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Record Group/Collection: George H.W. Bush Presidential Records
Collection/Office of Origin: Science and Technology Policy, Office of (OSTP)
Series: Bromley, D. Allan, Files
Subseries: General Science Files

OA/ID Number: 62040
Folder ID Number: 62040-004

Folder Title:
Life Sciences: Indirect Costs [1 of 2] [1991]

Stack:

Row:

Section:

Shelf:

Position:

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"Document Control"

TYPE: INFORMATION DOCUMENT NUMBER: 9125042
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS

FROM: PRESS, Frank: NATIONAL ACADEMY OF SCIENCES

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 12/04/91

SUBJECT: RE: THE RESULTS OF REVIEWS OF THE ACADEMY'S AND THE
NATIONAL RESEARCH COUNCIL'S INDIRECT COST
ALLOCATIONS UNDER GOVERNMENT CONTRACTS AND
COOPERATIVE AGREEMENTS.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED:

ACTION STAFF
REQUIRED: ACTION:

SENDER'S DUE DATE:

OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: EXT:
REMARKS:

OSTP RECEIVED: 12/06/91 DEPT RECEIVED:
FILE: P-LIFE SCIENCES-INDIRECT COST

CENTRAL FILES:

5042

NATIONAL ACADEMY OF SCIENCES

2101 Constitution Avenue Washington, D. C. 20418

DEC 12 20

OFFICE OF THE PRESIDENT

December 4, 1991

MAIL ROOM

The Honorable D. Allan Bromley
Assistant to the President for
Science and Technology
358 Old Executive Office Building
Washington, DC 20500

Dear Allan:

I am writing to inform you of the results of reviews of the Academy's and the National Research Council's indirect cost allocations under government contracts and cooperative agreements, which account for approximately three-quarters of our operating budget in our congressionally chartered role as an advisory institution of science.

Nine months ago, as some universities' indirect cost charges to the government came under congressional and media scrutiny, we commissioned an internal audit to be conducted by NRC staff auditors in cooperation with Price Waterhouse, our independent auditors. The audit focused on the indirect costs of the executive offices and councils of the Academies and the Institute of Medicine as well as the operations of the NAS Woods Hole Study Center over the past six years. The audit was completed last week and, based on the results described in the attached statement, the Academy has returned to the government \$168,723 covering the six-year period.

The audit did not identify any case of consistently charging to indirect costs an item disallowed by government regulations. Rather, the audit revealed occasional errors in allocating costs. We have also made some voluntary adjustments for cost allocations that, although not addressed in government regulations, deviate from established Academy policy.

The auditors are continuing their review of other areas of the indirect cost pool. In the meantime, we instituted some new procedures and safeguards to ensure that every effort is being made to reduce the margin of error. The enclosed statement also describes these actions.

Yours sincerely,



Frank Press
President

Enclosure

NAS Statement on Review of Indirect Costs

November 27, 1991

The National Academy of Sciences (NAS) and its affiliated institutions -- the National Academy of Engineering (NAE), the Institute of Medicine (IOM), and the National Research Council -- provide the federal government and other organizations with advice about science, technology, and health policy. The institutions produce approximately 200 reports each year, organize numerous scientific conferences and workshops, and engage in a variety of other activities that support their mission of public service.

Much of the institutions' work is performed by volunteers: scientists, engineers, health care professionals, and other experts who each year contribute services, valued conservatively at \$27 million, that are not charged to the government. In addition, the NAS last year spent \$4.4 million of its private funds on projects performed in the public interest.

In fiscal year 1991, the institutions' total budget was \$182 million. Of that figure, \$42 million was allocated to the "indirect cost pool," used to account for costs that, unlike "direct costs," cannot be associated with specific projects. Examples of indirect costs are building maintenance and depreciation, accounting services, and executive management of the organization. In 1991, 75 percent of the NAS's indirect costs were charged to federal grants and contracts.

According to guidelines set by the White House Office of Management and Budget (OMB), the NAS recovers indirect costs through "overhead" charges, applied to the direct staff costs of projects, and "general and administrative" (G&A) charges, applied to total direct costs. In 1991, the NAS's overhead rate was 67.5 percent and its G&A rate was 13.9 percent.

The NAS is governed by different OMB guidelines than those that apply to universities. The NAS estimates that, if its overhead and G&A rates are extrapolated to fit the guidelines used by universities, its overall indirect cost rate would be approximately 47 percent.

The NAS is regularly audited by the Defense Contract Audit Agency and the Office of Naval Research. In addition to cooperating with these external auditors, the NAS retains the accounting firm of Price Waterhouse and maintains an Office of Internal Audit.

Internal Audit

In March 1991, the NAS began an internal audit of indirect costs incurred by the institutions' executive offices; by the NAS, NAE, and IOM Councils; and by the NAS's study center at Woods Hole, Mass. Even though these cost centers account for only about \$3 million per year in indirect costs, they are supported, to a greater degree than other cost centers, by a combination of government and private funds. This joint funding increases the chance of mistakenly allocating costs to the wrong account.

The Office of Internal Audit reviewed more than 2,000 transactions that took place in these cost centers over the past six years. Price Waterhouse examined this review for accuracy, reviewed additional transactions, and used statistical methods to estimate the total amount of incorrect charges.

The internal audit did not identify any case of consistently charging to the indirect cost pool an item disallowed by government regulations. But the audit did reveal occasional errors in allocating costs. As a result of the internal audit, the NAS also made some voluntary adjustments for cost allocations that, while not addressed in the OMB guidelines, deviate from NAS policy.

Today, the NAS refunded to the federal government \$168,723 for errors and voluntary adjustments for the six-year period reviewed. The ten largest items account for three-quarters of the refund:

- The NAS maintains a hotel apartment for its vice president, who does not live in Washington but often must attend NAS activities on short notice. In addition to being vice president, the incumbent serves on a number of management committees, chairs several program committees, and advises the National Research Council on science and mathematics education. Two-thirds of the cost of the hotel room had been charged to the indirect cost pool. Because the apartment is vacant part of the time, the NAS has decided to refund a portion of the amount charged as indirect costs on federal contracts and grants.
- The NAS provides lapel rosettes and women's pins to new members and small gifts to retiring NAS leaders and visiting foreign dignitaries. Some of these items were mistakenly allocated to the indirect cost pool. Private accounts exist for these items and should have been used.
- Printing costs for holiday cards and award scrolls were mistakenly charged to the indirect cost pool. Other printing costs have been refunded because documentation on the purpose of the printing is missing.
- The NAS is refunding the difference between coach and first-class airfare for business-related travel.

- Although not required to follow federal travel regulations, the NAS has decided to refund travel expenses that exceeded the federal per diem.
- Files are missing for some items. Many of these missing files appear to have been lost in a major move to a new site.
- Trips taken for fund-raising activities for the IOM were mistakenly charged to the indirect cost pool.
- Tapes of Infinite Voyage, a series co-produced by the NAS for public television, were distributed to schools, foundations, and members of Congress.
- Table flowers were provided at some dinners at NAS functions.
- Parking tickets were incurred by an NAS van while delivering inter-office mail.

Actions Taken

To prevent future errors involving the indirect cost pool, the NAS has taken the following actions:

1. Training of accounting staff and contract managers. Since August, the accounts payable staff has been attending seminars on voucher examination. Price Waterhouse is developing a two-day seminar for the NAS that will be taken by other accounting staff and contract managers.
2. Informal discussions with staff. Senior financial managers of the institution have met with staff members responsible for preparing vouchers to discuss the kinds of errors found in the internal audit and how to correct them.
3. Staff awareness. The president of the NAS has prepared a memorandum for all staff stressing the importance of proper cost allocation and each employee's responsibility to be aware of policies governing indirect costs.
4. Occupancy records. The NAS vice president now provides a list of days spent at the hotel so that costs of the room can be allocated appropriately.
5. New cost center. A cost center has been established for parking tickets and other fines. Items in this cost center will not be charged to the indirect cost pool.
6. New financial positions. Financial officers are being hired for two offices where financial and administrative positions need strengthening.

7. Internal controls. Price Waterhouse and the Office of Internal Audit are preparing a list of recommendations to management for improvement of accounting controls.
8. Further internal audits. The Office of Internal Audit will review indirect cost allocations in cost centers other than the ones included in the recently completed audit.

Inquiry from House Subcommittee Staff

In November 1991, as the internal audit neared completion, the NAS received a request for information about indirect costs from the staff of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Rep. John Dingell (D-Mich.). In response, the NAS is providing the subcommittee staff with the results of the internal audit.

The NAS answered several questions about the NAS president's expenses posed by the subcommittee staff:

- The NAS has maintained a residence for its president since the presidency became a full-time position more than 25 years ago. The internal audit confirmed that no expenses related to the president's apartment are charged to the indirect cost pool. All expenses are paid with private funds, as was the original purchase.
- The NAS provides the president with a car and driver for transportation to business meetings during working hours and to private functions related to the president's duties. The internal audit confirmed that costs associated with business-related activities are appropriately charged to the indirect cost pool and costs associated with private activities are charged to NAS's private funds.

Mary

"Document Control for Division of Life Sciences"

TYPE: INFORMATION DOCUMENT NUMBER: 9124220
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS C

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 09/20/91

SUBJECT: RE: A STUDY ON SCIENTIFIC MISCONDUCT.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED: Alicia K. Dustira

ACTION STAFF
REQUIRED: ACTION: Comments to Bromley

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: EXT:

REMARKS: Alicia said that discussions are ongoing regarding the
definition of misconduct and the effort to enumerate the basic
principles in a model policy are proceeding as well. Close out
record.

OSTP RECEIVED: 09/27/91 DEPT RECEIVED: 10/04/91

FILE: P-LIFE SCIENCES-MISCONDUCT

Indirect Cost

CENTRAL FILES:

"Document Control for Division of Life Sciences"

TYPE: INFORMATION

DOCUMENT NUMBER: 9124220

ORIGINATOR: 02

STATUS C

DIRECTORATE STATUS I

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

Alicia
please

DATE OF
CORRESPONDENCE: 09/20/91

SUBJECT: RE: A STUDY ON SCIENTIFIC MISCONDUCT.

DIRECTORATE

STAFF

ASSIGNED:

ASSIGNED: D.A. Henderson

ACTION

STAFF

REQUIRED:

ACTION: Comments to Bromley

SENDER'S DUE DATE:

OSTP DUE DATE:

STAFF DUE DATE

DATE COMPLETED:

DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #:

CONTACT PERSON:

PHONE:

EXT:

REMARKS:

Discussions are ongoing regarding the definition of misconduct and the effort to ~~an~~ enumerate the basic principles in a model policy are proceeding well -

Alicia

OSTP RECEIVED: 09/27/91

DEPT RECEIVED: 10/04/91

FILE: P-LIFE SCIENCES-MISCONDUCT

"CORRESPONDENCE TRACKING"

TYPE: INFORMATION

ORIGINATOR: 02

STATUS C

DOCUMENT NUMBER: 9124220

DIRECTORATE STATUS

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 09/20/91

SUBJECT: RE: A STUDY ON SCIENTIFIC MISCONDUCT.

DIRECTORATE
ASSIGNED: STAFF
ASSIGNED:

ACTION
REQUIRED: STAFF
ACTION:

OSTP DUE DATE: SENDER'S DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
REMARKS:

OSTP RECEIVED: 09/2
DEPT RECEIVED:

10/4
Not-
Comment?
DAB

T

Yale University
RECEIVED

4222
DOROTHY K. ROBINSON
General Counsel
451 College Street
P.O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074
Telephone: 203 432-4949

91 SEP 27 AM 11:14

September 20, 1991

OFFICE OF THE
DIRECTOR

The Honorable D. Allan Bromley
The Assistant to the President for Science and Technology
Old Executive Office Building, Room 360
17th and Pennsylvania Avenue, N.W.
Washington, D.C. 20506

Dear Allan:

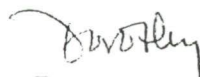
Thank you so much for having me to lunch at the White House with Bernadine Healy. I found our discussion extremely useful, and I look forward to following up with her on several of the topics.

Although we somehow got off the subject, I think your idea of a study on scientific misconduct would be very helpful. One fairly contained way to address the subject would be to focus strictly on the definition of scientific misconduct or fraud and explore the boundaries of the definition in the areas you described -- such as the role of error and the ethical significance, if any, of lapses in care in recordkeeping. PHS regulations have gone beyond intentional conduct such as fabrication, falsification and plagiarism, to include other deviations from accepted practice, but have expressly excluded "honest error" or "honest differences in interpretations in data." The NSF rules have a somewhat different definition, but similarly are intended to exclude mere error. Nonetheless, I am not sure the public appreciates how integral error is to the processes of science, and how damaging it can be to consider error merely in terms of its place on a sliding scale that proceeds toward fraud. As I mentioned, I also would endorse Bernadine Healy's suggestion that guidance to universities on conflicts of interest is clearly needed by them, and OSTP could play a unique and vital role in articulating the essential principles.

As always, please feel free to call on me if there is any way I can be of assistance to you as OSTP pursues these or other issues, including, of course, the year-long indirect cost study.

With best regards,

Sincerely,



Dorothy K. Robinson

THE WHITE HOUSE
WASHINGTON

December 4, 1991

Dear Dorothy:

It was a great pleasure having you here for lunch and I am sorry that it has taken so long to follow up on one of the questions raised in your letter. I have been traveling extensively since I saw you, hence the delay in clearing the huge pile of correspondence that has piled up on my desk--a phenomenon with which I am sure you are more than familiar.

Your comments concerning the study on scientific misconduct are very much on the mark and I have passed them on to D.A. Henderson, who is my point individual in this particular study. We are, I think, making excellent progress toward enumerating the basic principles in a model policy for both institutions and agencies.

Once we get a somewhat more final draft, I would look forward to the possibility of getting your candid and unofficial comments on it before we take it farther.

With warmest best wishes,

Sincerely yours,



D. Allan Bromley
The Assistant to the President
for
Science and Technology

Ms. Dorothy K. Robinson
General Counsel
Yale University
451 College Street
P.O. Box 1074 Yale Station
New Haven, Connecticut 06520

"LIFE SCIENCES (CORRESPONDENCE TRACKING)"

TYPE: INFORMATION DOCUMENT NUMBER: 9123213
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS C

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/31/91

SUBJECT: A COPY OF THE COMMENTS SUBMITTED ON BEHALF OF YALE
TO OMB WITH RESPECT TO CIRCULAR A-21.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED: D.A. Henderson

ACTION STAFF
REQUIRED: ACTION: Bromley Signature

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT: 09/25/91

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: EXT:
REMARKS: Originally sent to DLS FYI; on 08/14/91 Bromley asked DAH for
comments; on 09/05/91 Bromley asked to discuss it with DAH and
subsequently asked that DAH prepare response for his signature.

