

BY THE U.S. GENERAL ACCOUNTING OFFICE

# Report To The Secretary Of Health And Human Services

## Department Of Health And Human Services Should Improve Policies And Practices On Grant-Related Income

Many Department of Health and Human Services' grantees generate income under programs financed in whole or in part with federal assistance. Program income is a potential source of revenue for either increasing the size of federally assisted programs or reducing the federal government's and grantees' share of program costs. However, these objectives were not always being attained because regulations directing the grantees' use of the income did not exist or Health and Human Services' agencies and grantees were not always complying with existing regulations. GAO recommends a number of corrective actions.



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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT  
DIVISION

B-202774

The Honorable Margaret M. Heckler  
The Secretary of Health and Human  
Services

Dear Madam Secretary:

We recently performed a governmentwide review of federal agencies' and grantees' policies and practices on handling income generated under federally assisted programs. We found that a number of federal agencies, including the Department of Health and Human Services (HHS), had not established regulations conforming to the Office of Management and Budget's (OMB) grant related income standards and/or were not adequately implementing their grant related income regulations. As a result, the objectives which OMB sought to attain by issuing governmentwide program income standards--using the income to increase the size of federally assisted programs or to reduce the federal government's and grantees' shares of programs costs--were not always being attained. We are reporting the findings as they relate to your agency and recommending that you direct the HHS agencies included in our review to develop regulations on some grant related income issues and to comply with existing grant related income regulations so that the income standards' objectives can be attained.

HHS provided comments on this report, agreeing on some issues while disagreeing on others. Our evaluation of HHS comments is on page 11.

As you know, 31 U.S.C. §720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations. You must send the statement to the House Committee on Government Operations and the Senate Committee on Governmental Affairs within 60 days of the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. Our recommendations to you appear on page 11.

B-202774

We are sending copies of this report to the Director, Office of Management and Budget; appropriate Senate and House committees; and other interested parties.

Sincerely yours,

*W. J. Anderson*

William J. Anderson  
Director

RESULTS OF GAO'S REVIEW OF INCOME GENERATED  
UNDER DEPARTMENT OF HEALTH AND HUMAN  
SERVICES ASSISTANCE PROGRAMS

BACKGROUND

Grant-related income is any money received by grantees during the course of operating federally assisted programs. Grantees of many HHS programs generate income from (1) fees charged for providing health care and social services, (2) investment income (interest) earned on grant project funds, and (3) proceeds realized from the sale of property and equipment.

During the 1970's, OMB issued standards for handling income generated in whole or in part with federal funds.<sup>1</sup> By so doing, OMB established a governmentwide, uniform federal policy of generally holding grantees accountable for income.

OMB categorized different types of income by source and provided principles for each type's disposition, as follows:

- Interest earned by states or their instrumentalities on advances of federal funds need not be remitted to federal agencies per the provisions of the Intergovernmental Cooperation Act of 1968.
- Interest earned by others on advances of federal funds must be remitted to federal agencies.
- Proceeds from the sale of real and personal property are to be remitted to the federal government in proportion to the percentage of federal participation in the cost of the original project.
- All other program income (fees, rents, lease income, etc.) earned during the grant period is to be retained by grantees but used in one of three ways.

Circulars A-102 and A-110 specify the three available options for handling the last type of income--other program income. The grant agreement is to specify which one of the following options the grantee is to use:

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<sup>1</sup>Attachment E of Circular A-102: Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments, issued in 1971 (revised January 1981) and Attachment D of Circular A-110: Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations, issued in 1976.

1. **Additive:** Add the income to the funds committed to the project by the grantor and grantee and use it to further eligible program objectives. This is intended to result in a larger program than would otherwise be the case.
2. **Cost-sharing:** Use the income to finance the nonfederal share of the project. This is to result in the same size program. The grantee is allowed to use program income as part or all of its contribution toward project costs rather than having to contribute its share from its own resources. The federal contribution remains the same.
3. **Deductive:** Deduct the income from total project costs to arrive at net costs on which the grantor and grantee shares will be based. This is to result in the same size program, and unanticipated program income is used to reduce the grantor and grantee contributions rather than to increase the funds committed to the project.

These three options for handling other program income are graphically displayed in appendix II.

