTOR, OFFICE OF GRANT AND CONTRACT FINANCIAL MANAGEMENT, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. Chairman and Members of the Subcommittee: I am Gary M. Talesnik, Director, Office of Grant and Contract Financial Management of the Department of Health and Human Services.

I appreciate the opportunity to appear before the subcommittee to assist in its review of indirect costs. As the Assistant Secretary for Management and Budget indicated in his testimony before the subcommittee last May, this subject is very im-

portant to our Department since indirect costs account for almost a third of the total costs of the Department's research grants. Also, from a Government-wide perspective, HHS is responsible for the audit negotiation of indirect cost rates on behalf of all Federal agencies for the vast majority of colleges and universities receiving Federal research funds. We therefore have a major stake in assuring that the indirect cost process works effectively.

Much has occurred since the hearing in May to deal with the problems in this area identified by the subcommittee and others. Actions have been taken both to strengthen the policies governing the way indirect cost rates are determined as well as to improve the enforcement of those policies.

The policy improvements have focused on the "Cost Principles for Educational Institutions" in OMB Circular A-21. This Circular provides the basic groundrules for determining costs at colleges and universities and is at the heart of the indirect cost process. With the concurrence and support of HHS and the other agencies involved, OMB issued several major changes to the Circular this past October, aimed primarily at stopping the abuses arising from application of the Circular's previous rules. These changes tighten and clarify the rules on unallowable costs and establish a requirement that senior university officials certify that their indirect cost proposals do not include any unallowable costs. The revision also imposes a cap of 26 percent on the administrative components of university indirect cost rates, which is the area where most of the problems with unallowable costs have surfaced. Additionally, the revision requires that major research institutions provide assurances that Federal reimbursements for depreciation or use allowances on buildings and equipment are used to maintain and enhance research facilities, and requires that all institutions ensure that the Federal Government does not subsidize the indirect costs associated with research supported by industry or foreign governments.

Recent actions have also substantially strengthened the audit of indirect costs. As noted in Mr. Roslewicz's testimony, the HHS Inspector General has completed special audits of 14 major institutions to identify unallowable costs in their indirect cost pools. I am pleased to report that we have resolved most of these audits and the vast majority of the audit findings were sustained in the audit resolution process. The IG is also conducting a number of audits in collaboration with the indirect cost negotiators to assist in the negotiation process. Further audit coverage of indirect costs will be made by non-Federal auditors under guidelines recently issued by OMB under Circular A-133 "Audits of Institutions of Higher Education and Other Non-Profit Institutions." These guidelines require non-Federal auditors, primarily CPA firms, to review indirect costs as part of their overall audits of the institutions. The audits are required to cover various aspects of institutions' indirect cost proposals, including the controls established by the institutions to assure that unallowable costs are not included in the proposals. The audits will also test individual expense transactions to determine whether the indirect cost pools contain any unallowable costs.

Additionally, we have recently implemented a number of changes to our negotiation operations that we believe will strengthen our ability to negotiate reasonable and appropriate indirect cost rates. The most significant of these is a consolidation of our regional negotiation offices to provide a broader level of technical expertise in each office to handle an increasingly complex workload. This consolidation was fully implemented at the start of fiscal year 1992. We have also started contracting for specializing consulting services to assist the negotiators in evaluating certain technical aspects of indirect cost proposals that impact on the allocation of indirect costs.

Finally, we are continuing to examine possible long-term reforms to the current indirect cost system through the collaborative efforts of the Director of NIH, the Inspector General and the Assistant Secretary for Management and Budget. This effort is part of the overall Government-wide study of research costs being conducted under the auspices of OMB and the Office of Science and Technology Policy.

In sum, Mr. Chairman, we are committed to real and lasting improvements in this important and complex area. Given time, I believe the actions we have undertaken will go a long way toward that end.

That concludes my prepared statement Mr. Chairman. I hope it was useful and will be glad to respond to the subcommittee's questions.

#### TESTIMONY OF THOMAS D. ROSLEWICZ

Mr. ROSLEWICZ. Thank you, Mr. Chairman. Good afternoon. It is my pleasure to be here. I am Thomas Roslewicz, Deputy Inspector General for Audit Services at the Department of Health and

Human Services. Accompanying me today is Richard Ogden, who is our Regional Inspector General for our Boston regional office. Mr. Ogden was responsible for coordinating the 14 audits that we did at universities around the country. His staff did a commendable job in that effort, too.

With your permission, Mr. Chairman, I would like to keep my oral comments brief and submit my testimony for the record.

Mr. ROWLAND. Without objection.

Mr. ROSLEWICZ. When we appeared before this subcommittee in May of last year, we discussed the preliminary results of audits of indirect costs at 12 of 13 schools scheduled for such review. Since that time, we have added one school to this list and have finalized our audits. We are hereby submitting that report.

Also in discussions with staff of the committee, we agreed to prepare a summary report on our 1991 activities, other than what we did at the 14 universities. Some of that work is still ongoing. We feel the committee would be—would be able to make some use out of that work.

Mr. ROWLAND. Without objection, that will be made part of the record.

Mr. ROSLEWICZ. Thank you, sir. We also have a special report which Chairman Dingell requested back at the May hearing on the indirect cost rates that are charged to non-Federal researchers who do research at our colleges and universities. We have that report to submit.

Mr. ROWLAND. That will also be entered into the record.

Mr. ROSLEWICZ. We have a summary report on other indirect cost issues that we provided at the request of the Chairman of the Senate Labor Committee. That report too, we feel, would be of use to this committee; so we are submitting that for the record.

Mr. ROWLAND. Without objection, that also will be submitted into the record.

Mr. ROSLEWICZ. Thank you, Mr. Chairman. Our audit universe is very large. We have over some 600 universities that have research funds coming into them. Of that amount, about 262 of those receive 90 percent of these Federal research dollars. So our resources are small, but yet we are trying to use the resources that we have effectively to accomplish the work load we have there.

Our results to date show us that there are still some improvements that are needed in the way the Federal Government does business with the college and university community. To effect the best use of our limited resources, we developed a strategy which helps us to maximize coverage at these 262 schools which are the major recipients of Federal dollars. Based on geography and size, we focused our initial efforts on a general and administrative cost pool audit at 14 schools to make sure that the Stanford problems identified were not occurring at our universities as well.

I have up in front, Mr. Chairman, a chart or two charts that show the 14 universities in particular that we have been to. And as you can see, those 14 universities had a total amount of \$20.3 million in unallowable costs that had been charged to the general and administrative—G and A—cost pools. Of that amount, approximately \$2.9 million was allocated to organized research. That is the basis of our report that has been consolidated.

The next phase of our audit effort was to review the existing indirect cost rates and proposals of the remaining schools to ensure that they are adhering to OMB Circular A-21. We asked the remaining schools to begin the process themselves with their own in-house and contract resources, taking a look at their costs and coming back to us with the results of their self reviews.

To date, there are an additional 126 schools that have completed in-house reviews. They have identified an additional \$18 million in unallowable costs. About 15 percent of that amount is also being charged to organized research. The \$18 million is in addition to the \$20 million that has been identified by us at the colleges and universities listed on the chart.

The reviews at the remainder of the 262 universities are in progress, and they are developing the responses back to our initial requests. In the meantime, we are continuing to work with the Division of Cost Allocation, Gary Talesnik's group. We have helped do some assist work in helping him to prepare for his negotiations that he conducts at the various universities.

Three recently completed reviews precluded some \$9.8 million from being charged to research as a result of our assist work in the negotiation process. Maintaining a smart approach to using limited resources, we built on the work of non-Federal auditors as well. The OIG issued 82 reports on college and university matters in calendar year 1991; 211 of those were completed by our in-house staff; 615 of those were conducted by independent public accountants. That includes the other schools where we have cognizance, regardless of the dollar level of fundings for those universities.

To maximize the dollar payback, we built on those non-Federal findings that the independent public accountants report. For example, one area disclosed by our review of non-Federal audits is in the area of centralized activities such as computer services at universities. We found problems with the way the research centers computed the rates, which resulted in overcharges to Federal research.

Preliminary findings to date show an estimated \$1.8 million at 10 universities where there are such overcharges that we are finding as a result of our audit work. This is one way we intend to build upon the OMB Circular A-133, which requires that each university have an audit every 2 years, including a look at the A-21 provisions and a determination as to whether allowable costs are being charged. We will build upon the work done by these independent public accountants.

I also wanted to mention the findings on the special review we did for Congressman Dingell last year where he requested us to look at the indirect costs that are being charged by—or not being charged in some cases, to foreign governments having research done at our universities. Essentially what we found was that some schools offered reduced rates to foreign governments and corporations.

In some cases, the rate is zero percent, which was absorbed by the schools and not the Federal Government. This cost the schools we visited about \$46 million. We looked at 10 universities, so that is a relatively small group; but I think it is pretty representative of the, what is probably happening out there in the rest of the universities.

While progress has been made, there is still room for improvement in the way the Federal Government does business with schools. I see a twofold approach, a global and an incremental approach. Globally I think what we need to look at is, are we doing business with the schools in the best way we can, and are we working effectively to negotiate rates. Are there other ways in which we might be able to accomplish an agreeable amount as to what amount the Federal Government should pay for indirect costs at these universities?