OSTP RECEIVED: 08/02/91 FILE: P-LIFE SCIENCES-INDIRECT COST
DEPT RECEIVED: 08/14/91

"CORRESPONDENCE TRACKING"

TYPE: INFORMATION DOCUMENT NUMBER: 9123213
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/31/91

SUBJECT: A COPY OF THE COMMENTS SUBMITTED ON BEHALF OF YALE
TO OMB WITH RESPECT TO CIRCULAR A-21.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED:

ACTION STAFF
REQUIRED: ACTION:

*Don't
Commit!
DAB*

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: EXT:
REMARKS:

OSTP RECEIVED: 08/02/91 FILE: P-LIFE SCIENCES-INDIRECT COST
DEPT RECEIVED:

"CORRESPONDENCE TRACKING"

THE WHITE HOUSE

WASHINGTON

September 25, 1991

Dear Dorothy,

I thank you for your letter and the copy of your thoughtful comments as provided to Jack Sheehan.

The indirect cost reimbursement policies have been a long-standing problem and, given the events of this past year, a better formulation is urgently needed. A Task Force has been constituted under the chairmanship of senior OMB staff to develop more suitable and understandable regulations over the coming year. One of my senior staff will serve as Vice-Chairman of that Task Force.

In the meantime, the many pressures within Congress and the Executive Branch have made it necessary to issue interim regulations. Although they may not be optimal, they might forestall more draconian measures which could seriously harm our science infrastructure. Your concerns are well-founded and appreciated. Two of the concerns noted in your letter, "research allocations" and the "dedicated facilities fund," will be dropped and there will be some modifications to others pursuant to suggestions made by you and others and in informal meetings which have been held with senior administrators and scientists from a number of institutions. The final interim regulations will be published soon and, while perhaps failing to address fully some of the problems you raise, I believe they represent the best interim effort that can be made at this time.

I look forward to talking further with you as the process unfolds. I was glad to see you at our lunch with Bernadine.

Sincerely yours,



D. Allan Bromley
Director

Ms. Dorothy K. Robinson
General Counsel
Yale University
451 College Street
P. O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF SCIENCE AND TECHNOLOGY POLICY
WASHINGTON, D.C. 20506

September 25, 1991

Dear Dorothy,

I thank you for your letter and the copy of your thoughtful comments as provided to Jack Sheehan.

The indirect cost reimbursement policies have been a long-standing problem and, given the events of this past year, a better formulation is urgently needed. A Task Force has been constituted under the chairmanship of senior OMB staff to develop more suitable and understandable regulations over the coming year. One of my senior staff will serve as Vice-Chairman of that Task Force.

In the meantime, ~~because of~~ the many pressures within Congress and the Executive Branch have made it necessary to issue interim regulations. Although they may not be optimal, they might forestall more draconian measures which could seriously harm our science infrastructure. Your concerns are well-founded and appreciated. Two of the concerns noted in your letter, "research allocations" and the "dedicated facilities fund," will be dropped and there will be some modifications to others pursuant to suggestions made by you and others and in informal meetings which have been held with senior administrators and scientists from a number of institutions. The final interim regulations will be published soon and, while perhaps failing to address fully some of the problems you raise, I believe they represent the best interim effort that can be made at this time.

I look forward to talking further with you as the process unfolds.

*I have read
to see you at our lunch with Kervin.*

Sincerely yours,

D. Allan Bromley
Director

Ms. Dorothy K. Robinson
General Counsel
Yale University
451 College Street
P. O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074

*Paton White House
Stationery.*

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF SCIENCE AND TECHNOLOGY POLICY
WASHINGTON, D.C. 20506

September 24, 1991

Dear Dorothy,

I thank you for your letter and the copy of your thoughtful comments as provided to Jack Sheehan.

The indirect cost reimbursement policies have been a ~~much too~~ long-standing problem and, given the events of this past year, a better formulation is urgently needed. A Task Force has ~~now~~ been constituted under the chairmanship of senior OMB staff ^{to develop} with the expectation that more suitable and understandable regulations ~~can be~~ ^{developed} over the coming year. One of my senior staff will be serving as Vice-Chairman of that Task Force. ^{have made it}

In the meantime, ^{branch because of} and given the many pressures both within Congress and the Executive, ^{it was considered} necessary to issue ^{some} interim regulations, ^{which, if not} ^{be} ^{optimum} might at least forestall more draconian measures which would seriously harm our science infrastructure. Your concerns are well-founded and appreciated. Two of ^{the concerns} those noted in your letter, "research allocations" and the "dedicated facilities fund," will be dropped and there will be some modifications to others pursuant to suggestions made by yourself and others and in informal meetings which have been held with senior administrators and scientists from a number of institutions. The final interim regulations will be published soon and ^{some} while ^{perhaps} still failing to address fully certain of the problems you raise, I believe they represent the best interim effort which can be made at this time.

I look forward to talking further with you as the process unfolds.

Sincerely yours,

D. Allan Bromley
Director

Ms. Dorothy K. Robinson
General Counsel
Yale University
451 College Street
P. O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074

DRAFT to Robinson

Dear Dorothy; I thank you for your letter and ~~the~~ the copy of your thoughtful ^{as} comments provided to Jack Sheehan.

~~The~~ The indirect cost reimbursement policies have been a much too long-standing problem and, given the events of this past year, ^{and} a better ~~reconstruction~~ ^{formulation} is urgently needed. A Task Force has ~~been~~ ^{now} constituted under the chairmanship of senior OMB staff with the expectation that more suitable and understandable regulations can be developed over the coming year. One of my ^{senior} staff will be serving as Vice-Chairman of ~~the~~ Task Force.

In the meantime and given the many pressures both within Congress and the Executive, it was considered necessary to issue ^{some} interim regulations which, if not optimum, might at least forestall more draconian measures which would seriously harm ~~the~~ our science infrastructure. Your concerns ^{noted in your letter} are well-founded and appreciated. ~~these~~. Two of these "research allocations"

and the "dedicated facilities fund", will be dropped and there will be some
modifications to others pursuant to ~~the~~ suggestions made by yourself and others
in informal) and meetings which have been held with senior administrators and executives
from a number of institutions. The final interim regulation will be published
soon and while still failing to ~~meet~~ ^{address fully} certain of the problems you raise, I believe
they represent the best ~~interim~~ interim effort which can be made at this time.
I look forward to ~~discussing~~ ^{talking} further ^{with} you as the process
unfolds.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF SCIENCE AND TECHNOLOGY POLICY
WASHINGTON, D.C. 20506

August 20, 1991

MEMORANDUM TO ALLAN BROMLEY

FROM:

D.A. HENDERSON

SUBJECT:

ROBINSON LETTER ON INDIRECT COSTS

The letter is a thoughtful one which effectively highlights each of the major points presently in contention. I would note that responses to the Federal Register notice number perhaps 200 or so. Dorothy Robinson's observations are very much represented in the majority and are as well stated and as well thought out as any I have read.

We met on 18 August to discuss the shape of the final revisions. In brief, the drift is toward postponing implementation until July 1992; holding at the 26 percent cap; accommodating with appropriate language various rates of indirect costs provided by other than Federal agencies; the concept of a so-called "dedicated facilities fund" was never feasible for any number of practical and technical reasons and will be abandoned in favor of a reporting requirement; finally, language will be provided to clarify recovery of unallowable costs and interest rates. All in all, I believe the process is moving sensibly. By far, the largest single problem is the concern at NIH that they will not recover \$55 million in savings (200 grants) but somehow or other, I doubt that this will result in the collapse of the whole biomedical research enterprise, whatever our colleagues at NIH may believe.

*lets discuss with
what I would
respond to Dorothy
DAB*

"CORRESPONDENCE TRACKING"

TYPE: INFORMATION DOCUMENT NUMBER: 9123213
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS

FROM: ROBINSON, Dorothy K.: YALE UNIVERSITY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/31/91

SUBJECT: A COPY OF THE COMMENTS SUBMITTED ON BEHALF OF YALE
TO OMB WITH RESPECT TO CIRCULAR A-21.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED:

ACTION STAFF
REQUIRED: ACTION:

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: EXT:
REMARKS:

CLOSED

OSTP RECEIVED: 08/02/91 FILE: P-LIFE SCIENCES-INDIRECT COST
DEPT RECEIVED:

"CORRESPONDENCE TRACKING"

Yale University

RECEIVED

91 AUG 2 P 4: 25

3213
DOROTHY K. ROBINSON
General Counsel
451 College Street
P.O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074
Telephone: 203 432-4949

OFFICE OF THE
DIRECTOR

July 31, 1991

Dr. D. Allan Bromley
Assistant to the President for Science and Technology
Director, Office of Science and Technology Policy
Room 360, Old Executive Office Building
Washington, D.C. 20506

Dear Allan:

I have enclosed, for your information, a copy of the comments that we submitted on behalf of Yale to OMB with respect to the revisions to Circular A-21. In short, we are urging that the OMB-led process of developing more uniform cost accounting standards go forward expeditiously, and that it not be preempted by the precipitous imposition of a cap on administrative components of the indirect cost rate in the manner proposed.

As always, I would be more than happy to answer any questions you may have about our views, or to provide any information that would be useful to you.

With best regards,

Sincerely,



Dorothy K. Robinson

Enclosure

Yale University

DOROTHY K. ROBINSON
General Counsel
451 College Street
P.O. Box 1074 Yale Station
New Haven, Connecticut 06520-1074

Telephone: 203 432-4949

July 26, 1991

Mr. Jack Sheehan
Office of Management and Budget
New Executive Office Building
Room 10235
Washington, D.C. 20503

Dear Mr. Sheehan:

The following comments are submitted on behalf of Yale University in response to the invitation to comment on proposed revisions to the Office of Management and Budget (OMB) Circular A-21, "Cost Principles for Educational Institutions" published in the Federal Register on June 27, 1991 at p. 29530. We appreciate the opportunity to offer our views. As a major research institution, Yale University has very serious concerns about the proposed revisions and their implications, and believes that they should not be adopted as formulated.

Overall, we view indirect cost reimbursement policy as a critically important aspect of federal policy regarding support of university-based research. In the most general terms, policy since the mid-sixties has proceeded from the principle that the federal government, when sponsoring research, will reimburse the reasonable and necessary costs of the research. Significant departure from that principle toward mandatory cost-sharing by institutions raises the obvious question of whether alternative revenue sources such as tuition income or private charitable contributions can and should be called upon to subsidize the unreimbursed costs of government-sponsored research (surely, it would be wrong to "tax" students for these costs, and gift income is already overburdened by institutional demands), or alternatively, whether research programs will have to be curtailed. The proposed revision to Circular A-21 states that it is intended to address "excessive administrative costs." But it is logically unconnected to that problem, which has not been factually demonstrated, because of its arbitrary approach. It is also unrelated to alleged "abuses" of the system, which have already been addressed by OMB in its proposed revisions to Circular A-21 published on May 5, 1991, clarifying and adding certain types of expenses as unallowable. Those types of expenses in any event have not been shown to broadly affect administrative cost categories at universities or to significantly affect indirect cost rate calculations.

We welcome reform of the system for measuring and reimbursing indirect costs, which has proven to be poorly understood and contentious in large part because of allowance for different costing methods among institutions -- a feature that in other ways has served the system well. However, that reform should follow and reflect, and not precede, thorough study of the issues. OMB Director Richard Darman announced on May 15, 1991 the initiation of a Task Force to review the overall Circular A-21 mechanism and cost accounting standards for federal research grants. We understand that this effort will lead to the derivation of generally applicable cost accounting standards that will bring greater uniformity to the manner in which costs are treated as direct or indirect, and assigned to indirect cost pools. We applaud that undertaking, and urge that it be undertaken expeditiously and in consultation with representatives from the university community. We are hopeful that such standards can be the

basis for a system of full cost reimbursement in which the public, the government and the universities all can have confidence and which will operate equitably among institutions that have differing environments, structures and actual cost burdens.

1. Limitation on Administrative Costs

The imposition of a 26% cap on three administrative cost components limits reimbursement without regard to the legitimacy of the expenses or their necessity. It is a significant departure from the prevailing principle of cost-based reimbursement, essentially imposing on an arbitrarily selected set of universities a major and punitive burden of cost-sharing that may amount for some to as much as \$10 million annually in under-reimbursement. Yet there is no evidence that administrative costs at these particular universities are excessive in relation to any defined standard that accounts for differences in structure, accounting methods and cost burdens among universities. Nor has there been any demonstration that capping administrative costs bears any relation to any general or specific pattern of alleged abuse in indirect cost reimbursement at those universities.

Indeed, there is currently no valid basis for imposing a single rate of reimbursement for these three categories of administrative costs. First, different universities incur different costs for structural, geographic or other reasons. Urban universities bear costs for security that are unnecessary in rural locations; private universities bear certain kinds of costs that are not passed on to some public universities by their states, or may be covered in state appropriations; labor costs vary significantly in different parts of the country; universities that conduct little biomedical research do not incur expenses associated with animal care; and so on. Costs should be expected to vary among institutions, and differences have no necessary relationship to efficiency.

Second, universities, with the approval of their cognizant agencies, and as permitted by Circular A-21, have employed different methods of charging expenses to direct or indirect categories, and of assigning indirect expenses to one or another of the seven indirect cost pools. Thus, for example, some universities include security costs under operation and maintenance expenses, while others, such as Yale, include these costs in an administrative category. Some universities include facilities management costs under operation and maintenance expenses. Yale includes some of these in an administrative category. Some universities include the cost of radiation, chemical and biological waste disposal and safety costs under operation and maintenance expenses. Yale includes many of these costs in an administrative category. For some universities, the so-called administrative categories include the cost of handling and storing research materials, the cost of freight and transportation, the cost of complying with federal regulations for human subjects, animal care, and safety, the cost of employee parking, the cost of communications and other activities, while at other institutions these may be included in other indirect cost pools, or in some instances charged directly.

The foregoing differences in treatment of costs at different universities have been an important reason for calls to develop more uniform methodologies. Those will emerge, we hope, from the work of the OMB-led Task Force. We urge that this Task Force work closely with representatives of the research university community to ensure the feasibility and effectiveness of its recommendations. Most importantly, we urge that this process of studied review not be preempted by the imposition of a cap such as is proposed. An arbitrary limit not only does not allow for the rational recognition of valid costs, and does so in a punishing and discriminatory way among institutions, but it virtually would invite easy and repeated manipulation for short term federal budgetary gain without regard to potentially devastating

research policy implications. It also takes no cognizance of dramatically increasing cost burdens of federal regulations in many administrative areas.