OBJECTIVE, SCOPE,  
AND METHODOLOGY

Our review was undertaken to assess Federal agencies' policies and practices for reporting and disposing of grant-related income. Two HHS component agencies were included in our review--the Public Health Service (PHS) and the Office of Human Development Services (OHDS). We used the departmentwide regulations (45 CFR 74) issued by HHS' Office of Procurement and Assistance Policy, Office of the Assistant Secretary for Management and Budget, as the primary criteria for the review of the HHS component agencies.

Federal financial assistance for health and human services is provided to state and local agencies through many programs. Because existing information and reporting systems were inadequate for determining all programs which were generating income, we selected and examined six programs--PHS's Community Health Centers and Migrant Health Centers programs and OHDS's Head Start, Runaway Youth, Aging Nutrition, and Aging Title III A&B (supportive services) programs--that had generated income, according to reports submitted by HHS grantees. We also performed a limited survey of PHS' Community Mental Health Program in two states and OHDS' Title XX Social Services Program in Washington, D.C., but did not review them in detail after the programs were converted into block grants.

The number of states we visited and the grantees/subgrantees we contacted, by program, are shown below.

<u>Program</u>	<u>Number of states visited</u>	<u>Number of grantees/subgrantees contacted</u>
Community Health Centers	8	9
Migrant Health Centers	7	8
Head Start	1	2
Runaway Youth	3	4
Aging Nutrition	4	12
Aging - Title III A&B	4	12

Our selection was generally designed to yield grantees with varying dollar size grants and a combination of grants for which income was and was not reported. Because our selection was judgmental, we cannot project our findings to other grantees. We interviewed grantee officials having program, administrative, and financial responsibilities and examined grantee records to verify the information obtained.

In Washington, D.C., (headquarters) and in four federal regions--New York, Atlanta, Denver, and Seattle--we interviewed HHS officials having program, grants administration, accounting, budgeting, and auditing responsibilities. We examined agency records and reviewed summaries of HHS' Inspector General audit reports for calendar years 1980 and 1981. We used these summaries, along with information we obtained from our audit work, to determine program income practices of federal grant administrators and grantees. The scope of our review did not include verifying supporting data for the summaries or determining corrective actions taken. We conducted these interviews and record reviews to ascertain HHS' policies on grant-related income and to determine whether agency and grantee practices were in accord with the policies.

This audit was performed in accordance with generally accepted government auditing standards.

#### WHEN SHOULD PROGRAM INCOME BE SPENT?

HHS has varying policies on when program income should be spent. Sometimes grantees are to use the income for current expenses and, thus, are to reduce their requests for federal funds by the amount of income received. Other times, however, grantees are allowed to retain and spend the income after or later in the project period and, thus, they would not reflect program income in their current drawdowns of federal funds. In addition to the cash management implications of this practice, it may be difficult for federal agencies to ensure that program income retained for expenditure after the project period will be used for originally agreed upon purposes.

HHS departmentwide rules on when grantees are to spend program income funds vary according to the option used. Under the additive option, the regulations allow grantees to use program income after HHS support ends. Under the deductive and cost-sharing options, however, grantees are required to use income for current costs unless the granting agency authorizes deferral to a later period. OHDS' Administration on Aging does not distinguish by option. It always requires grantees to spend program income funds before spending federal grant funds.

The matter of when federally assisted grantees are to spend program income funds is important when viewed in the context of federal cash management objectives. Reduced federal borrowing costs by virtue of reduced federal fund advances or reimbursements could result by requiring grantees to use program income funds to defray project costs before requesting federal funds. Although not explicit, this appears to be the objective sought by attachment H of OMB Circular A-102 which requires grantees to subtract program income from their requests for federal funds.

Situations may occur when federally assisted programs would benefit if grantees were allowed to retain income for future use. These situations, we believe, should be determined on a case-by-case basis rather than HHS giving blanket approval for grantees to retain income for future use whenever the additive option is used. Amending HHS' regulation to generally provide for the spending of program income before spending federal funds would ensure that the income is spent on project purposes during the time the project is active. This would result in reductions of grantees' immediate needs for federal funds.

#### CLEARER AND CONSISTENT GUIDANCE NEEDED IN USING PROGRAM INCOME OPTIONS

Problems in handling program income exist at the federal agency and grantee levels because HHS policies conflict internally. We also noted problems in the application of the deductive option. As a result, the objectives of the various specified uses of program income are not being fully achieved.