Incrementally, I believe there are a lot of other things that can be done to Circular A-21 to help alleviate the problems that auditors and accountants run into when they are doing these scrub reviews, looking at the amounts that are being charged to the cost pools. The actions taken to date by OMB are certainly very helpful in terms of when you are out there and you are the grass root auditor looking at these individual transactions, it is much easier to have a clear criteria as to what is allowable and what is not.

And the recent changes to OMB which became effective in October will certainly help with that area. I think you know there are other things that we pointed out in our report which indicate what OMB can do—the Circular A-21 can be clarified further to help this process. I also agree with GAO's earlier recommendation that there needs to be serious thought given to the amount of resources that are being applied in this area, albeit audit resources in negotiations as well.

At this point, Mr. Chairman, I will conclude my oral testimony and be happy to answer any questions.

[Testimony resumes on p. 142.]

[The prepared statement and attachments of Mr. Roslewicz follow. The full text of the Inspector General report is retained in the subcommittee files.]

## STATEMENT OF THOMAS D. ROSLEWICZ

I am Thomas D. Roslewicz, Deputy Inspector General for Audit Services of the Department of Health and Human Services (HHS). With me is Richard J. Ogden, our Regional Inspector General for Audit Services in Boston. We are here this morning to discuss our progress in reviewing indirect costs at colleges and universities, recent changes to the cost principles in Office of Management and Budget (OMB) Circular A-21, and our future oversight plans. When the Inspector General and I appeared before this Subcommittee on May 9, we discussed the preliminary results of audits we had performed at 12 of 13 schools under review. We now have final results of audit work at 14 schools and I will be specifically discussing our findings and how the new revisions to A-21 will impact on these problem areas.

**BACKGROUND**

As noted in our previous testimony, we provided extensive background information on the subject of indirect costs, and the various OMB Circulars which provide guidance in the areas of oversight responsibility, direct and indirect costs, and audit requirements.

The cost principles in the Office of Management and Budget (OMB) Circular A-21 did not provide incentives to schools to minimize or contain costs allocated to research projects. Basically, A-21 permitted universities to charge expenses to Federal research when those expenses were allowable, allocable, and reasonable.

Costs were considered reasonable "if the nature of the goods or services acquired or applied, and the amount involved therefore, reflect the action that a prudent person would have taken under the circumstances prevailing at the time the decision to incur the cost was made." This subjective test of reasonableness provided great latitude for schools to include many items and services which might otherwise be excluded under the more specific Federal Acquisition Regulations (FAR). The FAR contains cost principles relating to contracts with commercial organizations and provides more specific guidance on allowable costs than previously found in A-21. Under A-21, a cost was allocable to a specific project if "the goods or services were chargeable or assignable to such cost objectives in accordance with relative benefits received or other equitable relationship." We noted that the non-specificity of A-21 provided discretion and, indeed, incentives to schools to define "benefit received" to their best advantage.

Our testimony also pointed out that the principles in A-21 were established over 30 years ago when the research environment and Federal funding were less complex. The Circular had been modified eight times, but still A-21 did not keep pace with changes in the scientific research arena and today's business and accounting practices. Effective October 1, 1991, OMB made the ninth revision to A-21 specifically designed to curb abuses in educational institution practices involving indirect costs

associated with Government funded research. Our testimony today will review some of these changes and discuss their potential impact in areas covered by our audits at 14 schools and on the overall recovery of indirect costs by all schools.

By way of background, we want to reemphasize the Federal Governments' commitment to scientific research. Since 1984, total Federal research and development funding to colleges and universities has risen 64 percent from \$5.6 billion to the current level of over \$9.2 billion. The indirect costs or unallocated overhead provided to colleges and universities for supporting its research activity increased 67 percent from \$1.5 billion to \$2.5 billion.

#### INDIRECT COST AUDITS AT 14 SCHOOLS

When we appeared before this Subcommittee in May of last year, we discussed the preliminary results of audits of indirect costs at 12 of 13 schools scheduled for such review. Since that time, we have added one school to this list and have finalized our audits. With your permission, we would like to submit for the record the review on the administrative costs claimed by 14 schools. We would also like to submit a report on how certain colleges and universities charge lower overhead rates to foreign governments and other domestic nonfederal organizations. This report was based on a request by Chairman Dingell. As shown in Exhibit I,

our audits found that the 14 schools included approximately \$20.4 million of unallowable costs in their indirect cost proposals submitted to the Department of HHS' Division of Cost Allocation. Of this amount, about \$3 million was allocated to organized research. Most of this \$3 million was then charged to Federal research. We also found that 4 of the 14 schools performed their own reviews of administrative costs prior to our audit and identified an additional \$11.4 million which was removed from indirect costs. We found charges for items that were clearly excluded for reimbursement by (both current and then effective version of) A-21. In addition, we found that apparent ambiguities in the then extant version of A-21 allowed schools to liberally increase the types and amounts of costs included in their General Administration accounts. For example, we discovered \$5.7 million in unallowable costs at the 4 "self-scrub" schools that were in addition to the \$11.4 million of items the schools had eliminated.

Let me give you examples of unallowable costs we found at the 14 schools:

- o travel (airfare for presidents' spouses, numerous trips to attend meetings which benefitted other institutional activities, airfare to Grand Cayman to attend meeting of investors as well as various other foreign travel)

- o entertainment (numerous charges for expenses related to attendance at football games, opera tickets and liquor)
- o public relations (a news service handling public relations for the university, announcements promoting the university and memberships in a public relations club)
- o legal fees (defense of an investigation brought by the Federal Government against the school concerning tuition price-fixing and violation of student civil rights)
- o memberships in social or civic organizations (university athletic associations and various social clubs)
- o activities associated with other school functions (art museum, bus service and services of the school chaplain)

Exhibits II and III show the types of unallowable costs found and the number of schools at which each occurred. In most cases, the schools agreed with our determinations regarding the administrative costs we questioned.

Based on the results of our audits and an analysis of recent revisions to A-21, we concluded that A-21 needs further improvements. Our consolidated report recommends that our Department's Assistant Secretary for Management and Budget (ASMB) continue to work with the OMB to further revise A-21 to (1) clarify the definitions of allowable and allocable costs, (2) clarify certain costs already considered unallowable, and (3) add additional categories of unallowable costs. We also recommend that ASMB (1) continue to work with schools to help them properly interpret A-21, (2) appropriately implement the 26 percent cap on administrative costs, and (3) adjust the previously negotiated indirect cost rates for the 14 schools audited and calculate refunds as appropriate.

#### RESOLUTION OF AUDIT FINDINGS AT 14 SCHOOLS

The responsibility for resolution of the audit findings and recommendations in OIG reports at the 14 schools rests with the Division of Cost Allocation which is located within the Office of the Assistant Secretary for Management and Budget. To date, the ASMB has resolved 12 of the 14 reports and will recover \$4.4 million from these schools (see Exhibit IV). This amount represents about \$3.8 million in refunds for prior years and about \$.6 million in adjustments to current indirect cost rates. The recoveries of \$4.4 million exceeds the total amount questioned by auditors for one year because the audit resolution

process involved multiple years. Resolution of costs questioned is underway at the remaining two schools.

Under the Department's audit resolution policy, disallowances of unallowable costs are required to cover three grantees fiscal years prior to the start of the audit. Therefore, since most of the audits of the 14 schools started in FY 1991, the disallowances usually go back to FY 1988.

NEGOTIATION OF INDIRECT COST RATES  
BY THE DIVISION OF COST ALLOCATION

The Division of Cost Allocation within ASMB reviews and negotiates indirect cost rates proposed by institutions. Where necessary, the OIG provides audit assistance during the negotiation process. Over the past several years, the OIG has been increasing its efforts in this area and the negotiators and auditors have an excellent working relationship.

The Division of Cost Allocation negotiators are quite aggressive in their negotiations of rates and frequently make substantial reductions in the rates proposed by schools. On average, these "up-front" reviews and negotiations have resulted in reductions to proposed rates of 7 to 8 percentage points. For example, the rates proposed by the universities for FY 1991 averaged 58.7 percent while the rates negotiated averaged 50.9 percent, a

reduction of 7.8 percent. The negotiated reductions in rates for colleges and universities resulted in savings to Federal research programs of over \$300 million in FY 1991. Exhibit V shows the most current rate in effect at the 14 schools we visited compared with the rate proposed and the projected annual savings at each school. For these 14 schools, the Division of Cost Allocation negotiated reduced rates resulting in savings of about \$83 million per year.

#### REVISIONS TO A-21

After the start of our audits of indirect costs, OMB proposed revisions to Circular A-21 to curb abuses in educational institution practices involving indirect costs associated with Federal research. It published notices in the Federal Register on May 15 and June 27, 1991, outlining these proposed changes and requesting comments. The revisions became effective on October 1, 1991. As shown in Exhibit VI, the major changes to A-21 include:

- o a cap of 26 percent on the administrative portion of indirect costs. This includes the General Administration, Departmental Administration and Sponsored Projects Administration cost pools.