2. Effective Date.

As proposed, the 26% cap would apply to sponsored agreements awarded, amended, continued, or renewed after September 30, 1991. As indicated above, we have serious objections to a cap in any event. However, the immediate effective date magnifies the unfairness of a cap, by imposing additional severe hardship on affected universities which will have insufficient lead time to adjust their budgets, reassign or terminate affected employees (who typically enjoy rights to notice under collective bargaining agreements or employment contracts or policies), or to modify ongoing research programs.

Moreover, were a cap to be implemented, there is an obvious unfairness in abrogating existing agreements, and permitting unilateral adjustments by cognizant agencies based on information in their files. This is particularly so in the case of predetermined rates, which represent a negotiated, compromise "bottom line" derivation of an overall rate, typically without set component parts.

3. Freeze of Accounting Designations

The proposal would effectively freeze accounting designations, existing as of May 1, 1991, of costs as either direct or indirect, and administrative as opposed to assignable to another indirect cost pool. This provision arbitrarily and unfairly penalizes some universities for past accounting choices they have made in full conformity with Circular A-21 while leaving others unaffected. Under the proposal, changes could be made in an institution's charging practices only where they are "at variance with acceptable practices followed by a substantial majority of other institutions," and if such a change is permitted by the cognizant agency. There is no reason to believe that only those practices currently followed by a "substantial majority" of institutions will ultimately be endorsed as the correct uniform standards, after the OMB-led Task Force and the Cost Accounting Standards Board carry out their studies. Perhaps some "minority" methods are superior. Moreover, data on what practices are followed by a "substantial majority" of schools does not, to our knowledge, even exist. Such information has never been made available by the government to individual institutions. This rule simply does not square with the objective of moving toward an agreed upon, generally accepted set of cost accounting standards.

4. Research Allocations

We have no objection to clarifying existing A-21 policy concerning the allocation of costs for university research activities sponsored by industry or foreign governments. Certainly, federal funds should not be used to subsidize research programs funded by industry and foreign governments. If the cost allocation is done properly, federal indirect cost rates currently do not reflect or subsidize in any way the costs of non-federally sponsored research. However, we note that differences in indirect cost rates charged to federal and industrial and foreign governments do not necessarily indicate a cross-subsidy. Moreover, the distribution of costs associated with research funded by industrial and foreign government sponsors between direct and indirect categories should not have to conform to that used for federally-sponsored research.

5. Dedicated Facilities Fund

As a matter of accepted accounting practice, depreciation recognizes the recovery of past investment for capital items. The proposed revision of Circular A-21 treats depreciation recoveries as revenue for new capital spending or paying debt on borrowing for research facilities. It thus restricts university funds doubly, in that funds already spent in the past for the requisite purpose of research facilities would be newly encumbered, while discriminating against situations where the university has used institutional rather than borrowed funds in the past to build or renovate. While unquestionably universities face enormous needs for capital refurbishment, and the intent to help them meet this need is laudable, in fact universities spend many times the amount of depreciation and use allowances they receive each year on research laboratory renovation and replacement. Thus, the dedicated fund is unnecessary to meet that objective, and contrary to appearances, it would not represent new (and badly needed) government support for those purposes. Rather, it would simply create another unnecessary administrative burden with no benefit to the institution or the government, and at a time when OMB has indicated its concern about the level and efficiency of university administrative expenditures. An elaborate system of pro rata allocations would have to be instituted for facilities that have mixed uses, as many do. Moreover, there is no designated length of time for the restriction on these funds. This provision imposes unwarranted restrictions, as well as micromanagement, on university funds and does so without rationale. We recommend that it be omitted.

6. Adjustment of Indirect Cost Rates and Refunds

The proposed method for recovering costs found to be unallowable requires a university to make a cash refund with interest, in the case of past periods, and, in the case of a current period, permits the cognizant agency at its discretion to require a refund or make a rate adjustment. We suggest clarification to provide that if a category of costs was allowable at the time of reimbursement of the costs, or, in the case of a predetermined rate, at the time of the rate proposal and negotiation, then no refund or rate adjustment should be required simply because of later redefinitions of allowables. It would be grossly unfair to subject universities to the retroactive application of shifting definitions and redefinitions of allowables.

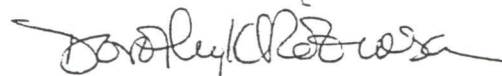
Moreover, in the case of predetermined rates, allowable costs for the covered years, when actually calculated, may significantly exceed the negotiated rate. (Even in the proposal year, the actual expenses will typically exceed by some amount the final negotiated rate.) Should there later be found to be unallowable costs in the proposal year, in the absence of fraud or intentional wrongdoing there should be no prohibition against substituting other allowable but unrecovered costs for those found unallowable. Finally, there should not be any assumption of unallowable costs made in subsequent years on the basis of a projection from the proposal year. Rather, each year, if necessary, should be separately examined, and, in the absence of fraud or intentional wrongdoing, unreimbursed, allowable costs (i.e., allowable costs in excess of the predetermined rate) should be permitted to be substituted for any costs in such years found to be unallowable.

In summary, Yale University supports efforts to derive improved, more uniform cost accounting standards as the basis for reform of the Circular A-21 reimbursement mechanism. We urge that that undertaking, commenced by the OMB-led Task Force, be consistent with and further the principle of reasonably determined, cost-based reimbursement that has underlaid the

success of university-based research in recent decades. The precipitous imposition of a cap on administrative costs prior to this review, we believe, would have damaging and patently unfair consequences not only for those institutions directly affected, but also more broadly by reducing rather than building the rationality of the reimbursement system. We urge that OMB reconsider this proposal, and defer major action until after the cost accounting reviews.

We appreciate this opportunity to present our views.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read 'Dorothy K. Robinson', with a long horizontal flourish extending to the right.

Dorothy K. Robinson
General Counsel

"CORRESPONDENCE TRACKING"

TYPE: ACTION DOCUMENT NUMBER: 9123288
ORIGINATOR: 02 STATUS I DIRECTORATE STATUS

FROM: CRECINE, John P.: GEORGIA INSTITUTE OF TECHNOLOGY

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/26/91

SUBJECT: REQUEST FOR REACTIONS ON THE ENCLOSED STATEMENT OF
THE LIKELY IMPACT OF THE OMB PROPOSED CAP ON THE
RECOVERY OF THE INDIRECT COST COMPONENT OF
FEDERALLY-FUNDED UNIVERSITY RESEARCH PROJECTS.

DIRECTORATE STAFF
ASSIGNED: LIFE SCIENCES ASSIGNED:

ACTION STAFF
REQUIRED: AS NECESSARY ACTION:

SENDER'S DUE DATE:
OSTP DUE DATE: 08/19/91 STAFF DUE DATE
DATE COMPLETED: 8/9/91 DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
Carl Bretscher

WHITE HOUSE TRACKING #: CONTACT PERSON:
REMARKS: *No action Necessary* PHONE: EXT:

OSTP RECEIVED: 08/06/91
DEPT RECEIVED:

FILE: P-LIFE SCIENCES-INDIRECT COST

RECEIVED

91 AUG 6 A 9:24

3268
Georgia Institute of Technology
Atlanta, Georgia 30332-0325
404•894•5051
404•853•9163 FAX

July 26, 1991

OFFICE OF THE
DIRECTOR

O. Allan Bromley
Science Advisor to the President
and Director of the Office of Science
and Technology Policy
Office of Science and Technology Policy
Old Executive Office Building
17th and Pennsylvania Avenue, NW
Washington, D.C. 20506

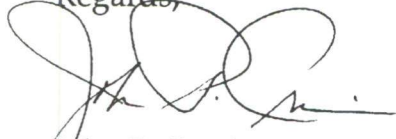
Dear Mr. Bromley:

In response to the OMB-proposed cap on the recovery of the indirect cost component of Federally-funded university research projects, I have prepared the enclosed statement of the likely impact of the OMB proposal. It is clear that the proposed provision, by further undermining the recovery of full project costs by the nation's research universities, serves to weaken our research capabilities, seriously undermines the undergraduate education programs in these institutions, and by singling out universities, places research universities at a further competitive disadvantage in relation to other non-profit and for-profit R&D organizations.

I hope you will examine this statement and take these arguments into consideration in determining your position on what I feel is an extremely important issue. I would appreciate your reaction. Feel free to distribute this in any way you see fit.

Thank you for your time and support.

Regards,



John P. Crecine
President

JPC/lid

Federally-Funded Research In Universities: Impact of Proposed OMB Indirect Cost Provisions

John P. Crecine
President, Georgia Institute of Technology
July, 1991

Most of the nation's research and development functions are carried on outside of the Government, in private and university-based research facilities, and are conducted by non-Federal employees. Most of the Federal Government's extramural research activities are conducted by the top 100 research universities in the United States. *Historically, there has been a clear and consistent position taken by the Federal Government in terms of the financing of research conducted by non-Federal institutions, namely a policy which allows the full recovery of all costs associated with the conduct of the research under Federal research contracts.* During the last decade there has been a clear trend toward more and more sharing of the total costs of research, where either the institution performing the research or some other agency (usually an industrial firm or State government in the case of public universities) share in financing the recovery of total research costs -- "cost sharing."

The rules for determining total costs have become increasingly elaborate, and in the case of research universities, subject to tighter restrictions and definitions of exactly which costs and institutional operations were directly associated with research. The Government has traditionally viewed this as a cost accounting problem and has focused on increasingly-precise measurement of those costs directly associated with research. E.g., increasingly elaborate procedures for measuring the time a faculty member spends directly on research as opposed to the educational and service activities of a university.

Over the past twenty years, the rules for calculating indirect or overhead costs associated with research have become more elaborate, precise, and restrictive as well. Research universities have educational, service, and research missions. Allocating central costs among the varied activities of a research university so as to determine costs that legitimately belong in the pool of indirect costs that can fairly be attributed to research has become more complicated and restrictive. Universities with significant numbers of Federally-financed research contracts often have a team of Federal auditors permanently located on their campuses, examining procedures for keeping accurate records of direct costs attributable to specific research projects and auditing those costs the university includes in its indirect cost pool. Future research contracts between the institution and the Federal Government then include an indirect cost charge which is a percentage of the direct costs. This charge is based on Federal auditors' recommendations.

More than a decade ago, OMB imposed new procedures for keeping track of researchers' time spent on particular research projects (OMB Circular A-21 guidelines). This was in response to an abuse where an individual was simultaneously billing the government for 100% of his salary for research at Stanford University on a Federal contract and for 100% of his salary for research at Stanford Research Institute on another Federal contract. The OMB response was to force research professionals to keep more accurate track of actual time spent on Federally-funded research activities.

Recently, OMB has proposed new procedures for calculating the elements of indirect costs attributable to research that can then be recovered by the institution through an indirect cost charge on future research. Indirect cost rates for current and future contracts are now based on audited indirect cost experience by the institution in previous years, so charges temporarily lag actual experience. There are several broad categories of indirect costs and explicit accounting guidelines for each. One of these categories is "administrative" expenses. Another category is "depreciation or use allowances for buildings and equipment" associated with research.

The regulations governing research cost reimbursement have always been in the context of "total cost recovery" for the institution or university.¹

In June of 1991, OMB proposed a set of regulations that would limit the administrative component of indirect cost reimbursement to 26% of a research project's direct costs. The proposed² 26% administrative cap was in response to another set of abuses by Stanford University. The 26% cap is independent of the true cost structure of the institution conducting the research, the nature of the research, or any consideration of the accounting system employed by the institution which determines whether a particular cost is the basis for a direct or an indirect charge. Whatever the real evidence, the answer to the question (as determined by Federal guidelines and accounting procedures) of the size of the administrative component of indirect costs, the Federal government will only allow the institution to recover up to 26%. If the real, indirect administrative costs are more than 26%, the Federal government will not allow full cost recovery. Based on current Federal auditing procedures, all or nearly all research universities' true administrative costs exceed 26% of direct costs.

This artificial constraint on full cost recovery destroys the consistency in Federal policy to date and will not allow full recovery of the costs of research. *It is interesting to note that the proposed regulation only applies to universities and not to the other providers of Federal research services, whose indirect costs are generally 50% to 100% higher than those of universities.*

The artificial constraint on full cost recovery, in effect, creates powerful incentives for a university to internally organize its research in a way that isolates research from other university missions (e.g., separates research from education) so that many administrative charges can be direct costs, thus escaping the 26% cap, rather than indirect charges and subject to the cap. For example a department of electrical engineering or chemistry in a research university would usually use the same organization to supervise educational programs as to supervise its Federally-sponsored research programs. Under these circumstances, departmental administration would be an indirect cost that has to be distributed between education and research functions. With a 26% cap there is a powerful incentive to conduct all research in an organization unit that only does research so that departmental administrative costs would all be direct charges and not subject to the 26% cap. *The actual effect of the proposed OMB provision to cap indirect administrative costs at 26% is to dictate a particular kind of organizational arrangement in research universities*

¹ It may be that the Federal granting agency requires some other entity to "share" the costs by participating in the financing of the research project, but always in the context of an accurate calculation of total project cost.

² This proposed regulation was recently embodied in the House NSF Authorization Bill (H.R. 2282).

and could be seen as overly intrusive. The real total costs of research would most likely be higher under an arrangement where research is separate from other university functions, creating the need for dual administrative structures.

If, indeed, the purpose of the Federal government is to determine accurately the total costs of Federally-funded research activities in universities, and to prevent inefficiencies and overcharges, creating an artificial cap on *one* cost component does not seem to be a sensible or fair way to approach the issue. More careful auditing and more precise accounting would seem more appropriate.