OMB issued Circulars A-102 and A-110 as part of a governmentwide effort to establish consistency and uniformity among federal agencies in administering grants to state and local governments and nonprofit organizations. While the HHS agencies we reviewed had issued regulations or policies dealing with the disposition of program income, their guidance and practices do not always reflect the consistent, governmentwide standards which OMB sought to achieve through its circulars.

#### Program income regulations and policies conflict internally

HHS regulations and policies governing certain aspects of program income conflict internally, thus confusing grantees on



the proper use of program income. HHS departmentwide regulations issued by the Office of Procurement and Assistance Policy provide that the deductive option is required when the grant agreement does not specify the option. Yet, an HHS component agency, OHDS, which has adopted the departmentwide regulations, requires, in its Grants Administration Manual, the additive option if no option is specified in the grant agreement.

In addition, OHDS' Administration on Aging allows the three HHS departmentwide options in one part of its regulations; but the statute authorizing the nutrition services portion of OHDS' aging program, incorporated into another part of the regulations, states that contributions made by service recipients must be used to expand services (the additive option).

We believe HHS regulations and policies concerning the options available for using program income should be clear and consistent and reflective of statutory requirements.

#### Implementation of the deductive option needs clarification

The deductive option available for using program income is not always being properly implemented and, therefore, the objective of the option is not always being achieved. The deductive option calls for program income to be deducted from the total project costs for the purpose of determining the net costs on which the federal share of costs will be based. The net effect is that if unbudgeted program income is earned, the federal and grantee funds needed to carry out the project will be less than that reflected in the approved budget.

Although only a few grants we reviewed specified the use of this option, we found that, as applied, the deductive option produced the results ordinarily achieved by the additive option. This occurred when HHS allowed grantees to exceed their budgets and use the program income to fund the additional expenditures. Operationally therefore, the grantee uses the program income to expand the project and, for accounting purposes, deducts the program income from the increased rather than budgeted total costs before computing the respective federal and nonfederal shares. As a result, the program income and additional expenditures are in effect netted-out, and the federal share is not based on a reduced amount as intended by the deductive option.

A PHS Community Mental Health project in Washington State illustrates how this use of the deductive method does not accomplish its objectives when total project costs are not limited to the grant budget. Federal funds of \$217,533 together with a grantee share of \$285,467 and anticipated program income of \$137,000, comprised the grant budget of \$640,000. The grant award specified the deductive option for handling any additional program income.

During the project period, the project had additional program income of \$50,901 which, by applying the deductive option, would have been shared between PHS and the grantee in proportion to their original shares. However, instead of reducing the Federal and grantee shares, the grantee added \$47,927 to the project and reduced its share of project costs by the remaining \$2,974. PHS approved a revised budget at the end of the grant year to authorize the increased actual expenditures. While this legitimized the grant activities, it, in effect, changed the use of the program income so as to accomplish the results that are obtained under the additive rather than the deductive option.

We recognize that circumstances may dictate the desirability of revising budgets and/or program income options during the course of, or upon completion of, projects. This example demonstrates, however, that HHS and grantees need to closely monitor program income and limit project expenditures to amounts in the approved budgets if the deductive option is to operate as intended.

#### BETTER REPORTING OF GRANT-RELATED INCOME IS NEEDED

Although the reporting of program income is required, grantees are failing to report millions of dollars of income generated under HHS programs. Many grantees are confused by the federal financial reporting forms and instructions and are either not completing the reports at all or are not completing them accurately. Further, not all types of grant-related income, such as interest and sales proceeds, are required to be reported. As a result, federal oversight and control of the disposition of the income are limited. Accurate and complete reporting of grant-related income would produce the information needed by HHS' component agencies to effectively oversee and control the significant amounts of income generated under federally assisted programs.

To determine the magnitude of nonreporting, we reviewed an HHS specially prepared computerized listing of pertinent HHS audit findings disclosing unreported grant-related income for calendar years 1980 and 1981. The printout showed that unreported income, as identified in the audit reports, totaled over \$13.4 million for the 2-year period. HHS reported that its operating components have concluded that, based on HHS' audit resolution process, \$10.1 million should be returned to HHS.

In addition to the grantees who simply neglected or were not required to report, others failed to report program income because they were confused by the financial reporting form and instructions. The basic financial reporting form used by HHS is the Financial Status Report (FSR)--Standard Form 269. We found that this form and the instructions for reporting program income are misunderstood by some HHS grantees.