- o a requirement that schools certify that no unallowable costs are included in indirect cost rates submitted on or after October 1, 1991.
- o a list of 14 specific items of expenditure that are unallowable, effective October 1, 1991. This includes liquor, alumni activities, housing and personal living expenses for school officers, and the like.
- o an assurance by schools that they have expended (or will do so within 5 years) amounts equal to that collected from Depreciation and Use Allowances for the acquisition or improvement of facilities or equipment.
- o a prohibition from shifting any under-recovery of costs associated with foreign or corporate research to Federal research projects.

With regard to the above revisions, our audits have shown that although they will provide much needed clarification, more guidance should be provided in the following areas:

- TRUSTEE EXPENSES - The current A-21 stipulates that travel and subsistence costs of trustees are unallowable. However, there are still General and Administrative costs incurred in connection with

trustees' oversight and governing responsibilities. Circular A-87, the comparable Circular for States and local government charges, provides that the salaries and expenses of the legislature, whether incurred for purposes of legislation or executive direction, are unallowable. As the governing responsibilities of trustees are similar in many respects to those of legislatures, we believe that all costs incurred relating to trustees should be unallowable.

- MISCELLANEOUS EXPENSES - We believe that many of the same, as well as other types of miscellaneous costs found to be unallowable during our audits, may be charged to organized research in the future unless additional guidance is provided, such as providing examples of unallowable miscellaneous costs.
  
- ALLOWABLE AND ALLOCABLE COSTS - Without clarifying the definitions of allowable and allocable costs, we believe that many of the same types of costs we found to be unallowable (professional services, travel, miscellaneous and others) may be charged to organized research in the future. At a minimum, additional guidance should include similar provisions as the FAR. In this respect, the FAR includes applicable Cost Accounting Standards within the definition of allowable

costs. Further, the FAR states that ". . . no presumption of reasonableness shall be attached to the incurrence of costs by a contractor . . ." and ". . . the burden of proof shall be upon the contractor to establish that such cost is reasonable . . . ."

Additional guidance should clarify when costs are necessary for the overall operation of the school and when they benefit organized research.

- EMPLOYEE MORALE - allowable employee morale costs per A-21 include recreational activities incurred in accordance with the institution's established practice or custom. Some school officials asserted that certain entertainment costs were allowable employee morale costs. There is a fine line between allowable recreational activities and unallowable entertainment. Accordingly, we believe that, in order to avoid confusion, additional guidance is needed to determine when recreational activities become entertainment.
- OTHER INSTITUTIONAL ACTIVITIES AND STUDENT ACTIVITIES - A more comprehensive list of these activities which are unallowable, especially those not so obvious, would provide school officials with less discretion to charge costs to Federal research.

-- FINES AND PENALTIES - Additional guidance could be provided by specifically including as an unallowable costs, interest on penalties and fines resulting from violations of Federal and local laws.

As we have in the past, we support A-21's 26 percent cap for controlling administrative costs. We issued a report in 1986 recommending that Departmental Administration be capped at 7 percent and we supported a 1986 recommendation, to cap 4 administrative cost centers at 26 percent, eventually to be lowered to 20 percent. These earlier attempts at capping administrative costs were only partly successful--ultimately only a small portion of the Departmental Administration cost pool was capped.

The current 26 percent cap on administrative costs could make available up to \$104 million nationwide on an annual basis for funding Federal research projects. In addition to reducing the potential for abuses of administrative costs, the cap should help close the gap between the amount of money available for research and the number of research projects deemed worthy of support. The HHS Public Health Service's National Institutes of Health (NIH) indicates it can award grants to only one out of every four research projects deemed to have scientific merit. If awards averaged \$200,000 Governmentwide (they average \$227,000 at NIH),

the availability of \$104 million in research funds could mean the creation of 520 new research projects per year.

AUDIT COVERAGE UNDER OMB CIRCULAR A-133

The foundation for our audit coverage at colleges and universities is organizationwide audits performed by independent auditors (mostly CPA firms) under OMB Circular A-110 and currently under A-133. Our coverage will be expanded under A-133 which went into effect on January 1, 1990. Circular A-133 requires that all colleges and universities receiving \$100,000 or more have an organizationwide audit at least once every 2 years. OMB has also issued an audit compliance supplement for A-133 which includes audit steps for the review of indirect costs. Independent auditors are required to determine if items included in the various indirect cost pools are allowable and properly allocated.

Most schools will begin to have A-133 audits performed for the 2 year period ending June 30, 1992. These audits will be submitted to the OIG regional offices for processing and issuance during early 1993. As required by the Circular and our professional standards, we plan to rely on these organizationwide audits and, where necessary, build upon the work performed by the independent auditors.

I would like to present the Subcommittee with an example of how this process works. We recently received a report on an organizationwide audit at Johns Hopkins University which was performed by the national CPA firm of KPMG Peat Marwick. The auditors had identified a number of system-wide deficiencies. One problem area involves recharge centers or specialized service facilities. One example of a recharge center might be a computer facility at a school which sells its services to various users. Problems with recharge centers involving the development and assessment of rates have also surfaced at a number of other locations around the country, and our auditors have decided to perform a nationwide review at selected schools. We will attempt to identify systemic problems and recommendations for potential reform of Federal cost principles and guidelines involving recharge centers.

The results of this type of review benefit all Federal agencies with funds at colleges and universities. We anticipate that other indirect cost issues will also surface as a result of A-133 audits at research schools and we plan to continue to perform indirect cost reviews that build upon the work of the A-133 audits.

OVERHEAD RATES CHARGED FOREIGN GOVERNMENTS AND OTHER NONFEDERAL  
RESEARCH ORGANIZATIONS

When we appeared before this Subcommittee in May, the Chairman expressed concern over the possibility that certain research universities were charging foreign governments and industry lower indirect cost rates than that charged the Federal Government. We indicated we would check into this situation and we are providing you today with a copy of our report on this matter. We reviewed the billing practices related to overhead for Federal research and that of nonfederal sponsors at 10 of 14 colleges and universities we had selected for administrative cost reviews. We found that all 10 schools entered into research agreements with nonfederal sponsors with overhead rates lower than that negotiated by the Federal Government. Three of the 10 schools entered into such agreements with foreign governments. Our review disclosed, however, that at all 10 schools the methods used to calculate and negotiate Federal rates ensured that the Federal Government did not pick up the tab for non-recovered overhead associated with the lower nonfederal rates. In effect, the schools absorbed these costs. We might note that the Division of Cost Allocation routinely monitors this aspect of the preparation of indirect cost proposals.

Schools gave several reasons for lower rates. Some schools indicated that lower rates were assessed certain nonfederal organizations because the schools had a greater concern for

adding to a body of knowledge in a particular discipline than in obtaining the highest possible recovery of overhead. Other schools indicated they accepted low indirect cost rates to (1) help advance the development of young researchers, and (2) accede to requirements of certain public interest organizations which limit reimbursement of indirect costs.

Several additional interesting facts developed during our review are that at the three schools with foreign sponsored research, there were only a total of nine awards or projects funded by foreign governments. At all three schools, these awards represented about 1 percent or less of nonfederally sponsored awards. Also, we found that the Federal Government was also receiving lower overhead charges on certain grants, although not proportional to benefits received by nonfederal sponsors. Based on the data at the 10 universities reviewed, we found that the Federal Government sponsored 76 percent of the organized research, but federally sponsored agreements received only 25 percent of the discount from unrecovered indirect costs.

In summary, although we found that foreign governments and other nonfederal sponsors of research are assessed lower rates for overhead than the Federal Government, we also found that the schools are absorbing the unrecovered portion of these costs. The Federal Government is not subsidizing the research of others in this situation. We also found that lower rates are offered

nonfederal sponsors to support young researchers, to accede to restrictions on overhead by special interest groups and to simply add to the research base. Finally, we found at the 10 schools we visited that research sponsored by foreign governments represented a very small percentage of all research. Notwithstanding, we still believe there is a basic question of fairness and equity related to the assessment of lower rates to certain nonfederal sponsors, especially those who may be in a position to pay their fair share. We will be reviewing this matter in more detail to determine options available for policy changes.

#### FUTURE AUDIT WORK

As discussed in our May Hearing we had contacted by letter about 260 additional schools (beyond the 14 in our nationwide review) with significant research dollars. We had urged these schools to conduct an internal review to ensure that only allowable costs are included in the indirect costs allocated to Federal programs. We will continue to follow-up and, along with the Division of Cost Allocation, bring to resolution issues at these schools, many of which are performing self-evaluations of General Administration costs. We will also continue to perform joint reviews with the Department's Division of Cost Allocation of selected indirect cost proposals. The Division of Cost

Allocation has requested such assist audit work at about 20 major research institutions during FY 1992.