If fairness and accuracy in determining total research costs is the objective, then careful examination of existing Federal reimbursement practices for use of equipment and facilities would seem to be required. As research, especially in the physical sciences, engineering, and medicine becomes more capital intensive, this component of research costs becomes more and more important. If one examines equipment and facility usage charges or depreciation expenses one instantly sees that universities seriously under-recover research costs. Federal cost-recovery guidelines assume a 50-year life (2% depreciation/usage charges) for buildings and research facilities, a 15-year life for equipment and instruments, and a 7-year life for computers. Each of these guidelines leads to a 100%-300% under-recovery of capital costs. *If the Federal policies toward recovery of indirect costs of research by universities are to be re-examined, then clearly the largest single "abuse" is the gross disparity between true equipment and facility costs and the charges allowed by the Federal Government.*

The primary impact in research universities, public or private, of the under-recovery of total research costs -- whether that under-recovery is due to an artificial cap on administrative costs or grossly inadequate equipment and facility charges -- is a negative impact on undergraduate education. Quite simply the costs of the under-recovery of research costs are nevertheless real costs, incurred by the institution and must be financed somewhere else in the budget. In private universities, this must come partly from private fund raising efforts, but more often from higher tuition charges to its students. In public universities it primarily comes in the form of higher student-faculty ratios, State appropriations, and higher tuition costs. The proposed regulations (26% cap) and existing policies (under-recovery of capital costs associated with research) ultimately attack the educational programs of the nation's public and private research universities.

If the policy objectives of the Federal Government are aimed at weakening the undergraduate educational programs of the nation's research universities or at reducing the amount of Federally-sponsored research done in universities vs. other for-profit and not-for-profit institutions, then it would seem preferable to use more direct approaches. If the policy objectives are to reduce overall costs of Federally-sponsored research and create incentives to fairly report true costs in determining both direct and indirect charges, then there are much better ways to proceed -- approaches that should be applied to all institutions performing research services under Federal sponsorship.

"LIFE SCIENCES (CORRESPONDENCE TRACKING)"

TYPE: INFORMATION DOCUMENT NUMBER: 9122812
ORIGINATOR: 02 STATUS C DIRECTORATE STATUS C

FROM: KENNEDY, Donald: STANFORD CENTENNIAL

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/19/91

SUBJECT: DOCUMENTS PERTAINING TO SIGNIFICANT CHANGES TAKING
PLACE AT STANFORD WITH RESPECT TO THEIR MANAGEMENT
OF AND ACCOUNTING FOR INDIRECT COSTS.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED:

ACTION STAFF
REQUIRED: ACTION:

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
PHONE: 415/723-2481 EXT:
REMARKS: Dr. Bromley asked DAH for comments. DAH stated that he did not
think the letter needed a response and that the attachments had
received VERY WIDE DISTRIBUTION -- DAH already has 2 sets!

OSTP RECEIVED: 07/25/91 FILE: P-LIFE SCIENCES-INDIRECT COST
DEPT RECEIVED:

"CORRESPONDENCE TRACKING"

TYPE: INFORMATION

DOCUMENT NUMBER: 9122812

ORIGINATOR: 02

STATUS C

DIRECTORATE STATUS

FROM: KENNEDY, Donald: STANFORD CENTENNIAL

TO: DR. D.A. BROMLEY

DATE OF
CORRESPONDENCE: 07/19/91

SUBJECT: DOCUMENTS PERTAINING TO SIGNIFICANT CHANGES TAKING
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OF AND ACCOUNTING FOR INDIRECT COSTS.

DIRECTORATE STAFF
ASSIGNED: ASSIGNED:

ACTION STAFF
REQUIRED: ACTION:

SENDER'S DUE DATE:
OSTP DUE DATE: STAFF DUE DATE
DATE COMPLETED: DATE COMPLETED/DEPT:

COPIES TO: D. Allan Bromley
LIFE SCIENCES

WHITE HOUSE TRACKING #: CONTACT PERSON:
REMARKS: PHONE: 415/723-2481 EXT:

OSTP RECEIVED: 07/25/91 FILE: P-LIFE SCIENCES-INDIRECT COST
DEPT RECEIVED:

**EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF SCIENCE AND TECHNOLOGY POLICY
WASHINGTON, D.C. 20506**

July 30, 1991

NOTE FOR ALLAN BROMLEY

FROM: D.A. HENDERSON

**SUBJECT: LETTER FROM DONALD KENNEDY
(Corres. Tracking #9122812)**

**I would recommend no letter in response. The
attached documents have been very widely distributed.**

I have already received two sets!

*Agreed
10/5/91*



Dr. Allan Bromley
Assistant to the President for Science
and Technology
Old Executive Office Building, 360
17th Street & Pennsylvania Ave, NW
Washington, DC 20506

2817
RECEIVED

July 19, 1991

91 JUL 25 P 2:48

OFFICE OF THE
DIRECTOR

Dear Allan:

As you are aware, the indirect costs of federal research contracts and grants at Stanford and other universities have been scrutinized closely during the past year. Some of these investigations revealed evidence of errors and inappropriate costs that were included in Stanford's indirect cost submissions.

Because the stewardship of federal research funds is an important public trust, I want to bring to your attention an initiative Stanford is undertaking to correct past deficiencies — and to implement reforms that will ensure sound, effective management of federal research funds now and in the future.

Enclosed are three documents pertaining to significant changes taking place at Stanford with respect to our management of and accounting for indirect costs — 1) A Program to Reform Financial Controls in Federally Sponsored Research at Stanford, 2) The final report of an Arthur Andersen & Co. seven-month study of Stanford's internal controls, and 3) A statement by a special outside Advisory Panel established to advise Stanford on accountability for federal research contracts and grants.

We believe that the actions and commitments described in the enclosed documents demonstrate Stanford's determination to correct past deficiencies and to implement reforms that will ensure sound, effective management of and accounting for indirect cost issues now and in the future.

Federal investment in basic scientific research at universities, including Stanford, has yielded extraordinary benefits to the nation. We hope the steps we are taking will assure you of Stanford's full accountability for public funds.

If you have any questions or comments, please call me at 415/723-2481.

With best regards,

Sincerely yours,

Donald Kennedy
President



STANFORD UNIVERSITY
A PROGRAM TO REFORM FINANCIAL CONTROLS
IN FEDERALLY SPONSORED RESEARCH

JULY 1991

Introduction: A Commitment to Act

Recent government audits and reviews by the Office of Naval Research (ONR), the Defense Contract Audit Agency (DCAA), the General Accounting Office (GAO), and the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Rep. John D. Dingell, have produced widely publicized evidence of error and inappropriate costs in Stanford's submissions for reimbursement of the indirect costs of federally sponsored research.

As a result of these outside investigations and the University's internal reviews, Stanford recognizes that there have been errors in indirect cost submissions and is committed to implement fundamental changes in the financial controls system and the way the University conducts its accounting. As President Donald Kennedy said in his March 23 statement: "Our obligation is not to do all the law permits, but to do what is right." This document describes the steps the University is taking to reestablish Stanford's reputation for integrity and sound management.

For decades, the nation's universities and the federal government have been in a successful partnership to carry out most of the basic research done in the United States, to train the next generation of our nation's scientists and engineers, and to discover and utilize fundamental knowledge that can benefit society. Universities conduct critical basic research in a variety of areas, including engineering, basic sciences like physics and chemistry, and medicine; medically related fields account for about half of the sponsored research at Stanford. In this partnership, the federal government provides grants and contracts that cover most of the reasonable costs of doing research, both the direct costs that can be attributed to individual projects and the indirect costs that must be borne by the institution as a whole to make these research efforts possible. Universities, including Stanford, have subsidized through cost-sharing the direct and indirect costs in the past and will continue to do so in the future. The partnership between universities and the federal government must be built on mutual trust. Stanford is determined to reestablish this trust.

1. Arthur Andersen & Co. Review of Internal Controls

In January, Stanford hired Arthur Andersen & Co. to make an independent evaluation of the University's systems and procedures related to government contracts and grants and to recommend appropriate improvements. The University's Board of Trustees has accepted the Arthur Andersen report. This report contains 35 detailed recommendations, which resulted from an in-depth review of Stanford's accounting systems and control procedures related to the accumulation, classification, allocation and billing of costs under federal government contracts and grants. Key recommendations of the Arthur Andersen report are:

- Develop a comprehensive written code of ethics and conduct which sets forth the standards that govern the conduct of all University employees.
- Establish the position of Compliance Support Officer to help facilitate compliance by all Stanford employees with applicable laws and regulations.
- Establish mandatory training for academic and administrative personnel with responsibility for matters related to government contracts and grants.
- Develop a clear and concise Accounting System and Sponsored Agreement Administration Manual to serve as a practical guide for principal investigators and administrative personnel involved in federal contract- and grant-related activities.
- Consolidate cost accounting practices into a Cost Accounting Practices Manual to serve as a guide for University accountants regarding the accumulation, classification, and allocation of costs under federal government contracts and grants.
- Establish accounts to capture unallowable costs and procedures for more effective front-end screening.
- Develop comprehensive indirect cost review submission policies and procedures.
- Revise and obtain Board of Trustees' approval of a policy regarding the granting of indirect cost waivers — that is, those instances in which Stanford waives all or part of the indirect costs of a contract or grant and bears those costs itself.
- Strengthen property administration by linking the equipment inventory system with the financial accounting system and by ensuring adherence to the biennial physical inventory requirements.

institute a new program of financial and compliance auditing. The new organization will include Certified Public Accountants, Certified Internal Auditors, Certified Information Systems Auditors and auditors experienced in governmental grant and contract compliance auditing. The Director of Internal Audit has also been assigned responsibility for the liaison function with all outside auditors. In this capacity, he is responsible for ensuring full and timely cooperation with all government and other external audits.

- ***A New External Audit Team*** Over the last several months, the Audit Committee of the Board of Trustees conducted an extensive search for a new external audit firm. Coopers & Lybrand, the firm which had previously been Stanford's external auditor, was selected because of its superior knowledge and experience in university auditing. However, at Stanford's request, Coopers & Lybrand has appointed an entirely new team, which includes experts in university accounting and indirect cost matters from around the country. The engagement partner, who is one of the nation's foremost auditors of universities, will relocate his office from Boston to San Francisco to oversee the Stanford audit. The University has expanded Coopers & Lybrand's duties to specifically include examination of Stanford's handling of indirect cost accounting. Stanford has also asked Coopers & Lybrand to periodically evaluate the quality of the University's internal audit function.

5. Management Review

President Kennedy has requested that Arthur Andersen undertake an independent, outside review, beginning with the Board of Trustees and the President's Office, to identify any management weaknesses or failures of communication in regard to financial issues related to federally sponsored research. A member of the Stanford Graduate School of Business faculty will participate in this review. The review should be completed by the end of the summer.

6. Prompt Resolution of Outstanding Audit Issues

President Kennedy and the Board of Trustees have reaffirmed that Stanford will continue to cooperate fully with all audits and investigations and do everything possible to expedite government review of Stanford's past submissions. Accordingly, the University has:

- Withdrawn \$1.35 million in unallowable and inappropriate costs previously submitted for reimbursement during the past decade.
- Transferred from the Stanford Controller to the newly appointed Stanford Director of Internal Audit responsibility for the liaison function with government auditors.

research effort. The Panel encourages the cognizant governmental agencies and the University to consider, amend, reform, and certainly, simplify the procurement process and its accounting and reporting requirements, particularly as to indirect costs.

(The full statement of the Advisory Panel contains extended general comments on the indirect cost issue. The statement can be obtained from the Stanford University Office of Public Affairs, Building 170, Stanford, CA 94305. Telephone: 415/723-2862.)

3. Arthur Andersen Review of Potentially Controversial Costs — Scrubbing of Inappropriate Costs

Stanford is committed to withdrawing all unallowable and inappropriate costs.

Arthur Andersen has been asked to review the University's indirect cost submissions for the open years of the 1980s. They will identify any indirect costs submitted for reimbursement that might be inappropriate and which have not already been removed. All items such as those identified by ONR, DCAA, GAO and the Subcommittee on Oversight and Investigations will be included in the review. A special internal University advisory group — including faculty members — will be appointed and asked to review Arthur Andersen's list of issues and to make recommendations as to how the University should handle these potentially controversial costs.

Arthur Andersen is also assisting the University in the preparation of its indirect cost submissions for 1989 and 1990.

4. New Financial Management Team

- ***A New Chief Financial Officer (CFO)*** Following a seven month search, Peter W. Van Etten was appointed the new Stanford CFO, effective July, 1991. Mr. Van Etten has extensive management experience at universities and in health care, most recently as Deputy Chancellor for Management and Finance at the University of Massachusetts Medical Center. The CFO reports to the President and is responsible for financial control, internal audit, and related functions. The new CFO's highest priorities will be to lead the implementation of the Arthur Andersen recommendations for change in Stanford's accounting and financial control practices and to resolve outstanding audit and rate-setting issues.
- ***A New Director of Internal Audit*** Reed N. Brimhall, a Certified Public Accountant and an experienced auditor, began work as Stanford's new Director of Internal Audit in late April, 1991. Mr. Brimhall previously worked for the accounting firm of Deloitte & Touche. Working with the President, the CFO, and the Audit Committee of the Board of Trustees, the new Director will reorganize the Internal Audit Department and will

President Kennedy has ordered the rapid implementation of all of Arthur Andersen's recommendations. The most urgent aspect of these recommendations relates to identifying and segregating unallowable and inappropriate costs at the time the costs are incurred. These recommendations and an associated training program will be implemented by September 1, 1991.

Arthur Andersen has also been asked to issue reports every six months to the Board of Trustees and to the special Advisory Panel (see below) documenting the University's progress in meeting these recommendations. These reports will be made public, as have the Arthur Andersen report and recommendations.

2. Special Advisory Panel

Last January, President Kennedy appointed a special outside Advisory Panel on Standards of Accountability for Federal Research Costs to advise the University on contract and grant issues. The Panel members are:

- Mr. Joseph E. Connor, Chairman, Price Waterhouse World Firm
- Dr. Timothy S. Healy, President, New York Public Library
- Admiral Bobby R. Inman, former Director, National Security Agency and former Deputy Director of Central Intelligence
- Mr. Paul O'Neill, Chairman and Chief Executive Officer, Alcoa
- Dr. Maxine Singer, President, The Carnegie Institution of Washington

The Panel reviewed the Arthur Andersen internal controls report and met both with Arthur Andersen staff conducting the study and with selected Stanford staff, officers, and Trustees. In a July 9 statement to the Stanford Board of Trustees, the Panel made three observations. The Panel believes that:

- The allegations made against the University are very serious, and corrective efforts have appropriately been made a high priority. The University has now directed its staff as to what is expected by way of ethical business practice — a prerequisite for the cultural change needed for implementing the recommendations for improving existing procedures.
- Effective implementation of the Arthur Andersen recommendations will give reasonable assurance of providing sufficient and appropriate internal accounting controls.
- The University's previous procedures have been appropriately criticized, but the Panel is concerned that the extent of additional accounting that the University may now undertake may result in excessive attention to accounting detail. Both the government and the University should strive to strike an appropriate balance between needed research, appropriate reimbursement of costs, and proper administrative accountability of the

- Assigned Arthur Andersen to assist Stanford in complying with government efforts to resolve open issues.
- Retained outside consultants to conduct cost studies in a number of disputed areas such as libraries, utilities, student services, building depreciation, and equipment inventory and depreciation. Members of the Stanford faculty will be deeply involved in the review of cost study methodologies in order to ensure that Stanford arrives at a fair distribution of costs between research and instruction.
- Responded to about 11,000 requests for information from six separate federal inquiries and provided approximately 75,000 pages of documents.