The FSR provides space for reporting program income when the additive or deductive options are specified in the grant award. On the face of the report form, the only reference to program income is on line 10c which calls for program income credits to be subtracted from the total outlays.

The instructions for reporting program income appear in two places on the back of the form and read as follows:

line 10b "Enter the total gross program outlays (less rebates, refunds, and other discounts) for this report period, including disbursements of cash realized as program income. . ."

line 10c "Enter the amount of all program income realized in this period that is required by the terms and conditions of the Federal award to be deducted from total project costs. For reports prepared on a cash basis, enter the amount of cash income received during the reporting period. For reports prepared on an accrual basis, enter the amount of income earned since the beginning of the reporting period. When the terms or conditions allow program income to be added to the total award, explain in remarks, the source, amount and disposition of the income."

The FSR provides only a small space for "remarks" on line 12, which may limit its usefulness for reporting the requested information.

Apparently these instructions were not understood by all grantees. For example, a Runaway Youth Program grantee in Oregon was not reporting program income to OHDS because it was misinterpreting the FSR. The grantees' accountant explained that program income is not shown as program income credits (line 10c, FSR) because ". . . program income is added to the program, not credited." The accountant did not realize that the income should have been reported in the remarks section (line 12, FSR.) The accountant was also reporting only federal fund expenditures and not total program expenditures, and he said that no questions were raised by OHDS. To further illustrate, a Headstart Program grantee subtracted, as program income, the amount of its letter of credit withdrawals.

Some HHS agencies prescribe their own forms for grantee reporting of project expenditures, but these forms do not always facilitate income reporting. For example, OHDS' Title XX Social Services Program used an agency-prescribed form to report quarterly expenditures. Although a line exists titled "federal share of collections received", the space for entering dollar amounts is shaded out.

HHS' Public Health Service also developed its own financial status report. The Public Health Service's Financial Status

Report (PHS-FSR) is similar to OMB's FSR except that it provides somewhat better instructions and provides an expanded line 12 for reporting program income used under the additive option. Nevertheless, a Community Mental Health Center grantee in New York did not report about \$4.5 million in program income to PHS because, as the grantee told us, he did not know how to show program income on the reporting form. HHS stated that on every grant award, PHS identifies two people from whom the grantee may request assistance, and apparently, the grantee did not think of requesting such assistance from PHS.

Also in New York, we noted that one Community Health Center Program grantee earned program income but did not properly complete the PHS form. Program income was reported in the "remarks" section; however, the grantee included the federal grant award itself in the program income total. Therefore, the grantee incorrectly reported a much larger program income amount than was actually generated. The grantee's report showed over \$3,816,000 in program income; however, only about \$1,513,000 in program income was generated according to a certified audit report. A grantee official said the PHS form

--reporting instructions are unclear,

--should be expanded to provide line items for sources of income, and

--reflects unaudited and in many cases incorrect figures because the report is required before the final audit.

In addition, an HHS regional grants official said the PHS-FSR form does not provide the type of information needed to properly administer the program because the report does not provide complete and comprehensive financial information or individual line items for sources of income and expenditures.

Neither OMB's FSR nor PHS' FSR provide for reporting of all grant-related income. For example, when grantees use program income under the cost-sharing option, neither OMB's nor PHS' financial report forms require reporting this information. In the case of OMB, the reporting standards were developed in the early 1970's and the form was not changed when the cost-sharing option was first allowed in the mid-1970's.

Other grant-related income, such as interest and sales proceeds, is also not required to be reported on either form. Rather, interest earned by nonstate agencies and a proportionate share of proceeds from sales generally are to be remitted to the federal government, but grantees do not always remit such income. In these situations, however, grantees are not required to identify such income in their FSR's and thus, federal agencies do not know how much income was generated or how it was used. We found one case where a Community Health Center grantee in South Carolina sold 18 used motor vehicles unbeknown to HHS.

In this case, the appropriate proceeds were neither remitted nor reported to HHS at the time of the sale.

In summary, the existing financial status reports are not entirely adequate for grantee reporting on the source, amount, and disposition of all grant-related income. In a report to OMB, we recommended that its FSR be revised.<sup>2</sup> OMB told us that it would review all provisions of the circular. We believe that HHS should improve its financial reporting forms by requiring grantee reporting on the source, amount, and disposition of all grant-related income.