Our audit strategy will also include continued reliance on audits performed at research schools by independent auditors under Circulars A-133 and A-128. Our National External Audit Resource Center will be reviewing such aud' ts for potential systemic issues requiring follow-up attention by OIG staff. Finally, we will also continue to perform direct cost audits such as those currently in process which are of special interest to the House Committee on Appropriations, Subcommittee on Labor, Health and Human Services, Education and Related Agencies, and to work on special projects such as the ASMB/NIH/OIG Indirect Cost Task Group. In summary our audit efforts will be directed at ensuring that only allowable and properly allocable costs are charged to research and that we continue to explore meaningful and effective reforms to the current method of reimbursement for such costs.

This concludes my testimony, I will be happy to answer any questions you may have.

Unallowable Costs Included in Indirect Cost Proposals

<u>College/University</u>	<u>Unallowable G&amp;A</u>	<u>Amount to Organized Research</u>
Dartmouth College	\$ 943,295	\$ 116,238
Duke University	918,198	155,271
Emory University	587,200	105,485
Johns Hopkins University	805,696	282,707
Rutgers University	3,645,973	178,767
University of Chicago	1,034,949	150,585
University of Miami	827,734	92,789
University of Michigan	8,285,157	1,258,515
University of Pennsylvania	1,250,620	307,777
University of Pittsburgh	528,681	75,178
University of Southern California	8,913	0
Texas S.W. Medical Center at Dallas	32,537	0
Washington University	478,566	14,836
Yale University	<u>1,041,700</u>	<u>257,508</u>
Total	<u>\$20,389,209</u>	<u>\$2,995,656</u>

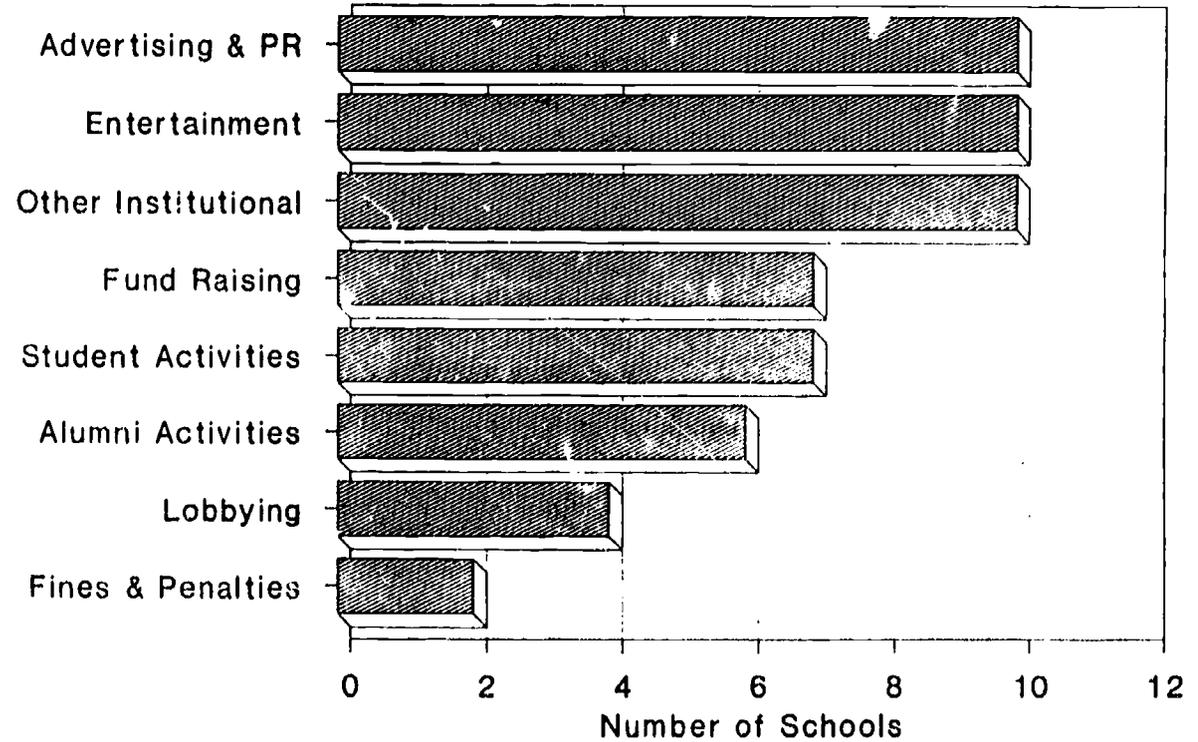
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# Costs Excluded by A-21

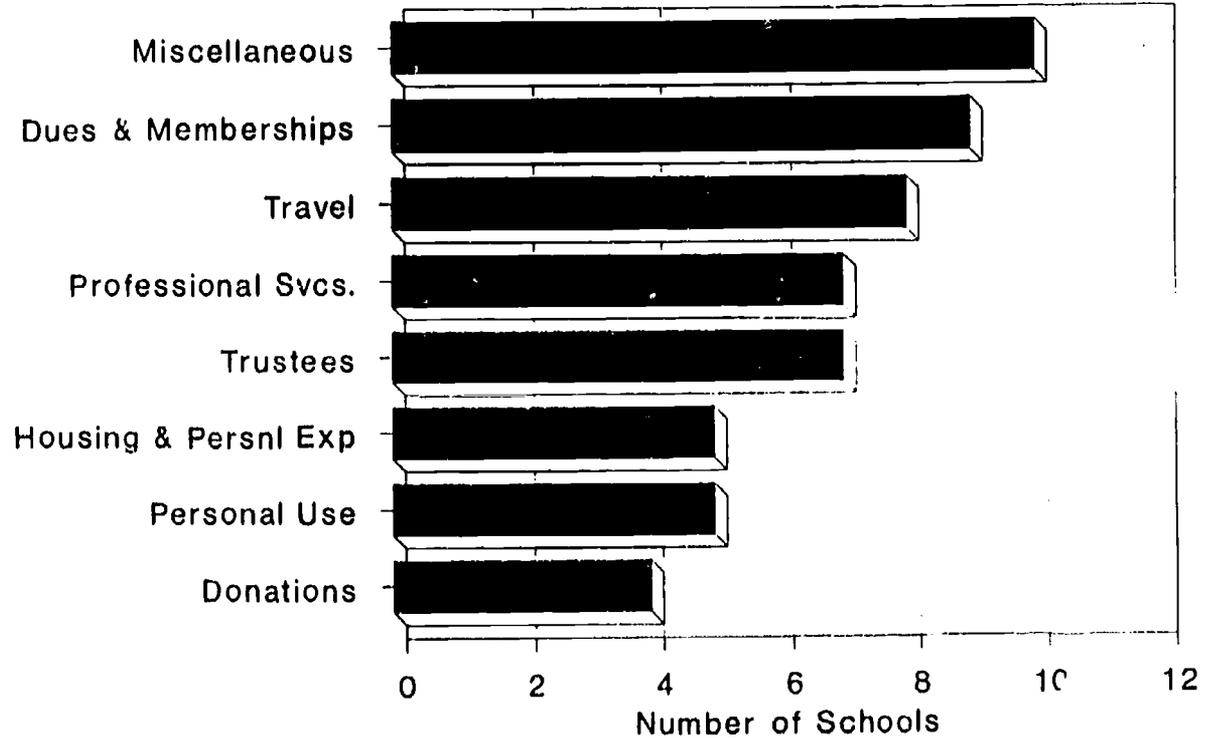


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# Costs Improperly Allocated to Research



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## Resolution of OIG SCRUB Audits of University Indirect Costs

SCHOOL	RESOLUTION STATUS	CASH REFUND	OTHER RECOVERIES
Dartmouth	Resolved	-	\$134,000
Duke	Resolved	\$82,000	
Emory	Resolved	308,000	77,000
Johns Hopkins	Resolved	490,000	
Rutgers	In-Process		
U. of Chicago	In-Process		
U. of Miami	Resolved	204,000	
U. of Michigan	Resolved	381,000	99,000
U. of Penn	Resolved	931,000	
U. of Pittsburg	Resolved	193,000	53,000
U. of Southern Calif.	Resolved	N/A	
U. of Texas S.W. Med. Ct.	Resolved	N/A	
Washington U.	Resolved	674,000	36,000
Yale	Resolved	491,000	104,000
		<b>\$3,754,000</b>	<b>(1) (2)</b>
			<b>\$603,000 (3)</b>

(1) \$3.75 million was recovered through cash refunds to the Federal Government.

(2) The total amount exceeds the amount reported by audit for one year for the 14 schools because the negotiators made adjustments for multiple years.

(3) Represents one year adjustment to current indirect cost rates in lieu of cash refund.