7. Reporting and Reviewing Allegations of Misconduct

- Faculty and staff at Stanford are encouraged to report suspected fraud and misconduct — anonymously if they prefer. The names of the offices to which such reports should be directed have been published in Stanford's newspaper, the *Campus Report*, and specific information on reporting misconduct will be sent to all Stanford employees along with the new written code of ethics and conduct (see Arthur Andersen recommendation on page 2).
- President Kennedy has promised that Stanford will review all charges of misconduct and take action where appropriate. Stanford asked the law firm of Arnold & Porter, along with Arthur Andersen, to conduct an investigation into several matters that were raised at a Congressional hearing in March. Their review was completed in June, and it found no criminal wrongdoing by any Stanford employee. Stanford has fully cooperated with government inquiries about possible misconduct and will continue to do so in the future.

Conclusion

The reform program outlined above combines extensive involvement by outside groups — including Arthur Andersen, Coopers & Lybrand, and the special Advisory Panel — together with new financial management to oversee the restructuring of Stanford's accounting and financial controls related to federally sponsored research. In addition, an extensive system of checks and balances regarding research accounting has been developed using internal and external resources. We are confident that, once this reform program has been implemented, Stanford will be able to avoid the errors and inappropriate submissions that have been the subject of so much attention.

SPECIAL ADVISORY PANEL TO STANFORD UNIVERSITY
STANDARDS OF ACCOUNTABILITY - FEDERAL RESEARCH COSTS

July 9, 1991

To the Board of Trustees
Stanford University

In response to the invitation of the president of Stanford University, Donald Kennedy, we have undertaken to advise Stanford as to recommendations being made to improve the University's accounting for indirect costs related to government-sponsored research efforts carried out by the University.

These recommendations have been made by the accounting firm of Arthur Andersen & Co. as part of Stanford's response to allegations and criticisms by a Congressional Subcommittee, US government auditors, and others of the University's practices in seeking recovery of a number of such indirect costs in submissions made under US government procurement regulations.

In our advisory role we have met with a number of University employees responsible for identifying and reporting such indirect costs, with the Arthur Andersen & Co. staff reviewing the present accounting activities in the indirect cost area, and with selected University trustees and officers. We have studied the problem areas, reviewed the work plan of Arthur Andersen & Co., considered their initial recommendations, and offered suggested changes to further improve these initial recommendations.

We are now prepared to offer our opinion on the adequacy of the final recommendations in meeting the University's intent to comply fully with government procurement regulations. After these comments, we make additional remarks concerning more general issues that surround the federal support of university research.

As a first observation, this Advisory Panel recognizes that the allegations made against the University of impropriety and inadequacy as to its accounting for indirect costs are very serious. The University appropriately has made corrective efforts a high priority. In our view, that is the right priority. We believe

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senior management of the University has reacted to this experience by giving clear and unequivocal direction to the University staff regarding management's expectation by way of ethical business practice concerning accounting for and reporting of costs supporting academic research. We view the University's action as a prerequisite in bringing about the cultural change needed to sustain a business process responsive to its obligation to conform to applicable procurement rules and regulations. This needed cultural attitude makes meaningful the necessary framework for implementing the recommendations aimed at improving existing procedures.

As a second observation, it is the Advisory Panel's opinion that the recommendations offered by Arthur Andersen & Co., as amended by the suggestions made by us, are appropriate. If put in place effectively, these recommendations give reasonable assurance of improving the control environment and providing appropriate internal accounting controls sufficient to account for and report indirect costs relating to US government-sponsored research projects in an accurate and responsible manner.

This is not to say that the expanded accounting control and reporting system for indirect costs can be expected to prevent all error or all misstatements. In the real world this is simply not possible. Any accounting system involves judgment in identifying costs and is subject to inadvertent human error in processing transactions and aggregating amounts. In reviewing the recommendations as a total package, however, the Advisory Panel believes a substantial good-faith effort has been made to design a system that should be capable of a significantly improved level of regulatory compliance reporting. We believe the new system should be responsive to correcting the deficiencies alleged as to Stanford's present practices.

We have a third observation, one about which we feel very strongly. While advising the University as to the acceptability of the Arthur Andersen & Co. recommendations for the purposes intended, we are concerned that the extent of additional accounting that the University may now undertake may result in an excessive attention to accounting detail. We state this even though the recommendations are well intentioned and the University's previous procedures have been appropriately criticized.

When public funding of scientific research first began in earnest after World War II, there were some principles established to foster an appropriate partnership between private or state institutions and the federal government. The recognition of the need for non-governmental scientists to participate in the nation's

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research efforts came, in part, from a study by Vannevar Bush, "Science--The Endless Frontier." In this study he stated:

"The publically and privately supported colleges, universities, and research institutes are centers of basic research. They are the wellsprings of knowledge and understanding. As long as they are vigorous and healthy and their scientists are free to pursue the truth wherever it may lead, there will be a flow of new scientific knowledge to those who can apply it to practical problems in government, in industry, or elsewhere."

The policies developed from Bush's principles have established an extraordinarily productive partnership in research. American science and technology has flourished and has served in innumerable ways to enhance the lives of Americans and the US economy. At the same time the universities have responded to the national needs embodied in the federal policy and enhanced their own efforts. They have grown in size and stature until they have become the standard for universities worldwide. Therefore, the Advisory Panel is happy to acknowledge that in spite of the problems found in Stanford's (and other universities') accounting for indirect cost reimbursement, the government remains committed to federally sponsored research in public and private institutions. The focus of government has been appropriately directed to examine and improve the internal control and reporting systems at Stanford and elsewhere. We support that objective.

But we caution that both the government and the University should not lose sight of another need. That need is, simply stated, to strike an appropriate balance between needed research, appropriate reimbursement of costs, and proper administrative accountability for the research effort.

Our concern is that the University, in responding to justified criticism, may have developed an accounting system that is excessive and far too expensive for the value sought. In a word: "overkill." The accounting tail may well now wag the research dog.

Accordingly, we are concerned lest the Arthur Andersen & Co. recommendations and our agreement with them in the context of Stanford's present circumstances be viewed as a model system for others, which if widely adopted, would resolve the real problem. It is not. We are therefore compelled to ask whether the

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current system for cost reimbursement and accounting for university research could be revised and improved.

In fashioning a remedy for what is admittedly a serious administrative problem, we challenge both parties to keep clearly in mind the real objective of the government/university relationship: the conduct of vital research in a manner which is in the overall best interest of the nation.

The government must remain sensitive to the dependence on federal support that grew as the universities' contributions to the nation's needs expanded. If these institutions are to sustain their research efforts and their uniquely successful coupling of teaching and research, then new policies on cost recoveries must be sensitive to their needs.

Similarly we urge the nation's universities to consider new approaches toward achieving the appropriate balance between cost recovery and accountability and to engage the government in constructive discussions to that end.

Clearly the accounting emphasis should be on the procurement of the human resource element--i.e., the intelligence and creativity inherent in research capability, the "brains" of the few who contribute so much to the advancement of progress.

Far simpler procurement, accounting, and reporting procedures seem to us appropriate to protect the infrastructure that supports that on-line human effort. These are the indirect costs. They cannot be as precisely accounted for as is the case with direct costs.

Reasonable accountants can and do differ on the definition and measurement of indirect costs benefitting research activity. There is no single correct answer, only a reasonable one. The precision that seems to be sought by the federal auditors may not realistically be attainable.

In short, the Advisory Panel encourages the Congress and cognizant federal agencies in consultation with the universities to amend and reform and, certainly, to simplify the procurement process, accounting, and reporting requirement, particularly as to indirect costs. New approaches can ensure not only the needs of public accountability but also give an encouraging signal to scientific creativity and be a forceful affirmation of the importance of the public and private universities to the nation's well-being.

* * * * *

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The Advisory Panel is prepared to continue to be available to Stanford University officials or anyone else involved in reforming this very important public service provided by our nation's scientists. Most importantly, the Advisory Panel hopes to ensure that the outcome of this episode is a system whereby proper accountability for taxpayer resources is assured while needed scientific research is both encouraged and promoted.

Yours very truly,

Joseph E. Connor
Chairman, Price Waterhouse World Firm

Dr. Timothy S. Healy
President, New York Public Library

Admiral Bobby R. Inman
Former Director, National Security Agency
and Former Deputy Director of Central Intelligence

Paul O'Neill
Chairman and Chief Executive Officer, Alcoa

Dr. Maxine Singer
President, The Carnegie Institution of Washington





STANFORD UNIVERSITY

Report on Review of Internal Controls Related to Federal Contracts and Grants

July 15, 1991

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I. EXECUTIVE SUMMARY

At the request of Stanford University, Arthur Andersen & Co. performed an in-depth review of the University's accounting systems and control procedures for complying with U.S. government contracting requirements. This report presents the recommendations resulting from that review.

The purpose of the review was to develop and present, for Stanford's consideration, recommendations for improvements which, if properly implemented, will reduce Stanford's risk of noncompliance with applicable government regulations. In this regard, particular emphasis was given to reviewing Stanford's systems and control procedures related to the accumulation, classification, allocation and billing of costs under federal government contracts and grants. Our purpose was not to assess the legality of any particular practice at Stanford, but rather to recommend improvements to the University accounting systems and control procedures. By making these recommendations to improve existing practices, we are not necessarily stating that any current practice is inconsistent with the law.

The review encompassed interviews with Stanford personnel, observation of control techniques as they were performed, examination of documentary evidence, and selective transaction testing. All documents requested were made available to us, and Stanford employees were cooperative in answering questions and providing information.

Stanford must comply with a variety of statutory and regulatory requirements which affect the award, pricing and performance of federal contracts and grants. Some of these statutes and regulations apply to all federal contracts or grants, while others are unique to individual agencies or even to specific programs within those agencies. The purpose of this report is to set forth, for Stanford's consideration, recommendations for improvements which, if properly implemented, will reduce Stanford's risk of noncompliance with applicable government regulations. Of course, no system of controls can totally eliminate all possibility of noncompliance.

Our recommendations arise from the following broad observations:

- Stanford's control environment needs to be strengthened to better facilitate compliance.
- Stanford's accounting system and control procedures need to be modified in certain respects to reduce the risk of future noncompliance.
- Training of, and communication among, Stanford employees involved in matters relating to contracts and grants need to be improved.
- Additional mechanisms for monitoring compliance and dealing with exceptions should be implemented.

In offering these recommendations, we recognize that Stanford and other universities are now operating in a changing regulatory environment. For example, as of the date of this report, the Office of Management and Budget ("OMB") is considering revisions to OMB Circular A-21, Principles for Determining Costs Applicable to Grants, Contracts and Other Agreements with Educational Institutions. At the present time, it is impossible to tell how these changes will affect Stanford's accounting and control obligations. Stanford's accounting systems and control procedures must be responsive to these and other changes which will be forthcoming. These control procedures are designed to assist Stanford in understanding and complying with this diverse set of rules.

Our recommendations are categorized as follows:

- Control Environment
- Establishment and Implementation of Written Policies and Control Procedures
- Accounting System
- Cost Allowability and Allocability
- Contract and Grant Administration

A summary of our recommendations is presented below. A more detailed description of each recommendation is set forth in Section II of this Report.

A. CONTROL ENVIRONMENT

The control environment is established at the top of the organization and directly influences all other aspects of internal control. It represents the composite effect of various factors, such as the attitudes and actions of Stanford's Board of Trustees and Administration concerning controls. It is reflected in management philosophy and operating style, organizational structure, and the assignment of authority and responsibility.

Additionally, Stanford's control environment is influenced by the often competing interests of the academic and administrative functions of the University. These competing interests and related lack of centralized control increase the potential for noncompliance with applicable procurement regulations.

To strengthen the control environment, we recommend that Stanford do the following:

1. Update and modify its Mission Statement specifically to acknowledge its responsibilities as a steward of public funds and for compliance with applicable laws and regulations.
2. Establish and adhere to a comprehensive written code of ethics and conduct which sets forth the standards that govern the conduct of all employees in their relationship to the University and which acknowledges and addresses, among other matters, Stanford's responsibilities under applicable laws and regulations and to the public.
3. Establish the position of Compliance Support Officer, reporting to the Dean of Research and having direct access to the President and the Chairman of the Audit Committee of the Board of Trustees.
4. Establish mandatory training requirements for all academic and administrative department personnel with responsibility for government contracting matters.

5. Establish and adhere to a formal program of government contract compliance auditing by the Internal Audit Department.
6. Consider implementing a policy of job rotation at the manager level and above within the Controller's Office to increase the knowledge and experience base of these personnel.

B. ESTABLISHMENT AND IMPLEMENTATION OF WRITTEN POLICIES AND CONTROL PROCEDURES

The establishment and implementation of written policies and control procedures is essential to ensuring that internal control objectives are effectively communicated, properly implemented and consistently followed.

To strengthen its written policies and control procedures, we recommend that Stanford do the following:

1. Develop a single, comprehensive Proposal Preparation Manual to be used by faculty members and their administrative assistants in the preparation of sponsored project proposals.
2. Develop a single, comprehensive Cost Accounting Practices Manual describing its cost accounting practices regarding the accumulation, classification and allocation of costs under federal government contracts and grants.
3. Establish a formal policy and related procedures for the preparation and submission of contract and grant billings and cost reports.
4. Develop a comprehensive Accounting System and Sponsored Agreement Administration Manual to serve as a practical guide for principal investigators and administrative department personnel involved in federal contract and grant-related activities.

5. Establish and adhere to written procedures for the preparation of Laboratory Time Cards.

C. ACCOUNTING SYSTEM

Stanford's accounting system is structured primarily to satisfy the management and external reporting requirements of the University. Those requirements differ in some respects from the specialized requirements of government research contracts and grants. This condition creates the risk that costs accumulated for federal procurement purposes may be unallowable or be assigned to the wrong cost pool.

Moreover, the current system is built upon a batch accounting system installed in the 1960s, thereby making it difficult to obtain needed management information on a real time basis. Therefore, in addition to the compliance-related recommendations set forth below, we recommend that Stanford modernize its accounting system so that users can capture better information more effectively and efficiently.