#### INTEREST EARNED ON CERTAIN FEDERAL FUNDS SHOULD BE RETURNED

Under the Intergovernmental Cooperation Act of 1968, states and their instrumentalities are not accountable for interest earned on advanced federal funds pending disbursement for program purposes. However, when interest is earned on (1) federal funds not pending disbursement and (2) federal funds advanced to nonstate agencies, grantees are required to remit the interest to the federal government.

The accountability requirement for these two interest earning situations is derived from the fact that the principal on which the interest is earned belongs to the government. However, HHS has not always taken adequate steps to identify and recover the interest earned.

#### Interest earned on federal funds not pending disbursement

The Intergovernmental Cooperation Act of 1968 (31 U.S.C. 6503(a)) exempts states and their instrumentalities from returning to the federal government interest earned on grant funds which are pending disbursement for program purposes. The act's nonaccountability provision, however, does not extend to interest earned by states and other grantees which are holding federal funds that are not awaiting disbursement for program purposes. Interest earned in these circumstances generally is required to be returned to the United States. HHS' regulations do not address the disposition of interest earned under these circumstances.

Our study of the cash management practices of nine states identified about \$126 million of federal funds that were owed to

<sup>2</sup>Improved Standards Needed for Managing and Reporting Income Generated Under Federal Assistance Programs (GAO/GGD-83-55, July 22, 1983).

the federal government but were not immediately returned. We estimated that about \$15 million of interest was earned on these funds. In our opinion, these funds were not being held pending disbursement for program purposes, and, therefore, the 1968 act's nonaccountability provision would not be applicable to the interest earned. The following examples illustrate the findings in the study.

- New York returned \$2.4 million of recoveries made under the Aid to the Aged, Blind, and Disabled Program between February and June 1980. While pending return, these funds were invested and the state earned over \$65,000 in interest on these funds. None of this interest was collected by the federal government.
- California recovered and invested \$2.7 million of Medicaid funds between August 1, 1979, and December 31, 1980. California earned over \$267,000 in interest on these funds but did not remit any of the interest to the federal government.

In these and similar cases, we believe that HHS should be recovering the interest earned on the federal share of funds not pending disbursement for program purposes.

#### Interest earned by nonstate agencies

Unlike states and their instrumentalities, other grantees are accountable for interest earned on advanced federal funds. Our review showed, however, that grantees are earning and retaining interest on premature advances and withdrawals of federal funds. For example:

- In an HHS Inspector General report dated December 31, 1980, the auditors noted that a New Mexico grantee, funded by HHS' Migrant and Community Health Service Programs, earned interest of \$6,588 over a 12-month period ending June 1979 on excess federal funds. The interest was not reported or returned by the grantee to HHS as required.

Our review of HHS Inspector General reports issued in calendar years 1980 and 1981 showed that HHS auditors identified 68 cases in which interest was earned on federal funds but was not reported or returned to HHS. The auditors calculated the interest earned was just over \$1 million. HHS stated that as a result of its audit resolution process, HHS operating components have concurred in almost all of these findings.

RECOMMENDATIONS TO THE SECRETARY  
OF HEALTH AND HUMAN SERVICES

We recommend that the Secretary of Health and Human Services:

- Direct the Office of the Assistant Secretary for Management and Budget to amend HHS' departmentwide regulations on grant-related income to provide that (1) income under all options be spent before federal funds unless the granting agency authorizes deferral to a later period, (2) all types of grant-related income including sales proceeds and interest be reported, (3) when the deductive option is used, grant budgets not be allowed to increase merely because unexpected program income was generated, and (4) interest earned on the federal share of funds not pending disbursement for program purposes be returned.
- Direct the Office of the Assistant Secretary for Management and Budget and OHDS to review and, where appropriate, revise their regulations and policies on the options available to grantees for using program income to ensure that they reflect statutory requirements, and to clarify them to remove internal conflicts.
- Direct PHS and OHDS, in concert with the Office of the Assistant Secretary for Management and Budget, to revise their financial reporting forms to provide for reporting on the source, amount, and disposition of all grant-related income.
- Direct PHS and OHDS to enforce their regulations requiring nonstate grantees to return interest earned on advanced federal funds.

AGENCY COMMENTS AND OUR EVALUATION

HHS provided comments on this report, agreeing on some issues while disagreeing on others. (See app. III.) Where HHS agreed, it stated its intention to change some of its regulations after OMB completes its study of the grants administration circulars and issues new policies.