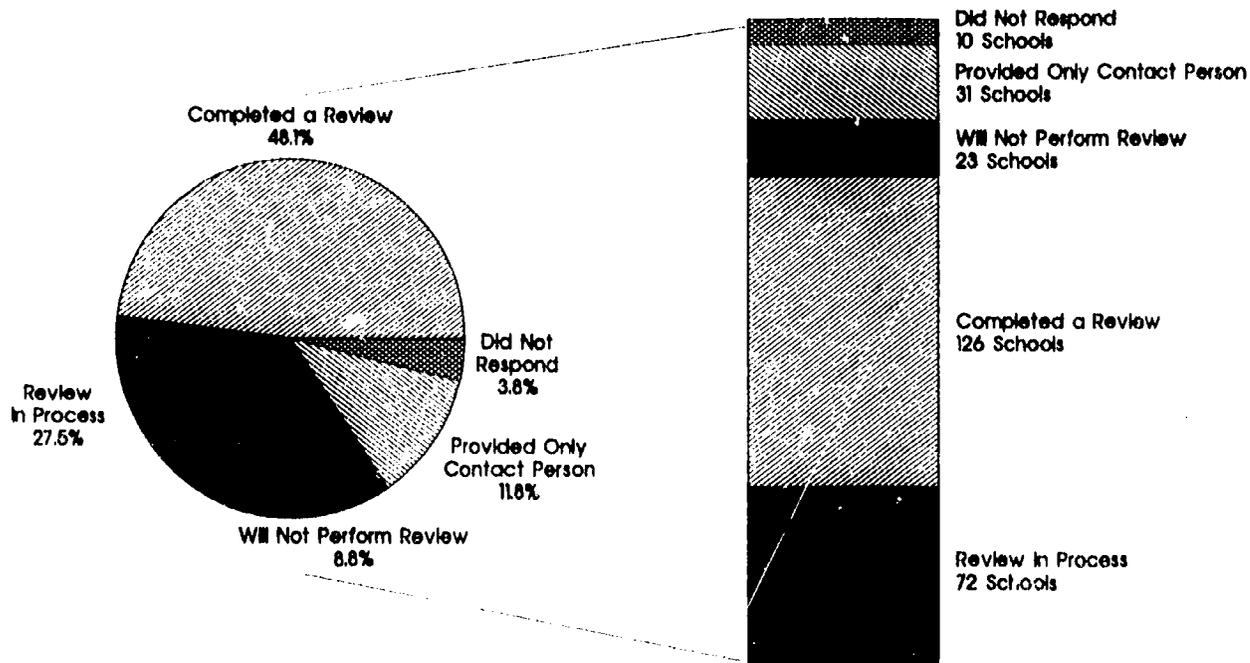
## Recap of DCA Negotiations of 14 -SCRUB- Schools

MOST CURRENT PERMANENT RATE	SCHOOL	----- Indirect Cost Rate -----		SAVINGS (MILLIONS)
		PROPOSED	NEGOTIATED	
1992	Dartmouth	78.5%	62.0%	\$1.6
1992	Duke	57.0%	52.0%	2.9
1992	Emory	76.5%	52.0%	6.7
1992	Johns Hopkins	74.0%	65.0%	9.7
1989	Rutgers	88.7%	64.0%	2.7
1990	U. of Chicago	77.4%	65.0%	4.8
1992	U. of Miami	69.5%	54.0%	2.8
1992	U. of Michigan	63.4%	57.0%	4.9
1992	U. of Penn	77.7%	65.0%	10.0
1992	U. of Pittsburg Main Campus Medical Center	78.5%	47.0%	7.0
		93.4%	49.0%	10.0
1991	U. of Southern Calif.	85.9%	60.5%	14.0
1992	U. of Texas S.W. Med Ctr	57.9%	48.5%	2.5
1991	Washington U.	63.6%	32.0%	1.3
1991	Yale	71.6%	68.0%	1.8
				\$82.7

**Major Revisions to A-21  
Effective 10-01-91**

- Admin portion of schools' indirect costs capped at 26%
  
- Schools to certify that no unallowable costs included in proposals submitted on or after 10-01-91
  
- Specific expenses are unallowable, e.g., liquor, alumni activities, etc.
  
- Schools to use depreciation recoveries for better equipment/facilities within 5 years
  
- No shifts to Federal research of under-recovered OH related to foreign or corporate sponsored research

# Requests to Schools for a Self-Scrub of Indirect Costs



Total: 262 Schools

Fig D-29f

Mr. ROWLAND. Thank you very much, Mr. Roslewicz. It's the 14 schools that the IG is now conducting audits at; is that correct?

Mr. ROSLEWICZ. Yes. Those audits are all complete. We completed those between February of 1991 and now. We have completed the 14 individual audit reports which have been submitted to universities, commented on by the universities, issued in final. The report we are presenting today consolidates the results of those 14 audits. Mr. Talesnik, as he indicated in his testimony, has already resolved, I believe, 12 of the 14 audit reports that we have issued.

Mr. ROWLAND. For the record, would you name those schools?

Mr. ROSLEWICZ. Yes, sir. Dartmouth, Duke, Emory, Johns Hopkins University, Rutgers, the University of Chicago, University of Miami, University of Michigan, University of Pennsylvania, University of Pittsburgh, University of Southern California, Texas South West Medical Center at Dallas, Washington University and Yale University.

Mr. ROWLAND. In those audits, HHS questioned approximately, as you pointed out, \$20.4 million of unallowable costs, and the schools identified an additional \$11.4 million based on their HHS auditors arriving on the scene; is that correct?

Mr. ROSLEWICZ. That is correct, yes, sir. [See exhibit 1, p. —.]

Mr. ROWLAND. So a total of \$31.8 million was scrubbed out of those 14 schools; is that correct?

Mr. ROSLEWICZ. That is correct, sir.

Mr. ROWLAND. Of that, approximately \$5 million was charged to Federal research, is that about right?

Mr. ROSLEWICZ. As a result of the 14 universities, there was about \$3 million.

Mr. ROWLAND. What was scrubbed also, does that total come to about \$5 million?

Mr. ROSLEWICZ. Yes, approximately \$5 million, yes, sir.

Mr. ROWLAND. OK, in your testimony you give some general examples of what was found, but in terms of specifics, what were some of the larger problem areas, the specific examples that you found?

Mr. ROSLEWICZ. OK, we can do that for you two ways, Mr. Chairman. We can give you the broad categories at the 14 universities or if you want exact, individual transactions, we can do that as well, but as you can see costs improperly allocated to research, in the area of miscellaneous type things, flowers, and what different kinds of things do we have there, Dick?

Mr. ROWLAND. Can you do individual?

Mr. ROSLEWICZ. Would you like individual schools? OK, Dick, do you want to give some individuals?

Mr. OGDEN. I can name the individual schools, Mr. Chairman, that come under each one of those categories that are listed. For example, we found costs improperly allocated to research in a miscellaneous category at Dartmouth, Duke, Emory, Johns Hopkins, Miami, Michigan, Penn, Pitt, Texas and Yale.

We had problems with dues and membership with Dartmouth, Duke, Emory, Miami, Johns Hopkins, Michigan, Penn, Pitt, and Yale.

We found problems in travel being improperly allocated to research at the following schools, Mr. Chairman, Dartmouth, Duke,

Emory, Johns Hopkins, Miami, Michigan, Penn, and Pitt. We had problems with the improper allocation to research for professional services at Dartmouth, Emory, Rutgers, Miami, Pitt, Washington and Yale. Trustees at seven schools, I think were problems, they were Dartmouth, Duke, Emory, Johns Hopkins, Michigan, Penn, and Washington. We found problems of housing and personnel expenses at five schools, Mr. Chairman; Dartmouth, Johns Hopkins, Miami, Penn, and Yale.

We found problems with personal use, costs pertaining to personal use improperly allocated to research at Dartmouth, Miami, Michigan, Pitt, and Yale, and we had problems with donations being charged to research, improperly allocated to research at Johns Hopkins, Pitt, Texas and Yale.

Now, that chart, Mr. Chairman, shows costs improperly allocated to research. We have another chart that shows the kind of costs which were specifically excluded from A-21.

Mr. ROWLAND. Let's see that chart.

Mr. ROSLEWICZ. If I can add something before we look at that second chart, the distinction between those two are the first group that Mr. Ogden referred to, they are all sort of questionable between—as I mentioned earlier in my testimony, the auditors and the accountants disagree as to whether flowers really add to the morale or the cost of research, so you have some disagreements there.

The second chart that Mr. Ogden is going to give you some examples on, these are specifically excludable by A-21, there is no argument as to whether it is excludable or not, so, Dick, if you would, please.

Mr. OGDEN. Certainly. We found problems at 10 schools, Mr. Chairman, regarding advertising and PR costs. Those 10 schools were Dartmouth, Duke, Emory, Johns Hopkins, Rutgers, Michigan, Penn, Pitt, Washington, and Yale.

Now, again, these are costs which are specifically excluded by A-21. Entertainment, there were problems at 10 schools. To some extent, of course, I keep repeating these same schools. Dartmouth, Duke, Emory, Johns Hopkins, Miami, Michigan, Penn, Pitt, Texas, and Yale.

Other institutional costs that we believe should not have been charged to research affected the following schools: Dartmouth, Duke, Emory, Johns Hopkins, Miami, Michigan, Penn, Pitt, Washington, and Yale, Mr. Chairman. Fund raising costs which were excluded by A-21 but which still wound up charged to research; we found that at Johns Hopkins, the University of Chicago, Michigan, Penn, Pitt, Texas, and Yale.