To improve compliance controls within the accounting system, we recommend that Stanford do the following:

1. Perform a review of existing indirect cost accounts to determine whether their current classification within accounting system "functions" is consistent with the types of costs being charged to each account.
2. Eliminate the use of department special codes.
3. Establish general ledger accounts to record unallowable costs at the time they are incurred.
4. Establish written procedures for the opening of indirect cost accounts for academic and administrative departments.

5. Revise its current accounting policy and related procedures to require supervisory review and approval of cost transfers that have a high potential of being inappropriate.

D. COST ALLOWABILITY AND ALLOCABILITY

Federal government contracts and grants require compliance with specified laws and regulations, many of which impose specialized cost accounting and reporting requirements. For example, Stanford is required to comply with the provisions of OMB Circular A-21, Principles for Determining Costs Applicable to Grants, Contracts and Other Agreements with Educational Institutions. This Circular requires that costs be properly classified, that they be charged to the appropriate project or indirect cost pool, that unallowables be excluded from reimbursable costs, and that costs be allocated to projects on an equitable basis.

To strengthen the system of internal control in this area, we recommend that Stanford do the following:

1. Establish a policy and related procedures to require approval and documentation of significant cost accounting policy decisions.
2. Implement effort reporting procedures in selected departments which engage in activities, the costs of which are unallowable under federal contracts and grants.
3. Establish a formal, written policy and related procedures that require comprehensive front-end transaction screening for unallowable costs.
4. Identify specific high-risk accounts for additional "scrubbing" for unallowable costs prior to filing its indirect cost submission.

5. Establish a formal, written procedure to improve documentation of, and to better account for, all reclassifications made among indirect cost pools as part of the year-end indirect cost submission process.
6. Develop formal documentation standards for the preparation of indirect cost submission workpapers.
7. Develop procedures to be used by the Government Cost and Rate Studies Department Manager and Assistant Controller for Cost Accounting Policy and Cost Recovery to review Stanford's annual indirect cost submission.
8. Establish a policy and related procedures regarding the timely review and updating of special cost studies such as those for the Operations and Maintenance and Libraries indirect cost pools.
9. Establish a policy and related procedures to require testing of space inventory surveys.
10. Reinstate service center accounting procedures to require regular reviews of billing rates and any related variances from actual costs incurred by the Government Cost and Rate Studies Department.
11. Establish a formal, written policy and related procedures to identify and account for "applicable credits" as defined in OMB Circular A-21.

E. CONTRACT AND GRANT ADMINISTRATION

Government contract compliance requires internal control over contract administration functions. Such controls help ensure that the University is compliant with all of the requirements of its sponsored agreements.

To strengthen controls over contract and grant administration, we recommend that Stanford do the following:

1. Modify its Sponsored Projects Manual to include a formal file document checklist to be used by the Sponsored Projects Office.
2. Implement a policy to require that the Monthly Expenditure Statement internal certifications executed by principal investigators specifically address the appropriateness of all costs charged directly to sponsored agreements and to provide that all other requirements of the contract or grant have been met.
3. Establish a formal policy regarding the granting of indirect cost waivers.
4. Assign responsibility to the Sponsored Projects Office for monitoring and ensuring that principal investigators have filed all required technical reports on a timely basis.
5. Implement computer system changes to permit the transfer of data from the main University-wide accounting system to the Equipment Inventory System.
6. Develop and implement a program to conduct physical inventories of property on a biannual basis in accordance with the requirements of OMB Circulars A-21, Section J.9 and A-110, Attachment N.
7. Centralize controls over government property administration by increasing the responsibility and authority of the University Property Administrator.
8. Establish review procedures over the preparation of Post Award Administrative Data Sheets used for sponsored project billings and cost reporting purposes.

II. SPECIFIC RECOMMENDATIONS

A: CONTROL ENVIRONMENT

A1: MODIFY STANFORD'S MISSION STATEMENT

We recommend that Stanford's Mission Statement be updated and modified specifically to acknowledge its responsibilities as a steward of public funds and for compliance with applicable laws and regulations. Stanford's Mission Statement sets forth the purposes of the University, the principles that guide the pursuit of these purposes, and the University's objectives in matters such as academic affairs, student affairs and business affairs. While the Mission Statement currently includes, as one of its principles, that "Stanford shall act with integrity in all of its affairs and as a good citizen in the local community," a reaffirmation of Stanford's responsibilities with specific reference to its handling of federal funds is advisable. Accordingly, we recommend that the following statement, or one of equivalent intent, be incorporated into the principles section of the updated Mission Statement:

Stanford shall act with integrity in all of its affairs
and as a good citizen in the local community.
Stanford shall in all matters comply with applicable
laws and regulations and act in a manner
consistent with its responsibilities as a steward of
taxpayers' funds.

Additionally, we recommend that the Mission Statement as updated and modified be reviewed and ratified by the Board of Trustees and distributed to all Stanford employees, and other parties, as deemed appropriate.

A1: MODIFY STANFORD'S MISSION STATEMENT (Continued)

Related Recommendation:

A2: Develop a Stanford University Code of Ethics and Conduct

A2: DEVELOP A STANFORD UNIVERSITY CODE OF ETHICS AND CONDUCT

We recommend that Stanford establish and adhere to a comprehensive written code of ethics and conduct which sets forth the standards that govern the conduct of all employees in their relationship to the University and which acknowledges and addresses, among other matters, Stanford's responsibilities under applicable laws and regulations and to the public. Responsibility for development of the code should rest with the President of the University, subject to review and ratification by the Board of Trustees. We understand that preparation of a code of ethics and conduct is underway. The code should be disseminated to all Stanford employees. Current employees involved in matters related to federal contracts and grants should be provided with training regarding the code, and new employees should be provided with orientation to the code at the time of employment.

With respect to matters related to federal contracts and grants, the code should include, but not be limited to, the following elements:

- Integrity in soliciting and securing federal contracts and grants, including descriptions of prohibited activities.
- Integrity of time and expenses charged to projects.
- Integrity of relationships with subcontractors, vendors and contract employees, including prohibitions against preferential treatment and kickbacks.
- A statement regarding conflicts of interest, indicating that individuals are not to profit from contract-related activities.
- A statement that University personnel will be held accountable for compliance with the Code.

A2: DEVELOP A STANFORD UNIVERSITY CODE OF ETHICS AND CONDUCT (Continued)

- A statement encouraging University personnel to report issues of noncompliance to a designated official or in accordance with such other internal mechanism as may be established.

Related Recommendations:

- A1: Modify Stanford's Mission Statement
A4: Increase Compliance Training

A3: ESTABLISH THE POSITION OF COMPLIANCE SUPPORT OFFICER

We recommend that Stanford establish the position of Compliance Support Officer, reporting to the Dean of Research and having direct access to the President and the Chairman of the Audit Committee of the Board of Trustees. The principal function of the Compliance Support Officer should be to help facilitate compliance by all Stanford employees with applicable laws and regulations. In connection with the establishment of this position, it should be made clear that the ultimate responsibility for ensuring compliance rests with each individual Stanford employee rather than the Compliance Support Officer. The responsibilities of the Compliance Support Officer should include, but not necessarily be limited to, the following:

- Keep the Dean of Research, University President and Board of Trustees informed regarding compliance issues.
- Establish and maintain compliance-related policies and procedures.
- Develop and oversee a comprehensive training program for personnel associated with federal contract and grant activities. The training program should address Stanford's code of ethics and conduct and compliance with applicable laws and regulations.
- Participate in the review and disposition of all matters of actual or potential noncompliance, including those raised by Stanford personnel on a confidential basis.
- Coordinate with Stanford's Controller's Office and Internal Audit Department, Vice President and General Counsel and Chief Financial Officer, as required, to monitor and ensure compliance with applicable federal contracting requirements.

A3: ESTABLISH THE POSITION OF COMPLIANCE SUPPORT OFFICER
(Continued)

We also recommend that the position of Compliance Support Officer and its effectiveness be reviewed every two years, or more frequently as required, and that changes be made as appropriate.

Related Recommendations:

- A4: Increase Compliance Training
- A5: Expand Internal Audit Department Compliance Reviews
- D1: Require Review and Approval of Cost Accounting Policy
Decisions

A4: INCREASE COMPLIANCE TRAINING

We recommend that Stanford establish mandatory training requirements for all academic and administrative department personnel with responsibility for government contracting matters, including department administrators, Controller's Office personnel and principal investigators. The Compliance Support Officer should be responsible for developing and overseeing the training curriculum. Department administrators and principal investigators should be trained in matters such as the code of ethics and conduct, cost estimating and proposal preparation, labor charging, grant and contract administration, and the use of Stanford's accounting system. Training for accounting personnel should include compliance with OMB Circular A-21, other applicable laws and regulations, and sponsor requirements. The Compliance Support Officer, Controller and department heads should be jointly responsible for identifying all personnel required to complete this training.

Related Recommendations:

- A2: Develop a Stanford University Code of Ethics and Conduct
- A3: Establish the Position of Compliance Support Officer
- B1: Develop a Single Proposal Preparation Manual
- B2: Develop a Single Cost Accounting Practices Manual
- B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual
- C4: Establish Procedures for Opening Indirect Cost Accounts

A5: EXPAND INTERNAL AUDIT DEPARTMENT COMPLIANCE REVIEWS

We recommend that Stanford establish and adhere to a formal program of government contract compliance auditing by the Internal Audit Department. This program should be reviewed, approved and monitored by the Audit Committee of the Board of Trustees. In implementing this program, we recommend that Stanford:

- Hire internal audit personnel having the requisite experience in government contract accounting, auditing and compliance.
- Reorganize the internal audit function into two distinct areas: (1) compliance auditing and (2) financial and operational auditing.
- Develop a long-range audit plan, covering the next two to three years, which would include audits of all government contracting activities. These audits should focus on Stanford's accounting systems and control procedures related to the accumulation, classification, allocation and billing of costs under federal government contracts and grants.
- Develop mandatory compliance training for staff auditors.

Related Recommendation:

A3: Establish the Position of Compliance Support Officer

B4: DEVELOP A COMPREHENSIVE ACCOUNTING SYSTEM AND SPONSORED AGREEMENT ADMINISTRATION MANUAL

We recommend that Stanford develop a comprehensive Accounting System and Sponsored Agreement Administration Manual to serve as a practical guide for principal investigators and administrative department personnel involved in federal contract and grant-related activities. The manual should be divided into two sections: "Accounting Systems" and "Contract and Grant Administration."

The Accounting Systems section should:

- Introduce the chart of accounts and describe its organization and use, including the use of allowable and unallowable cost codes.
- Describe the proper procedures for charging direct and indirect costs, including any required authorizations, forms and procedures for dealing with unusual expenditures, rejected transactions and cost transfers.
- Describe the requirements of OMB Circular A-21 and other applicable regulations.
- Establish guidelines for use in determining the reasonableness, allocability and allowability of costs.
- Describe procedures for opening and closing indirect cost accounts.

The Contract and Grant Administration section should:

- Describe the procedures for establishing and closing sponsored project accounts.

B4: DEVELOP A COMPREHENSIVE ACCOUNTING SYSTEM AND SPONSORED AGREEMENT ADMINISTRATION MANUAL (Continued)

- Describe the requirements for monitoring project costs against budgets and disposing of project underruns and overruns.
- Describe procedures for subcontract and purchase order administration, including small business requirements.
- Describe procedures for contract modifications and renewals.
- Describe procedures for handling cost-sharing requirements.
- Describe procedures for filing interim and final technical reports.
- Describe procedures for contract closeout and resolution of disputes with sponsors.

Related Recommendations:

- A4: Increase Compliance Training
- B2: Develop a Single Cost Accounting Practices Manual
- B5: Improve Laboratory Time Card Procedures
- C1: Review of Indirect Cost Accounts
- C3: Establish Accounts to Capture Unallowable Costs
- C4: Establish Procedures for Opening Indirect Cost Accounts
- C5: Revise Cost Transfer Policy and Procedures
- E2: Strengthen Monthly Expenditure Statement Certification
- E4: Assign the Sponsored Projects Office Responsibility for Interim and Final Technical Reports

B5: IMPROVE LABORATORY TIME CARD PROCEDURES

We recommend that Stanford establish and adhere to written procedures for the preparation of Laboratory Time Cards. These procedures should:

- Describe how to complete a Laboratory Time Card.
- Describe required reviews and approvals of the time cards.
- Provide an example of a properly completed time card.

Formal, written procedures for Laboratory Time Cards will reduce the risk that such time cards will be improperly prepared, thereby resulting in incorrect charges to sponsored projects.

Related Recommendation:

B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual

C: ACCOUNTING SYSTEM

C1: REVIEW OF INDIRECT COST ACCOUNTS

We recommend that Stanford's Government Cost and Rate Studies Department perform a review of existing indirect cost accounts to determine whether their current classification within accounting system "functions" is consistent with the types of costs being charged to each account. Stanford's accounting system accumulates costs by "function." A function in this context represents either a major University activity, such as Organized Research, or an indirect cost pool, such as Operations and Maintenance.

This review should include the following steps:

- Prepare a computer listing of the indirect cost accounts within each function code, indicating the balance in each account.
- Require that academic and administrative department managers responsible for indirect cost accounts prepare a formal description of those accounts.
- Evaluate indirect cost accounts with department managers to determine whether account expenditures are consistent with the existing function classification and whether account titles accurately reflect the expenditures.
- Reassign or close accounts not assigned to the appropriate accounting function.
- Close accounts with insignificant activity.

Performing this review will improve documentation of the purpose and use of existing accounts and reduce the risk that indirect costs might be improperly classified in Stanford's indirect cost submissions.

A5: EXPAND INTERNAL AUDIT DEPARTMENT COMPLIANCE REVIEWS

We recommend that Stanford establish and adhere to a formal program of government contract compliance auditing by the Internal Audit Department. This program should be reviewed, approved and monitored by the Audit Committee of the Board of Trustees. In implementing this program, we recommend that Stanford:

- Hire internal audit personnel having the requisite experience in government contract accounting, auditing and compliance.
- Reorganize the internal audit function into two distinct areas: (1) compliance auditing and (2) financial and operational auditing.
- Develop a long-range audit plan, covering the next two to three years, which would include audits of all government contracting activities. These audits should focus on Stanford's accounting systems and control procedures related to the accumulation, classification, allocation and billing of costs under federal government contracts and grants.
- Develop mandatory compliance training for staff auditors.

