# Memo
## Operating Guidance

No. 89-3
January 20, 1989

VICE CHANCELLORS — BUSINESS AND FINANCE/ADMINISTRATION*
CONTRACTS AND GRANTS OFFICERS (NON-LAB)
OFFICE OF THE PRESIDENT FUNCTIONAL MANAGERS

Subject: Documentation of Costs Directly Charged to Grants
Under the FDP

At the Contracts and Grants Meeting on the Federal Demonstration Project (FDP), December 12, 1988, campus representatives requested the Office of the President C&G office to issue guidelines on what documentation is needed to support costs directly charged to grants under the FDP. This memo is a response to that request.

CURRENT A-21 REQUIREMENTS AND DEFINITIONS

Paragraph 2.b. of the FDP General Terms and Conditions (distributed to campuses via C&G Memo 88-17, Suppl. 1, 10/26/88) specifies that the University must comply with the A-21 standards in determining the allowability of costs under the FDP.

The term "allowability" as used in A-21 has both a broad and narrow meaning. The broad meaning is that a cost has four characteristics: allocable; reasonable; allowable, i.e. not identified in A-21 Section J as unallowable; and has been incurred in a financial system that operates with consistency. The narrow meaning of allowable typically means that a particular direct cost is specifically named in A-21 Section J, where particular direct costs are defined as allowable or unallowable. To avoid confusion as to whether the broad or narrow meaning of allowability is intended in this guidance, the term "reimbursable" will convey the broad meaning, and the term "allowable" will convey the narrow meaning of A-21 Section J.

<u>Discussion of Reimbursability</u>

The term "reimbursable" encompasses the four A-21 standards of allocability, reasonableness, consistency, and allowability (see C&G Manual Chapter 6, Sections 6-530 through 6-534, and OMB Circular A-21, Section C).

Included in these four standards are the following ideas:

<u>Allocability</u>. A cost is allocable to a sponsored project if it meets the "benefits test", i.e. if the cost is incurred to advance the work on the project and charged in accordance with relative benefits

*Note: The addressees above represent the standard distribution of Contract and Grant Memos. Additional addressees, if any, may be added based on the subject of the Memo. See cc's.

received or other equitable relationship. This standard applies both to initial charges and to charges that are transferred to the project from somewhere else.

Reasonableness. A-21 defines reasonableness in terms of the "prudent person test". The general guide of reasonableness is, does the action "make sense" considering the context in which, and the purpose for which, the action is being taken. Usually the PI is in the best position to answer this question, but generally there will be other administrative control points within the system to ensure that prudent decisions are being made.

Allowability. For our purposes, we will use the narrow meaning of allowable to refer to a cost that (1) appears in Section J of A-21, agency regulations, or the notice of award as an unallowable cost, or (2) appears in Section J of A-21, agency regulations or the notice of award as requiring prior agency approval and that approval was not obtained. We can refer to this standard as the "Section J test."

Consistency. This standard refers to an attribute of the institution's financial system and it is attained through the consistent application of generally accepted accounting principles. We can refer to this standard as the "GAAP test."

It follows from the above that a cost charged to a federally-sponsored project may be subject to disallowance and not reimbursed if it fails one of the four tests: the benefits test, the prudent person test, the Section J test, or the GAAP test. Conversely, a cost is not likely to be questioned if it can be shown to pass all four tests.

EFFECT OF THE FDP

The purpose of the NSF and PHS prior approval systems was to provide documentation that a cost had passed the benefits test (allocability) and the Section J test (allowability) where the agency had delegated approval authority to the institution. The FDP has eliminated most cost related prior approval requirements. One might think, then, that elimination of certain prior approval requirements and elimination of requirements to have prior approval systems would be relatively easy to implement: all one need do, presumably, is change the list one uses when applying the Section J test. Why has implementation proved so difficult?

To answer this question, one must remember that, before the FDP, agencies kept a fairly tight rein on a PI's allocation decisions through the use of prior approval requirements, cost transfer restrictions, approved budgets, and controlled budget periods. The FDP, in various ways, has eased all of these controls. This has prompted renewed federal interest in what controls remain on the institutional level. In fact, every federal agency that has so far eliminated prior approval requirements has added a caveat to the effect that costs must still be allocable, reasonable, allowable, and consistent.

The University response has been to examine the ways in which costs charged to federal sponsors pass the benefits test (allocability), the prudent person test (reasonableness), the Section J test (allowability), and the GAAP test (consistency). Our findings are presented below:

DOCUMENTATION NEEDED UNDER THE FDP

<u>The Benefits Test (Allocability)</u>. This test is principally qualitative. The focus is on whether the action will advance or benefit the work on the project, i.e. is the action needed for those purposes. The benefit to the work on the project should be plausible. This test requires scientific judgment and expertise.

Prior to award the PI exercises scientific judgment by defining a research budget. Federal sponsors apply scientific expertise via peer review or competent agency scientific staff to confirming the judgments first made by the PI.

After award, when rebudgeting is needed, it is the PI who makes and is responsible for the decision. In accordance with existing University policy as stated in Section 6-440 of the C&G <u>Manual</u>:

> The Principal Investigator is the primary person responsible for financial management and the control of project funds in accordance with University and sponsor policies and procedures.

The benefits test requires that there be some evidence that the PI made the determination and authorized the charge.