Cost pertaining to student activities, again, costs which should not have wound up charged to research—Emory, Rutgers, Chicago, Michigan, Penn, Pitt, and Yale. Charges pertaining to alumni activities. These charges were passed on to the research costs at Dartmouth, Chicago, Michigan, Penn, Pitt, and Yale.

Lobbying costs at four schools, Mr. Chairman: Miami, Michigan, Penn, and Yale. Finally, fines and penalties, costs pertaining to fines and penalties, Michigan and Pittsburgh, Mr. Chairman.

Mr. ROSLEWICZ. Fines and penalties is an example where I said A-21 could be further refined because under A-21 it doesn't address the interest on fines and penalties.

Some of the universities we had been into were actually charging interest to the indirect cost pool as well, even though the fines and penalties are unallowable, but those are the kinds of clarifications that can be made to A-21, which would help alleviate some of this fighting that goes on between the Federal auditors and university accountants.

Mr. ROWLAND. Mr. Roslewicz, on page 15 of your prepared statement, you said that when you were here in May, before this subcommittee, you agreed you would check into those foreign governments, and you have already told me that you have done that, and according to your testimony, you checked this out at 10 of 14 universities and found that all 10 were offering lower rates to foreign governments and non-Federal research organizations, than they were to American taxpayers; is that correct?

Mr. ROSLEWICZ. Yes, sir, that is correct.

Mr. ROWLAND. Can you list 10 schools where you conducted this review?

Mr. ROSLEWICZ. OK. We will have that for you in a second, sir.

Mr. OGDEN. Do you want me to read it?

Mr. ROSLEWICZ. Yes.

Mr. OGDEN. Those 10 schools are, Mr. Chairman, Yale, Dartmouth, Rutgers, Johns Hopkins, Pitt, Emory, Duke, the University of Miami, University of Chicago, and USC. We found that all 10 of these universities entered into sponsored agreements with reduced indirect cost rates. Three of those universities had entered into agreements with foreign governments.

Most had entered into agreements with foreign corporations.

Mr. ROWLAND. Which were the three?

Mr. OGDEN. With the foreign governments, Mr. Chairman?

Mr. ROWLAND. Yes.

Mr. OGDEN. Johns Hopkins, Pitt, and Duke.

Mr. ROWLAND. So with which governments?

Mr. ROSLEWICZ. We can give you that, too.

Mr. OGDEN. There were eight governments—Egypt, Austria, Canada, France, Brazil, Spain, Sweden, and the United Nations, Mr. Chairman.

Mr. ROWLAND. So what you are saying is that these universities, just like Stanford, while they charged the full rate to the American taxpayer to support American research, were willing to subsidize research for those governments that you mentioned?

Mr. ROSLEWICZ. Yes, sir, that is correct. In cases of those 8 or 9 foreign nations, 6 of those—7 of those were charged zero percent indirect cost rate. One was charged about 5.2 percent and another one had about a 15 percent rate, which was substantially lower than the rate charged for Federal research.

Mr. ROWLAND. Can you explain this or do you have any—

Mr. ROSLEWICZ. Sure. What we found, Mr. Chairman, is that fortunately when they are computing the indirect cost rate, they include the amount that the foreign corporations, countries, their amounts are included in the base that is used to compute the indirect cost rate, so the indirect cost rate is based upon the total

amount of research that is being done, which means, then, that the Federal Government, in turn, is not being billed for the research costs, indirect costs that relate to the foreign researchers.

For example, if there is \$100 million in total research at a university, the modified total direct cost base, which includes the foreign research dollars in that base, is divided by the amount of the indirect cost. For example, \$45 million indirect costs divided by \$100 million total cost would give you a 45 percent indirect cost rate.

If they were to remove the—let's say it was a \$90-\$10, \$90 million was Federal research and \$10 million was other than Federal research, if they did not include that \$10 million in the base, the indirect cost rate would have been 50 percent, which is the \$45 divided by \$90 million, the 50 percent then would be charged to the Federal Government. In that particular situation, if that is what they were doing, we would be absorbing the cost of the indirect cost of the foreign research.

What happens in this case, though, is the universities or these 10 schools were giving up approximately \$46 million because they were willing to—I guess they wanted to have that foreign research, whether it was a special project or whatever it is. They have given us several reasons. Sometimes they wanted to encourage young scientists to come to them, and they claim they don't just have the money to pay the indirect cost.

We have a whole list of reasons that the universities gave us as to why they would not charge indirect cost rates. If you would like, I could read some of those reasons for you, sir.

Mr. ROWLAND. Well, why would you not charge Egyptian taxpayers when you do charge the U.S. taxpayers?

Mr. ROSLEWICZ. That is a good question. We have not been able to come up with an answer on that one.

Mr. ROWLAND. Let me ask you this—several years ago Mr. Kusserow testified before this subcommittee regarding laboratory charging practices, and it was discovered that labs in the United States were charging the Federal Government more than it was charging their non-Federal patients, and the solution was to guarantee that the Federal Government got the best rate being offered.

If you wanted to subsidize your private payers, you had to offer that same rate to the American taxpayer. Do you believe, based on what you found at all 10 schools, that a similar solution would be warranted in this case?

Mr. ROSLEWICZ. It certainly is a solution that should be considered by the universities, but it has to be weighed against, I guess, their objections as to why they feel they should not do that. They felt in these instances that we looked at, which are very few compared to total universities in the country, that the desire to have that type of research being done at their university was sufficient enough for them to make a decision that they would absorb the indirect cost of that particular research project. That is a decision that they have made.

Now, it does not affect, it unfortunately does not affect the amount of research that we pay, but I certainly see your point, where, you know, why should the Government be paying a higher

rate. I don't have an immediate answer as to how the universities can go about rectifying that.

Their concern is that they could possibly lose the research dollars all together if they were to charge an indirect cost rate. I believe our department and National Institutes of Health has a policy where when we have research going on at a foreign university or foreign country, we do not pay indirect costs. It is specifically excluded.

Mr. ROWLAND. All right. You point out in your testimony that while foreign governments and other non-Federal sponsors are assessed lower rates that the universities were absorbing the uncovered portion of the cost and not in effect having the Federal Government subsidize these discounts. That is fine, but isn't the real question that if universities are willing to absorb actual costs in conducting research for the government of Japan, say, or for Weight Watchers that they should be willing to absorb the same cost for the American taxpayer?

Mr. ROSLEWICZ. That is a very strong argument, sir, to eliminate all the indirect costs on the side of Federal research, the schools, I am sure, would have a very difficult time in giving up, in other words, charging the Federal Government a zero percent rate. Their major complaint, I am sure, would be that they are not getting reimbursed the full cost of research, but you are absolutely right, though, how do they make that determination that there is such a benefit?

Feel free to jump in, Dick.

Mr. OGDEN. All I was pointing out, Mr. Chairman, is that we do conclude in our final written testimony that we do believe there is a basic question of fairness and equity relating to the assessment of the lower rates to certain non-Federal sponsors, especially those who may certainly be in a position to pay their fair share, just as the Federal Government is, and it is something that we say in our written testimony that we are going to review in more detail to determine options available for policy change.

Mr. ROWLAND. Mr. Talesnik, do you believe that it is fair and equitable? You negotiate rates with these universities, and they try to justify every dime they can get and then turn around and are extraordinarily benevolent to foreigners and needy corporations such as Exxon. Do you think that is fair?

Mr. TALESNIK. While we do negotiate those rates, we do make sure that the institution isn't shifting the indirect cost attributable to those other sponsors to Federal programs. We don't have any particular authority to do anything about whether or not they actually charge those other sponsors for the full freight, if you will, for those indirect costs.

It really is basically a policy question as to whether or not there ought to be a Federal policy that says that the Federal Government will pay the lowest rate, and that is something that presumably will be further studied by the IG's office.

Mr. ROWLAND. Mr. Roslewicz, I have learned how to pronounce your name, I think.

Mr. TALESNIK. It may be easier to say Tom, Dick, and Gary.

Mr. ROWLAND. Mr. Roslewicz, you said that they are afraid of losing foreign business. Why aren't they concerned about losing U.S. business?

Mr. ROSLEWICZ. I am sure that they certainly would be if the move were to be made to reduce the indirect cost rates. Basically I would have to say that, you know, the only alternative that the universities would have, either they charge these foreigners a different rate or the same rate as the Federal Government or they lose that research business.

Now, we have not looked at the types of research that is being done in this country by foreign governments to make a determination as to whether it is of use or not. I would think before a decision were made that you would have to look at more in-depth reviews as to what does this research consist of, is it really benefiting our country, I guess you could look at it from that perspective. If it is something that is only going to benefit the foreign country, then I would begin to wonder.

Again, I am wandering in the policy area, and I really shouldn't do that, but I would begin to have reservations from a personal standpoint as to, well, if it is not benefiting the American taxpayer and if it is only going to benefit the foreign country where the research is going back to, well, then, I would begin to have some concerns if I were in a policymaking position, which I am not, I am the auditor. I audit the facts, but, you know, from a personal taxpayer point of view, I would begin to have very similar questions myself.

Mr. ROWLAND. In your testimony you stated that you have contacted by letter 260 additional schools beyond the 14 in your nationwide survey with significant research dollars.