Related Recommendation:

A3: Establish the Position of Compliance Support Officer

A6: ROTATE JOB ASSIGNMENTS WITHIN THE CONTROLLER'S OFFICE

We recommend that Stanford consider implementing a policy of job rotation at the manager level and above within the Controller's Office. The policy's objective should be to increase the knowledge and experience base of Managers and Assistant Controllers regarding the various activities and responsibilities of the Controller's Office. Implementation of the policy will reduce the risk of undue reliance on any single individual and promote improved compliance with applicable policies and procedures.

Related Recommendations:

None

B: ESTABLISHMENT AND IMPLEMENTATION OF WRITTEN POLICIES AND CONTROL PROCEDURES

B1: DEVELOP A SINGLE PROPOSAL PREPARATION MANUAL

We recommend that Stanford strengthen its existing procedures by developing a single, comprehensive Proposal Preparation Manual. This will assist faculty members and their administrative assistants in the preparation of sponsored project proposals. The manual should expand upon existing procedures and, at a minimum, should:

- Describe the role and responsibilities of the Sponsored Projects Office.
- Include cost estimation guidelines and cost or pricing data disclosure requirements.
- Provide an example of a properly prepared and documented proposal.
- Provide guidance regarding certifications, waivers and other administrative requirements.
- Include internal administrative procedures for reviews and approval.
- Specifically recognize differences in the proposal preparation requirements for contracts and grants.

Related Recommendations:

- A4: Increase Compliance Training
- E1: Develop a Sponsored Agreement File Documentation Checklist
- E3: Revise Indirect Cost Waiver Procedures

B2: DEVELOP A SINGLE COST ACCOUNTING PRACTICES MANUAL

We recommend that Stanford develop a single, comprehensive Cost Accounting Practices Manual. This manual should describe Stanford's cost accounting practices regarding the accumulation, classification and allocation of costs under federal government contracts and grants. Preparation of this manual should include the development of any additional analyses and documentation required to support Stanford's cost accounting practices. The following are among the principal matters that should be addressed in the manual:

- The requirements of OMB Circular A-21 and other applicable regulations.
- Stanford's definitions of direct and indirect costs.
- Descriptions of costs included in each indirect cost pool.
- Descriptions of the allocation bases for the various indirect cost pools.
- Descriptions of the distribution methods for indirect cost pools, including special cost studies.
- Descriptions of service centers, including development of standard rates, applicable allocation bases, and the disposition of variances.
- Descriptions of property and equipment accounting practices.
- Procedures for approval and implementation of accounting practice changes, including requirements for communication of proposed changes to the government.

Implementation of this recommendation has already begun.

B2: DEVELOP A SINGLE COST ACCOUNTING PRACTICES MANUAL
(Continued)

Related Recommendations:

- A4: Increase Compliance Training
- B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual
- D1: Require Review and Approval of Cost Accounting Policy Decisions
- D7: Develop Indirect Cost Submission Review Procedures
- D8: Perform Timely Special Cost Study Reviews and Updates
- D9: Implement Testing of Space Inventory Surveys
- D10: Reinstate Service Center Accounting Procedures
- D11: Establish a Policy and Related Procedures for Applicable Credits
- E5: Integrate Equipment Inventory System
- E6: Conduct Biannual Inventories of Property

B3: ESTABLISH FORMAL BILLING AND COST REPORTING POLICIES AND PROCEDURES

We recommend that Stanford establish a formal policy and related procedures for the preparation and submission of contract and grant billings and cost reports. This guidance should address all aspects of billing and cost report preparation and should include, at a minimum, the following:

- File documentation standards.
- Preparation, review and approval criteria for final billings.
- Preparation, review and approval criteria for cost reports.
- A checklist of items to be reviewed and approved for each bill and report prior to signature and submission to the sponsor for payment.

Related Recommendation:

E8: Establish Review Procedures for Post Award Administrative Data Sheets

B4: DEVELOP A COMPREHENSIVE ACCOUNTING SYSTEM AND SPONSORED AGREEMENT ADMINISTRATION MANUAL

We recommend that Stanford develop a comprehensive Accounting System and Sponsored Agreement Administration Manual to serve as a practical guide for principal investigators and administrative department personnel involved in federal contract and grant-related activities. The manual should be divided into two sections: "Accounting Systems" and "Contract and Grant Administration."

The Accounting Systems section should:

- Introduce the chart of accounts and describe its organization and use, including the use of allowable and unallowable cost codes.
- Describe the proper procedures for charging direct and indirect costs, including any required authorizations, forms and procedures for dealing with unusual expenditures, rejected transactions and cost transfers.
- Describe the requirements of OMB Circular A-21 and other applicable regulations.
- Establish guidelines for use in determining the reasonableness, allocability and allowability of costs.
- Describe procedures for opening and closing indirect cost accounts.

The Contract and Grant Administration section should:

- Describe the procedures for establishing and closing sponsored project accounts.

B4: DEVELOP A COMPREHENSIVE ACCOUNTING SYSTEM AND SPONSORED AGREEMENT ADMINISTRATION MANUAL (Continued)

- Describe the requirements for monitoring project costs against budgets and disposing of project underruns and overruns.
- Describe procedures for subcontract and purchase order administration, including small business requirements.
- Describe procedures for contract modifications and renewals.
- Describe procedures for handling cost-sharing requirements.
- Describe procedures for filing interim and final technical reports.
- Describe procedures for contract closeout and resolution of disputes with sponsors.

Related Recommendations:

- A4: Increase Compliance Training
- B2: Develop a Single Cost Accounting Practices Manual
- B5: Improve Laboratory Time Card Procedures
- C1: Review of Indirect Cost Accounts
- C3: Establish Accounts to Capture Unallowable Costs
- C4: Establish Procedures for Opening Indirect Cost Accounts
- C5: Revise Cost Transfer Policy and Procedures
- E2: Strengthen Monthly Expenditure Statement Certification
- E4: Assign the Sponsored Projects Office Responsibility for Interim and Final Technical Reports

B5: IMPROVE LABORATORY TIME CARD PROCEDURES

We recommend that Stanford establish and adhere to written procedures for the preparation of Laboratory Time Cards. These procedures should:

- Describe how to complete a Laboratory Time Card.
- Describe required reviews and approvals of the time cards.
- Provide an example of a properly completed time card.

Formal, written procedures for Laboratory Time Cards will reduce the risk that such time cards will be improperly prepared, thereby resulting in incorrect charges to sponsored projects.

Related Recommendation:

B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual

C: ACCOUNTING SYSTEM

C1: REVIEW OF INDIRECT COST ACCOUNTS

We recommend that Stanford's Government Cost and Rate Studies Department perform a review of existing indirect cost accounts to determine whether their current classification within accounting system "functions" is consistent with the types of costs being charged to each account. Stanford's accounting system accumulates costs by "function." A function in this context represents either a major University activity, such as Organized Research, or an indirect cost pool, such as Operations and Maintenance.

This review should include the following steps:

- Prepare a computer listing of the indirect cost accounts within each function code, indicating the balance in each account.
- Require that academic and administrative department managers responsible for indirect cost accounts prepare a formal description of those accounts.
- Evaluate indirect cost accounts with department managers to determine whether account expenditures are consistent with the existing function classification and whether account titles accurately reflect the expenditures.
- Reassign or close accounts not assigned to the appropriate accounting function.
- Close accounts with insignificant activity.

Performing this review will improve documentation of the purpose and use of existing accounts and reduce the risk that indirect costs might be improperly classified in Stanford's indirect cost submissions.

C1: REVIEW OF INDIRECT COST ACCOUNTS (Continued)

Related Recommendations:

- B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual
- C4: Establish Procedures for Opening Indirect Cost Accounts
- D5: Implement Indirect Cost Reclassification Controls

C2: ELIMINATE DEPARTMENT SPECIAL CODES

We recommend that Stanford eliminate the use of "Department Special Codes." Department Special Codes are general ledger expenditure accounts which may be used by any academic or administrative department wishing to accumulate and monitor separately a designated category of expenditures. Department Special Codes are currently overused. They may contain miscellaneous expenditures which are more appropriately classified in other general ledger accounts or unallowable costs which should be excluded from billings to the government. Eliminating Department Special Codes will reduce the risk that unallowable costs might be charged to government contracts and grants or that allowable costs might be inappropriately allocated.

Related Recommendation:

C3: Establish Accounts to Capture Unallowable Costs

C3: ESTABLISH ACCOUNTS TO CAPTURE UNALLOWABLE COSTS

We recommend that Stanford establish general ledger accounts to record unallowable costs at the time they are incurred. The establishment of these accounts will facilitate the segregation of unallowable costs and will reduce the risk that such costs might be charged to government contracts and grants. Moreover, the use of unallowable cost accounts will reduce the amount of analytical work required to "scrub" indirect costs at year-end, when Stanford prepares its indirect cost submission. The general ledger accounts to be established should include, but not necessarily be limited to, the following:

- Alcoholic beverages
- Entertainment
- Fines and penalties
- Fundraising
- Student activities
- Insurance - unallowable
- Memberships and dues - unallowable
- Travel - unallowable
- Lobbying
- Promotional materials
- Advertising - unallowable
- Professional services - unallowable

Related Recommendations:

- B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual
- C2: Eliminate Department Special Codes
- D3: Implement Comprehensive Front-End Screening of Unallowable Costs
- D4: Perform Additional Reviews of Selected High-Risk Accounts

C4: ESTABLISH PROCEDURES FOR OPENING INDIRECT COST ACCOUNTS

We recommend that Stanford establish written procedures for the opening of indirect cost accounts for academic and administrative departments. These accounts consist of an "organization" code and a "function" code. The organization code designates the departments incurring the cost. The function code identifies either a major University activity, such as Organized Research, or an indirect cost pool, such as Libraries. The absence of formal, written procedures for the opening of these accounts increases the risk that they may be assigned improper function codes and misclassified in Stanford's indirect cost pools.

Procedures developed should include a requirement that new account requests be in writing, that the purpose of the account be described in detail, and that account requests be approved by the department head. Otherwise, they should be rejected. More complete descriptions of the purpose of indirect cost accounts will enhance consistency in assigning function codes and reduce the risk that costs might be accumulated in the wrong cost pools. The procedures should also provide that ultimate responsibility for assigning account numbers, including the proper function code, rests with the Controller's Office. Currently, the Controller's Office is responsible for opening indirect cost accounts, but function codes are generally assigned by the requesting academic or administrative departments and are subject only to a cursory review by the Controller's Office.

Related Recommendations:

- A4: Increase Compliance Training
- B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual
- C1: Review of Indirect Cost Accounts
- D5: Implement Indirect Cost Reclassification Controls

C5: REVISE COST TRANSFER POLICY AND PROCEDURES

We recommend that Stanford revise its current policy and related procedures to require supervisory review and approval of those cost transfers that have a high potential of being inappropriate. Such cost transfers include transfers from sponsored project accounts to indirect cost accounts, transfers between sponsored project accounts, and any transfers of sponsored project cost overruns.

Transfers are primarily made to correct mistakes in charges to sponsored and nonsponsored projects. Cost transfers can be initiated either on-line or via completion of a manual form by academic and administrative department personnel, provided proper approval is obtained from the department receiving the transferred costs. Transfers are currently reviewed only by staff personnel in the Grant and Contract Accounting ("GCA") and Nonsponsored Projects Accounting ("NSPA") departments prior to being recorded in the accounting system. We understand that until approximately one year ago supervisory personnel in GCA and NSPA reviewed and approved cost transfers. Stanford should reinstate this procedure. Requiring supervisory personnel to review such cost transfers will provide additional assurance that only appropriate transfers are made and will reduce the likelihood of costs being incorrectly charged to government contracts and grants.

The revised policy should include a definition of the specific types of cost transfers requiring supervisory approval. Responsibility for initially identifying these types of transfers should be assigned to the GCA and NSPA staff personnel currently performing cost transfer processing.

As an additional control mechanism, Stanford should consider developing computer edits to prevent cost transfers of the type described above from being recorded in the accounting system without supervisory review and approval.

C5: REVISE COST TRANSFER POLICY AND PROCEDURES (Continued)

Related Recommendation:

B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual

D: COST ALLOWABILITY AND ALLOCABILITY

D1: REQUIRE REVIEW AND APPROVAL OF COST ACCOUNTING POLICY DECISIONS

We recommend that Stanford establish a policy and related procedures to require approval and documentation of significant cost accounting policy decisions. Procedures developed should define decisions that are subject to review and require the approval of the Controller and Chief Financial Officer. Examples of such decisions include those related to:

- Gray area cost allowability interpretations.
- OMB Circular A-21 cost allocation interpretations.
- Changes to existing allocation practices.
- Performance and updating of special cost studies.
- The level of documentation required.

Related Recommendations:

- A3: Establish the Position of Compliance Support Officer
B2: Develop a Single Cost Accounting Practices Manual
D8: Perform Timely Special Cost Study Reviews and Updates

D2: IMPLEMENT EFFORT REPORTING ON A SELECTIVE BASIS

We recommend that Stanford implement effort reporting procedures in selected departments which engage in activities, the costs of which are unallowable under federal contracts and grants. Examples of these activities include fundraising, lobbying and investment management, the costs of which are principally recorded in the Office of Development, the Office of Public Affairs and the Treasurer's Office, respectively. Effort reporting would not be required in any departments which Stanford eliminates in their entirety from inclusion in billings to the government. However, in other departments where costs may be partially allowable and partially unallowable, effort reporting should be implemented to help support the allowable costs claimed.

Related Recommendations:

None

D3: IMPLEMENT COMPREHENSIVE FRONT-END SCREENING OF UNALLOWABLE COSTS

We recommend that Stanford establish a formal, written policy and related procedures that require comprehensive front-end transaction screening for unallowable costs. These procedures should specifically address the requirements of OMB Circular A-21 and other applicable regulations. Implementation of this recommendation will reduce the risk that unallowable costs might be charged to government contracts and grants.

The Accounts Payable and Travel and Reimbursement departments should be responsible for identifying all unallowable costs incurred by Stanford and ensuring the proper classification of those charges within the accounting system. The personnel in these departments should participate in a program of ongoing training to ensure that they are properly prepared to carry out these responsibilities.