Documenting that the PI made the decision and authorized the charge is, in the opinion of this office, sufficient to pass the benefits test in the absence of more restrictive sponsor or University policy. Such documentation can take many forms:

> the PI can sign or initial the University form that initiates the transaction;
>
> the PI can sign or initial a memo indicating his/her concurrence;

a person authorized in writing to act on behalf of the PI can sign or initial the form or memo; or

the PI can be given an access code or password for initiating a transaction on a computerized system (where the system is self-documenting and maintains an audit trail).

The focus of the foregoing documentation definition is to eliminate any need for the PI to write out or have recorded a lengthy explanation of the allocation determination for defensive purposes and third party review in the future. We do not believe this kind of documentation is required by published federal policy or regulation.

This focus, on the other hand, does not mean that PIs can act independently and autonomously from established University systems.

For checks and balance purposes, the minimum documentation required of the PI must be viewed in the context of University systems. The minimum documentation required by A-21 together with the documentation and internal controls built into institutional systems is more than adequate to assure prudent outcomes.

There are numerous areas where University policy requires approvals beyond that of the PI, in addition to the documentation required to pass the A-21 benefits test, e.g.

*All purchase requisitions require departmental approval, and certain kinds of purchases require additional reviews and approvals, such as major computer purchases, acquisition of dangerous drugs and hazardous materials, purchases of rugs and carpets, and subagreements.

*Purchase requisitions require a statement of the purpose of the purchase.

*Travellers on University business may not approve their own travel. Travel advance requests and travel claim forms contain blocks where the purpose of the travel should be stated.

*Consultant agreements have extensive review and approval requirements, as do orders for alterations and renovations.

Please refer to Chapter 7 of the Contract and Grant Manual for references to the University policy documents applicable to direct charges to extramurally-funded projects.

With respect to cost transfers, compliance with existing University policy in B&F Bulletin A-47 will ensure that sufficient documentation exists to pass the benefits test for transfers between unrelated projects. Cost transfers between related projects under the FDP do not need to be justified.

The Prudent Person Test (Reasonableness). Unlike the question of benefit, the question of what cost is reasonable to accomplish a given objective may not be within the PI's area of expertise. University policy recognizes this by providing for specific determinations of cost reasonableness by a designated University official for all purchases (including equipment), consultant costs, alterations and renovations, and travel. University personnel policy governs charges for salary, fringe benefits, moving expenses, and other payments to University employees paid as compensation. In general, the University operates under the principal that no one person should have complete control over all aspects of a financial transaction. The approvals required before disbursements of various kinds can be made (see Accounting Manual Chapter D-371-16) provide controls to ensure that costs charged to federal awards will pass the prudent person test. Therefore, no additional procedures are required to document that the prudent person test has been passed. The same is also true for the two following sections: the Section J test and the GAAP test.

The Section J Test (Allowability). University policy, as contained in Accounting Manual Chapter A-000-4, Section III.C.1.(b), requires campus accounting offices to monitor all financial and budgetary transactions to ensure compliance with the terms and conditions prescribed by external funding sources. The campus accounting office routinely reviews charges against federal awards to make sure the federal sponsor is not billed for unallowable costs (including costs that require prior approval where no approval has been given).

Under the FDP, most cost-related prior approval requirements have been eliminated. However, the federal agencies still have a legitimate interest in retaining prior approval authority for changes in scope of work, establishing project relatedness, and change in PI. The PI has the responsibility to make sure that these programmatic prior approval requirements are met. A list of the remaining prior approval requirements was distributed as Enclosure 4 to C&G Memo No. 88-17, Supplement No. 1, October 26, 1988.

A special case arises in the NIH and ADAMHA special FDP terms which suggest that a single budget deviation of more than $25,000 or 25% of the direct cost budget (whichever is greater) may constitute a change in scope of work. This requirement falls in the general framework of a PI's responsibility for determining when a change in scope is needed. PIs should accordingly be advised that one indication of a change in scope may be a significant budget deviation, where "significant" is defined by NIH and ADAMHA as more than $25,000 or 25% of the direct cost budget (whichever is greater). Of course, any such deviations must also pass the other three tests (benefits, prudent person, and consistency) and be processed in accordance with normal University procedures.

The GAAP Test (Consistency). In accordance with C&G Manual Chapter 4, Section 4-300, the Senior Vice President--Administration is responsible for assuring that audits of extramural funding agreement are performed in accordance with sponsor requirements. Federal audit requirements are currently contained in OMB Circular A-110, Attachment F, Paragraph 2.h. Accordingly, A-110 audits of the University's financial management systems have been conducted for the past 8 years. Of course, the University's financial statements are also audited annually. These audits provide sufficient documentation that the University's accounting system gives consistent treatment to both federal and nonfederal funds.

In conclusion, we can say that when a charge to a grant under the FDP has been authorized by the PI or designee and does not require prior agency approval, campuses need not impose additional prior approval requirements beyond those the University requires for nonfederal funds. This office recommends that campus do as much as they can to eliminate prior approval requirements and other controls that diminish the PI's ability to responsibly allocate resources under FDP grants.

Refer: Bill Sellers
ATSS 8-582-3045
(415) 642-3045

Subject Index: 06, 19
Organization Index: U-115

David F. Mears

David F. Mears
University Contracts and
Grants Coordinator

cc: Federal Systems Committee
Campus Accounting Officers
Don Alter
Wayne Ove
Kip Meader