The IG's office has received a significant budget reduction; is that correct?

Mr. ROSLEWICZ. I missed the last part of your question, sir.

Mr. ROWLAND. The IG's office has received a significant budget reduction; is that correct?

Mr. ROSLEWICZ. Yes, sir, we have. This fiscal year has been very difficult for us. We were underfunded, and as a result I am downsizing the audit staff from 800 to about 700. That has made this job more challengeable for me. It is a tremendous challenge to try to provide coverage to a department that has a \$.5 trillion budget, the amount of research on that \$.5 trillion budget is about 1 percent of the total department's budget.

On the other hand, I am devoting into the area approximately 7 percent of my auditors, looking at 1 percent of the department's total funding. It is a challenge in regards to how can I—if I keep shifting more auditors over to the college and university area, I am using more auditors to look at less funds.

Now, the dollar return has been certainly very beneficial. I mean, for each of the 50 auditors that we put into the college-university area, we got back at least about \$800,000, so certainly none of my auditors are getting paid \$800,000. If they are, I would like to know who, but if you can get \$800,000 back for putting an auditor into the area, it certainly is a very efficient and economic way to do it.

On the other hand, if you are looking at the larger programs in the department, you are talking about Medicare, Medicaid, all of the public health service agencies, Social Security, all the children and youth family type programs, the dollar return there is much larger because you are dealing in bigger dollars, you are dealing with hundreds of billions of dollars in these programs, and the return on investment for an auditor in that case is in the neighborhood of \$7 million, so, you know, either way I look at it as I can do only as good a job as the resources I am given to cover a mammoth organization the size of Health and Human Services.

We are trying many different ways to try to use our audit resources that we have effectively. We have begun trying to cover the other major 262 universities, we are working with them. We are on the phone with them. We send them letters, we meet with the staffs, the president, the university officials. They come in and they brief us on how they are computing their indirect cost programs, their plans, so we are making a major effort to get out there and try to provide the coverage with these scarce resources we have, but it does become very difficult when you try to get down to doing transaction-by-transaction audits, charges into these individual pools. That eats up a lot of resources just trying to go in there and review these individual transactions, especially when the criteria isn't clear and you have arguments between the accountants, the auditors, and the general counsels for the universities involved.

So to answer your question more briefly, yes, we are having a problem budget resource-wise, and I certainly could use a lot more resources to do the work out there I should be doing.

Mr. ROWLAND. So not only is this a good effort to ferret out the fraud, waste and abuses of the taxpayers' money, but it has more than paid for itself, hasn't it?

Mr. ROSLEWICZ. Yes, sir, absolutely, no doubt in my mind.

Mr. ROWLAND. I guess we would have to ask the question, then, what has happened to the funding?

Mr. ROSLEWICZ. Well, this year's budget, I guess with the new cap on the budget ceilings, various amendments have been placed on the IG's budget, and we didn't get the funding we had requested for 1992.

As a result, we have received only about maybe \$.5 million more than what we requested, and on the other hand we have to absorb \$5 million in additional costs as a result of the locality pay, pay increases, special pay rates for investigators all around the country.

All of that put together, you ended up with a budget less than what we had requested, and as a result I have no choice. I understand the situation. We have a budget deficit in this country.

Mr. ROWLAND. When the IG's office budget is cut, that doesn't serve the taxpayer very well, does it?

Mr. ROSLEWICZ. I would agree with you on that, sir.

Mr. ROWLAND. Mr. Talesnik, how has the work of the IG's office aided in your overhead negotiations with the universities?

Mr. TALESNIK. We have been working with the IG's office for sometime to try to identify those institutions that we could work together on doing joint collaborative type reviews of various aspects of their indirect cost proposals. We have a number of those in

process right now. We completed a number of them over the past year.

Basically what we do is the auditors and the negotiators—and I am basically representing the negotiators—get together, they identify which schools could use this additional audit effort, the auditors and negotiators then decide what aspects of those proposals ought to be evaluated in some depth by the auditors.

The auditors do that, they provide us a so-called management advisory report. That then is weaved into the negotiation process. We have had some substantial successes with that.

Mr. ROSLEWICZ. If I might add, Mr. Chairman, if the staff—

Mr. ROWLAND. Would you name some of those successes that you had?

Mr. ROSLEWICZ. Let's look at this chart. This will show you some of the successes, the two charts on the comparison of negotiated rates with the proposed rates. Gary, why don't you go ahead and speak from there? That will give you some good examples.

Mr. TALESNIK. I am going to use—

Mr. ROSLEWICZ. Or some additional ones.

Mr. TALESNIK. I am going to use, if you will—I am going to use Emory, because that is probably the most recent one that we have done through this collaborative process. Basically—and by the way, that happened to be also one of the—well, these 14 were also the schools that were—where there was a scrub audit.

In fact, there were two audits done at Emory: One was a scrub audit which basically was designed to look for unallowable costs in their general administration pool, and the other one was, in a sense, an assist audit to look at other areas, and in the case of the assist audit, the auditors helped us look at a number of aspects of the Emory proposal. One was the library study.

We talked about library studies in some of the previous testimony, to see whether or not the library study that Emory had put together, hung together, that is whether the library study resulted in an equitable distribution of those library costs or whether there were some holes in it.

As a result of work done by the auditors, it was, in our view, at least, pretty conclusive that it didn't hang together, and so we questioned the study and we ended up requiring the institution to use the so-called standard allocation method in Circular A-21. They also helped us look at the allocation and classification of space.

A large part of that process drives the allocation of a lot of your facility costs, utilities, depreciation on buildings and equipment, that sort of thing. The auditors helped us with that as well, so that kind of a process, but when we focus on specific areas—by the way, when we do our negotiations, in a normal sense, we focus on specific aspects of those proposals that we think are vulnerable, and we spend extra time looking at those things, and when we were able to work out a collaborative arrangement, as we did in this case, we have the auditors work with us.

Mr. ROWLAND. We won't ask you to go through all of that, but you have this all to submit for the record, all this information here?

Mr. TALESNIK. Yes.

Mr. ROSLEWICZ. That is attached to the written testimony. If not, we will make sure. One other thing on those two charts there, if you could—those are the 14 universities where we conducted our audits.

As you can see, the total savings—we believe in working up front. If you get a lot of these costs weeded out up front, you can hopefully avoid a lot of the things that we are finding at Stanford and MIT and other universities, but just by working together with Gary and his people, we have been able to save up front \$82.7 million.

I think that is certainly a good approach in light of the scarce resources. You have got to look for other ways to get the job done with the scarce resources that you have.

Mr. ROWLAND. That is the question I wanted to ask. You are saving millions of dollars. HHS-IG, in conducting these audits, is able to help you in being in a better bargaining position with the universities, is that not true?

Mr. TALESNIK. Absolutely.

Mr. ROWLAND. OK. Let me ask you this, Mr. Talesnik, there has been an overall inflation and indirect cost rate for a number of years. Do you believe the evolving Stanford situation and the work of the HHS-IG had an impact on the growth in indirect cost rates this year?

Mr. TALESNIK. Well, it is hard to measure that, and this is very preliminary. My sense is that it has had an effect. Just looking at the numbers, the growth of indirect cost rates for the last several years has averaged something like seven-tenths of 1 percent.

That doesn't sound like a lot, but if you get a lot of years string together, it can start to add up. In the past year, that is the rates we negotiated for fiscal year 1992, fiscal 1992, compared to the rates we negotiated in 1991, there was still some creep, but the creep is smaller than it was in the three previous years.

Again, I can't pinpoint exactly what that is attributable to, but the slow—the reduction in the rate of growth I think has something to do with the things that have been going on over the past year.

Mr. ROWLAND. Do you believe the universities are more aware and sensitive to the fact that only allowable and reasonable charges should be included in the cost base for negotiation with the Federal Government?

Mr. TALESNIK. Unquestionably. There is absolutely no question in my mind that institutions are much more conscientious and conservative, if you will, in terms of what they do to try to screen these things out, and they are doing, as we have seen in a number of things that we have gotten from institutions in response to letters, they are, in fact, doing a lot of work either with their own internal staff, internal auditors or with external CPA firms trying to find these things, what these costs are.

That was pointed out very explicitly in the 14 scrub audits. That is a technical word I know, but it is basically an audit that looks for—scrubs an indirect cost pool to try to find unallowable costs, that there were a fair number of those same institutions that were subjected to those audits, that had before the audits even started had done a number of reviews.

Mr. ROWLAND. Well, where do you think we ought to go from here? Has the word gotten out and auditors can back away or do you believe it is necessary to up the pressure or maintain the pressure through audits during the transition period?

Mr. TALESNIK. Are you asking me or Tom?

Mr. ROSLEWICZ. Are you saying should the auditors back away? I would say absolutely not. I don't think that is an appropriate course of action. I am looking forward to—what would be Circular A-133 now requires each college or university receiving \$100,000 in Federal funds to have an annual audit done at least once every 2 years, I should say. An audit done at least every 2 years which would also require that independent public accountants look at the charges being charged to the indirect cost pools in compliance with A-21, so we will see as a result, we will begin to see these audits coming in for the fiscal years ending June 30, 1992.