Related Recommendations:

C3: Establish Accounts to Capture Unallowable Costs

D4: Perform Additional Reviews of Selected High-Risk Accounts

D4: PERFORM ADDITIONAL REVIEWS OF SELECTED HIGH-RISK ACCOUNTS

We recommend that Stanford identify specific high-risk accounts for additional "scrubbing" for unallowable costs prior to filing its indirect cost submission. This procedure should be performed to capture any additional unallowable costs which may not have been detected during front-end screening. Additionally, Stanford has expressed interest in being able to remove costs which, although allowable, it may wish to voluntarily exclude from billings to the government. These procedures need not be performed, however, for accounts automatically excluded in their entirety from allowable contract costs. This additional scrutiny of high-risk accounts will reduce the risk that questionable or unallowable costs might be charged to government contracts and grants.

Related Recommendations:

- C3: Establish Accounts to Capture Unallowable Costs
- D3: Implement Comprehensive Front-End Screening of Unallowable Costs
- D7: Develop Indirect Cost Submission Review Procedures

D5: IMPLEMENT INDIRECT COST RECLASSIFICATION CONTROLS

We recommend that Stanford establish a formal, written procedure to improve documentation of, and to better account for, all reclassifications made among indirect cost pools as part of the year-end indirect cost submission process. This procedure should require written documentation of the reason for each reclassification, identification of the accounts and amounts reclassified, approval by the transferee, and control totals to ensure that reclassifications are in balance. Should our recommendation C1 be implemented, the need for this procedure to better control indirect cost reclassifications would be substantially reduced or eliminated. In the interim, however, the number of reclassifications warrants this recommendation. For example, preparation of the fiscal year 1988 indirect cost study involved over 200 manual cost reclassifications totaling approximately \$90 million.

Related Recommendations:

C1: Review of Indirect Cost Accounts

C4: Establish Procedures for Opening Indirect Cost Accounts

D6: DEVELOP INDIRECT COST SUBMISSION WORKPAPER
DOCUMENTATION STANDARDS

We recommend that Stanford develop formal documentation standards for the preparation of indirect cost submission workpapers. Establishment of these standards should begin with the development of work programs describing each work step that must be completed, and initialed by the individual performing that step, when preparing an indirect cost submission. The documentation standards should include requirements for explanatory notes and descriptions on schedules and memoranda regarding allowability and allocability decisions. We also recommend that Stanford standardize the indirect cost study system of computer spreadsheets and analyses. Standardization should include consistency in computer spreadsheet format, mathematical functions, formulae, programming and file organization. Well documented workpapers and standardized computer practices will reduce the risk of errors, omissions and inconsistencies in the indirect cost submission from year to year.

Related Recommendation:

D7: Develop Indirect Cost Submission Review Procedures

D7: DEVELOP INDIRECT COST SUBMISSION REVIEW PROCEDURES

We recommend that Stanford develop procedures to be used by the Government Cost and Rate Studies ("GCRS") Department Manager and Assistant Controller for Cost Accounting Policy and Cost Recovery to review Stanford's annual indirect cost submission. Procedures should include review of work programs and workpapers completed by GCRS personnel during the indirect cost submission preparation process. Both the GCRS Manager and Assistant Controller should initial the work programs, indicating that they have reviewed the indirect cost submission and that all work program steps have been completed to their satisfaction. Specific matters to be considered during this review process should include, but not necessarily be limited to, the following:

- Proper elimination of unallowable costs.
- Inclusion of allowable costs in the proper indirect cost pools.
- Appropriateness of cost allocations to final cost objectives in accordance with documented costing policies and procedures or applicable special cost studies.

Upon completion of the above-described process, the indirect cost submission should be forwarded to the Controller for a final higher-level review and determination that all substantive matters have been resolved. Thereafter, it should be forwarded to the Chief Financial Officer ("CFO") for certification. The CFO should not certify the submission until he or she is satisfied that the foregoing review process has been effectively completed and any other questions he or she has have been appropriately addressed.

D7: DEVELOP INDIRECT COST SUBMISSION REVIEW PROCEDURES
(Continued)

Related Recommendations:

- B2: Develop a Single Cost Accounting Practices Manual
- D4: Perform Additional Reviews of Selected High-Risk Accounts
- D6: Develop Indirect Cost Submission Workpaper Documentation Standards

D8: PERFORM TIMELY SPECIAL COST STUDY REVIEWS AND UPDATES

We recommend that Stanford establish a policy and related procedures regarding the timely review and updating of special cost studies such as those for the Operations and Maintenance and Libraries indirect cost pools. Special cost studies are analyses performed by Stanford's Government Cost and Rate Studies ("GCRS") Department to document appropriate methodologies for the distribution of indirect cost pools.

Procedures to review and update special cost studies should require GCRS to review the assumptions underlying each study at least biannually, or as agreed to with the government. The results of the review should be documented in writing, including conclusions reached regarding the validity of those assumptions.

Related Recommendations:

B2: Develop a Single Cost Accounting Practices Manual

D1: Require Review and Approval of Cost Accounting Policy
Decisions

D9: IMPLEMENT TESTING OF SPACE INVENTORY SURVEYS

We recommend that Stanford establish a policy and related procedures to require testing of space inventory surveys. The space inventory is an important factor in the development of indirect cost rates, including the depreciation and operations and maintenance indirect cost pools. Stanford currently conducts a space inventory which serves as the basis for cost allocations. This survey is not routinely reviewed or tested for accuracy.

Annual testing on a scope basis should be required to ensure that, over time, all relevant space inventory surveys are accurate. The testing procedures should include inquiries of department personnel regarding space usage, site visits and physical observations of space utilization. This testing should be performed by the Internal Audit Department. We also recommend that responsibility for conducting the space inventory be shifted from the Facilities Project Management Department to the Controller's Office.

Related Recommendation:

B2: Develop a Single Cost Accounting Practices Manual

D10: REINSTATE SERVICE CENTER ACCOUNTING PROCEDURES

We recommend that Stanford's existing service center accounting procedures be revised. Stanford has numerous service centers which charge University and outside users at standard rates for services provided (e.g., copy centers and computer data centers). Service center billing rates are developed by the academic and administrative departments responsible for each service center and may vary from actual costs incurred.

The revised procedures should require that Stanford's Government Cost and Rate Studies Department personnel review service center billing rates regularly to ensure that they reasonably reflect actual costs incurred and that variances are properly accounted for. We understand that this procedure was in place until September 1990. Reinstatement of this procedure will reduce the risk that service center expenditures are inconsistently or improperly charged to government contracts and grants.

Related Recommendation:

B2: Develop a Single Cost Accounting Practices Manual

D11: ESTABLISH A POLICY AND RELATED PROCEDURES FOR APPLICABLE CREDITS

We recommend that Stanford establish a formal, written policy and related procedures to identify and account for "applicable credits." OMB Circular A-21 defines applicable credits as "... those receipts or negative expenditures that operate to offset or reduce direct or indirect cost items." This policy should define applicable credits, provide examples of applicable credits within Stanford's accounting environment, specify the accounts in which they are recorded, and assign responsibility within Stanford's Government Cost and Rate Studies Department for reviewing those accounts and ensuring that applicable credits are properly accounted for in accordance with OMB Circular A-21.

Related Recommendation:

B2: Develop a Single Cost Accounting Practices Manual

E: CONTRACT AND GRANT ADMINISTRATION

E1: DEVELOP A SPONSORED AGREEMENT FILE DOCUMENTATION CHECKLIST

We recommend that Stanford modify its Sponsored Projects Manual to include a formal file documentation checklist to be used by the Sponsored Projects Office ("SPO"). This checklist should specifically list all required documentation to be included in the file and indicate on a current basis whether each item has been included or is not applicable. It should be completed by the SPO grant and contracting officer responsible for the agreement. We recommend that this checklist include the following:

- A completed SU-42 Sponsored Project Summary
- Indirect cost waiver memorandum (if applicable)
- Research compliance documentation
- Statement of work
- Detailed budget by cost category
- Biographical sketches of the researchers
- Subcontract budget and commitment letters
- Consultants' commitment letter
- Percentage of principal investigator effort
- Budget justification
- A listing of open administrative items and their ultimate disposition
- Executed certifications
- Subcontractor release forms
- Executed sponsored agreement
- Modifications to the contract or grant
- Progress and final technical reports

Related Recommendation:

B1: Develop a Single Proposal Preparation Manual

E2: STRENGTHEN MONTHLY EXPENDITURE STATEMENT
CERTIFICATION

We recommend that Stanford implement a policy to require that the Monthly Expenditure Statement ("MES") internal certifications executed by principal investigators specifically address the appropriateness of all costs charged directly to sponsored agreements and to provide that all other requirements of the contract or grant have been met. Currently, principal investigators certify on a monthly basis only that "Salary and wage charges have been reviewed and are reasonably accurate approximations of effort applied and charged to this project."

We recommend that the revised certification read substantially as follows:

I certify that salaries, wages and all other direct charges to this project accurately reflect labor effort applied and other costs directly chargeable to the project in accordance with the sponsored agreement's provisions, sponsoring agency requirements, applicable federal regulations and Stanford University policy. Discrepancies, if any, have been corrected by submitting adjusting entries through the accounting system.

Signature and date

We also recommend that this new policy require the certification to be completed by the principal investigator within 45 days after month-end. All certifications should be centrally filed within the respective academic departments or independent laboratories. Responsibility for ensuring that all certifications are completed and filed on a timely basis should rest initially with each Department Chair and ultimately with the Controller. Compliance with this

E2: STRENGTHEN MONTHLY EXPENDITURE STATEMENT
CERTIFICATION (Continued)

certification requirement should be monitored by the Compliance Support Officer and periodically tested by the Internal Audit Department.

Implementation of the foregoing recommendations would be facilitated by modifying the accounting system to permit on-line review of the MES and by electronic certification of the validity of charges to sponsored projects.

Related Recommendation:

B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual

E3: REVISE INDIRECT COST WAIVER PROCEDURES

We recommend that Stanford establish a formal policy regarding the granting of indirect cost waivers. This policy should set forth the basis upon which waivers will be granted, and it should be reviewed and approved by the Board of Trustees.

Furthermore, we recommend that Stanford revise its existing procedures for documenting the granting of indirect cost waivers to require that a memorandum indicating the reason for the waiver be included in the sponsored agreement file. Each memorandum documenting the granting of the waiver should indicate:

- The sponsoring agency.
- Reasons and justification for the waiver.
- Item(s) excluded from the application of indirect cost rates.
- The estimated amount of cost recovery waived.
- Required reviews and approvals.

After the memorandum has been reviewed and approved by the Department Head, School Dean and Dean of Research, consistent with current approval levels, it should be maintained in the agreement file by the Sponsored Projects Office. A report of indirect cost waiver activity should be made quarterly to the President and the Operations Council and at least annually to the Board of Trustees.

Related Recommendation:

B1: Develop a Single Proposal Preparation Manual

E4: ASSIGN THE SPONSORED PROJECTS OFFICE RESPONSIBILITY FOR INTERIM AND FINAL TECHNICAL REPORTS

We recommend that the Sponsored Projects Office be assigned responsibility for monitoring and ensuring that principal investigators have filed all required technical reports on a timely basis. However, responsibility for the submission of technical reports in accordance with sponsored agreements should remain with the principal investigator.

Related Recommendation:

B4: Develop a Comprehensive Accounting System and Sponsored Agreement Administration Manual

E5: INTEGRATE EQUIPMENT INVENTORY SYSTEM

We recommend that Stanford implement computer system changes to permit the transfer of data from the main University-wide accounting system to the Equipment Inventory System.

OMB Circular A-21, Section J.9 requires that Stanford support depreciation and use allowances through adequate property records and physical inventories conducted at least once every two years. OMB Circular A-110, Attachment N requires that Stanford annually submit and certify a listing of all government furnished or funded property on hand. Moreover, Stanford is required, at the completion of a sponsored agreement, to report any such property no longer in use. Finally, individual sponsoring agencies may impose other government property reporting requirements.

Implementation of this recommendation will reduce the risk that depreciation charges and use allowances might be inaccurate or that government property status might be incorrectly reported.

Related Recommendations:

- B2: Develop a Single Cost Accounting Practices Manual
- E6: Conduct Biannual Inventories of Property
- E7: Strengthen Centralized Government Property Administration Controls

E6: CONDUCT BIENNIAL INVENTORIES OF PROPERTY

We recommend that Stanford develop and implement a program to conduct physical inventories of property on a biennial basis in accordance with the requirements of OMB Circulars A-21, Section J.9 and A-110, Attachment N. Implementation of this program should, at a minimum, encompass the following:

- The University Property Administrator should be responsible for coordination of the program, conduct of the physical inventories, and reconciliation of physical inventory results to detailed property records.

Detailed work programs should be developed for the conduct of the biennial inventories.

The Internal Audit Department should observe the inventory process and test the results.

Related Recommendations:

- B2: Develop a Single Cost Accounting Practices Manual
- E5: Integrate Equipment Inventory System
- E7: Strengthen Centralized Government Property Administration Controls

E7: STRENGTHEN CENTRALIZED GOVERNMENT PROPERTY
ADMINISTRATION CONTROLS

We recommend that Stanford centralize controls over government property administration by increasing the responsibility and authority of the University Property Administrator ("UPA").

Currently, over 400 Department Property Administrators, principally secretaries, are responsible for the acquisition, maintenance, reporting and disposition of all property in accordance with the provisions of sponsored agreements and federal regulations. Implementation of this recommendation will reduce the risk that government property might be improperly used, discarded or otherwise disposed of. Centralized government property administration functions should include UPA approval prior to equipment fabrication or the sale or other disposition of property.

Related Recommendations:

- B2: Develop a Single Cost Accounting Practices Manual
- E5: Integrate Equipment Inventory System
- E6: Conduct Biannual Inventories of Property

E8: ESTABLISH REVIEW PROCEDURES FOR POST AWARD
ADMINISTRATIVE DATA SHEETS

We recommend that Stanford establish review procedures over the preparation of Post Award Administrative Data ("PAAD") sheets used for sponsored project billing and cost reporting purposes. A PAAD is a one-page summary of key sponsored agreement terms and conditions which is relied upon by the Grant and Contract Accounting ("GCA") department to ensure that sponsored project billing and reporting requirements are properly followed. PAADs include information about the proper billing and reporting form or format to be used, as well as billing and reporting schedules. PAADs are prepared from the sponsored agreement by a GCA accountant and are not currently reviewed by a supervisor. We recommend that each PAAD be reviewed by the GCA manager or assistant manager for compliance with specific billing and cost reporting requirements, such as:

- Line item budget limitations.
- Funding limitations.
- Indirect rate limitations, if any.
- Revisions and no-cost extensions.
- Contract and grant closeout requirements.

Related Recommendation:

B3: Establish Formal Billing and Cost Reporting Policies and Procedures