Now, that in turn is going to increase our workload because, again, we as accountants and auditors have to review that audit to make sure it is done in compliance with standards. What we do then is build upon the work that the independent accountants do. For example, at Johns Hopkins University there was an A-110 audit done there, which was the circular prior to A-133, and we reviewed that report. That was done by an independent public accountant and found that there was some concerns we had in the area of recharge centers. So what we did is started a nationwide audit based on the results of that audit that was submitted to us for review.

We are now looking at I think approximately 10 or 11 universities at the way they are handling recharge centers. These are centers where they bill directly to the Federal grants amounts for computer services, motor pools, and things like that. They bill their rate based upon the actual charges, and it is billed directly to the specific grants.

We are finding that there is some unallowables being included in the computation of billing rates. We are finding that where surpluses are generated, they are supposed to filter that back to the Federal agencies and the other researchers, but they are not doing that, they are using those funds to cover other areas of their departments, and we are also finding that in the case of where there is a deficit, they are charging that into the indirect cost pool and billing it back to the Federal Government, so we find those kinds of things coming from these other audits that have been done by independent public accountants.

Now, the jury is not in yet as to how effective that approach will be, but the Inspector General has supported single audit all through the 1980's when this issue was debated in the Congress as to single audits at State and locals as well as colleges and universities and nonprofits, so in light of the scarce resources, I don't see a lot of resources being available under the current conditions of our economy.

We have to start looking for other ways to do things, but on the other hand, either way you go I can still use additional resources to get some of this work done.

Mr. TALESNIK. Could I add on to that a little bit?

Mr. ROWLAND. Sure.

Mr. TALESNIK. The so-called A-133 audits, that is a relatively new circular. There were similar requirements in a previous circular, Circular A-110, but they were kind of loose and vague and didn't really say a heck of a lot. The new rules or requirements for those audits are much more comprehensive. Again, that was issued, I guess, about 2 years ago, the circular, but there was a long delay date, so we won't be seeing audits, I guess, for still a number of months, but the other thing that is important, though, is that this past October, OMB issued some supplemental guidelines, we call it a compliance supplement, that gives some instructions, if you will, to the auditors on what they ought to be looking at, and that, I believe, for the first time, makes it explicitly clear that those audits need to cover indirect costs, they need to look at the allowability issues, that is what kind of costs are included in the pools, whether those costs are allowable or not allowable, the controls the institution has to screen out unallowable costs as well as the allocation, so if those audits are done in accordance with that compliance supplement, guidelines, whatever word we want to use, then I think we will get something out of that process that will give us some good information we can use in the negotiation.

Mr. ROSLEWICZ. I concur with that. I think getting back to my oral statement, there were two approaches, you have the global approach to fixing the problem and the incremental steps. I mean, even with A-133 you still have these independent public accountants going out there auditing in compliance with A-21, which is obviously needed to be fixed, and OMB made some changes to it, but there is still some further clarifications that can be made that we are recommending to our department to work with OMB on trying to get some further clarifications, but I think the more clarified you make this, if you have good criteria to audit by, it makes the job easier and faster to get it done.

Mr. ROWLAND. I am going to ask you one last question. Do you think the university community is marching in lock step or are you finding that there is a mixed bag with some universities very quickly getting the message and moving forward while other universities are being less receptive and in fact I guess you might say hunkering down to kind of weather the storm? What is your feeling about that?

Mr. TALESNIK. There is always going to be a bit of a mixed bag. I am not in a position to point to particular institutions that are on one end of the spectrum or the other. We still have some institutions that are pretty aggressive, most institutions are still pretty aggressive in terms of trying to claim the costs that they think they are entitled to.

Mr. ROWLAND. Can you name some of those or not?

Mr. TALESNIK. I would prefer not to, but one of them—well, never mind, I think I will stay away from that. I do think, though, that with respect to the thing that kind of raised all this, that is the questions of what kinds of costs institutions were including in their indirect cost pools, this whole unallowable cost issue, that I see in virtually all the schools that we have had occasion to look at, they are being much more careful with that sort of thing, so I think that will continue. The other aspects are hard to judge.

Mr. ROWLAND. OK. Mr. Chairman, I am finished with my line of questioning. Do you have any questions, comments?

Mr. DINGELL. Mr. Chairman, thank you very much. Gentlemen, I want to thank you for your presence here, for your invaluable assistance to the committee. As you have observed from the comments of the chairman, that he and I are very much troubled about the curious situation in which we find ourselves where overhead or foreign contractors, foreign nations, companies and individuals, either American or otherwise, in this country or elsewhere, often times is lower or nonexistent, zero, whereas the Federal Government is paying the levels or overhead that you are observing here. I note with some interest, for example, that Egypt, Austria, Canada, France, Brazil, Spain, Sweden all have ongoing research projects in colleges and universities. I think that is a splendid thing. I am glad to see our colleges and universities get the business, but I note that American colleges and universities do not assess the same overhead charges against these folks who are in many instances competitors of the United States, and where a lot of the work that is done is enhancing their competitiveness at the expense of our own.

I have a couple of questions I would like to ask. First, is there any evidence here that work done for these other companies and other countries outside the United States is essentially being subsidized by high overhead payments which are being made by the U.S. Government for research which is done for the United States?

Mr. ROSLEWICZ. No, sir. As I indicated earlier with Dr. Rowland, our audit of the 10 universities clearly showed that they were not—the Federal Government is not absorbing the costs. I can repeat the example that I used earlier, if you would like me to. Let's assume—

Mr. DINGELL. No, if you will tell me that and the record is complete on that, I will not burden either you or the record further, but tell us what the case is just in brief summary so we have it reiterated for purposes of the record.

Mr. ROSLEWICZ. Sure. They compute the indirect cost rate. It is based upon the total research at a university. Let's say it is 90 percent Federal, 10 percent foreign and non-Federal, let's use \$100 million as an example. If you have \$100 million in research cost, and let's say there is a \$45 million indirect cost added to that, you are talking about an indirect cost rate of 45 percent, which includes the \$10 million for the foreign countries and other non-Federal researchers.

As long as that amount is included in there, the Federal Government is not going to absorb the cost of the indirect cost that the foreign universities require. On the other hand, if they excluded that \$10 million, which our audit indicates that they did not, the indirect cost rate would have been \$45 million divided by \$90 million or a 50 percent indirect cost rate that the Federal Government would have been paying.

That, in turn, would have indicated the Government was absorbing the indirect cost for the foreign research. Our audits at these 10 universities indicated that that was not the case, so what we have is the universities, and these 10 universities were absorbing

\$46 million out of their own pocket to pay that share of the research cost for the foreign countries.

Mr. DINGELL. Well, is that really a correct assumption? Here you have got the United States paying 50, 60 percent overhead, Japan paying zero overhead. Clearly the university has certain costs. Clearly the university is not, if I understand their tax status, a profitmaking institution. Essentially they are non-profit. That means that they don't have any profits that they can use to charge these costs that they are absorbing for noncompensated overhead to, let's say, Japan or Sweden, Canada, or whoever it might happen to be.

How can I then take the comfort that our people are not paying the cost, let's say, of subsidizing some other government? The university has a pool of a particular size in terms of earnings and resources. Those earnings and resources are allocated in certain ways; some of them for overhead, some of them for other things. But let's say that the foreign government contributes absolutely nothing to that overhead.

How can I come to the conclusion that there is no contribution being made, perhaps even a small one, by the United States or others to carry the overhead costs, let's say, of work that is done for Sweden or Japan or Canada or Germany or Spain?

Mr. ROSLEWICZ. Let me see if I can respond to that. I don't know if I can give you a real complete answer on this, but, again, the amount based upon these audits is clearly not coming out of the indirect cost pools, it is not being charged through the indirect cost pools.

Now, the university is obviously absorbing that from endowment funds or higher tuition rates. They are getting it from some other funding mechanism in the department. I don't know what that is. That was not within the scope of our audit to go back and try to pinpoint exactly where this \$46 million that the universities absorbed came from.

All we can demonstrate through the audit was that it was definitely not being charged back to the Federal Government through the indirect cost rate.

Mr. DINGELL. How about moneys the Federal Government pays in through things like Pell grants or tuition from the students or other programs, for example, that are conducted by, let's say, the Public Health Service or health research or something of this kind?

Mr. ROSLEWICZ. That could be. That could require additional audit work to go back in and look at where are these funds actually coming from that they used to pay that, to absorb the cost.

Mr. DINGELL. I just was sitting here thinking, maybe it would be a good idea to help the university to avoid this embarrassment by simply saying the Federal Government gets the best rate and somebody else gets it without overhead, maybe the Feds ought to do the same thing. After all, this is the American taxpayers. Do you think the universities would approve that?

Mr. ROSLEWICZ. I would think not.

Mr. DINGELL. Well, Mr. Chairman, I thank you for your kindness.

Gentlemen, thank you.

Mr. ROWLAND. Thank you. Thank you very much, gentlemen. The hearing is now adjourned.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

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