With regard to our proposal that HHS require grantees to spend grant-related income before spending federal funds, HHS stated that to prevent possible abuses by grantees, it proposes to amend its regulations on the deductive and cost-sharing options to require that when HHS authorizes deferred spending of income to a specified later period, the income carried over must be used before using grant funds.

HHS disagreed, however, that changes are needed for the use of income for those grantees using the additive option. In these cases, HHS said that the costs borne by the income would not be those for which the federal grant funds may be spent. Thus, HHS concludes that it does not make any difference when the grantee spends such income because there would be no effect on the need for or use of federal funds.

HHS' regulations, however, on the grantees' use of income under the additive option are not as narrow as HHS states. HHS regulations do not preclude using income for allowable costs. Our review of grant awards authorizing grantees to use the additive option showed that grantees used additional program income to defray costs that were otherwise allowable as charges to federal funds. Thus, when grantees under the additive option use the income for allowable project costs, grantees' immediate needs for federal funds could be reduced if HHS adopted our recommendation.

HHS agreed that most, but not all, types of income should be reported, but it does not believe that its departmentwide regulations need to be amended to accomplish this. HHS agrees that general program income and interest should be reported, but not sales proceeds, and that reporting requirements should be on the forms themselves rather than in the regulations as we proposed. In line with this, HHS has proposed changes to OMB to ensure that general program income is properly reported on PHS financial status reports.

HHS regulations on grant-related income (45 CFR 74.4) do not require reporting of any program income. Other HHS regulations on financial reporting requirements (45 CFR 74.7) reference OMB's FSR and SFs 272 and 270, but these forms do not require the reporting of (1) income received by grantees under the cost-sharing option, (2) all types of interest income, and (3) sales proceeds. Amending HHS' departmentwide regulations on grant-related income to incorporate an income reporting requirement would serve to alert grantees that a reporting requirement exists and would provide information on how and where grantees are to report any income.

HHS believes that interest should not be reported on the FSR but on another existing OMB form, the Federal Cash Transactions Report (SF 272). HHS intends in early 1984 to adopt in its grant and contract payment system a modified version of this OMB form which includes a line and instructions for reporting interest.

HHS' proposed action will not fulfill our recommendation for several reasons. First, the SF 272 is designed to assist federal agencies in monitoring advances to grantees and to obtain disbursement information, not for monitoring program income. Unlike the FSR, the SF 272 does not require grantees



to show the source or disposition of the income. Second, the SF 272 is used only by grantees under the letter of credit or automatic check advance systems. Other grantees submit the SF 270, Request for Advance or Reimbursement, which does not provide for reporting interest. Third, grantees using the SF 272 need report only interest earned on advances. For full and complete income reporting, we believe that interest should be reported on the FSR.

HHS disagreed that sales proceeds realized by grantees when disposing of real or personal property should be reported. HHS' reasons were that (1) reporting is unnecessary because a grantee must remit the funds whether or not reports are required and (2) OMB circulars prohibit HHS from imposing requirements which would require detailed grantee property reports for many years and long after project completion.

We believe that a requirement to report sales proceeds would help ensure that the funds are ultimately remitted when remittance is required. We found that not all grantees remitted their sales proceeds. Also, OMB's property management standards, adopted by HHS, require grantees to maintain accurate property records up to and including disposition of the property. Neither the OMB standards nor our recommendation would require more property reports than grantees now maintain. Rather, grantees would report the sales proceeds on their FSRs when their projects are active and they dispose of property. For completed projects, grantees would continue to follow HHS' property management standards.

HHS does not concur with our proposal that its department-wide regulations on grant-related income be amended to provide that when the deductive option is used, grant budgets should not be allowed to increase merely because unexpected program income is generated. Instead, HHS plans to amend its regulations on the deductive option to clarify how it intends for the grantees to use unanticipated income to increase services or activities. HHS noted that seldom would its purposes be served by an alternative which reduces a grant rather than allowing a grantee to increase the size of the supported activity.

If HHS intends, whether because of statutory requirements or as a matter of policy, for grantees to increase the size of grant supported activities when unanticipated income is realized, then it should use the additive option as defined in OMB's standards and clarify in its regulations when the additive option, rather than the deductive option, should be used. When the deductive option is to be used, we believe it should be applied consistently with OMB's governmentwide standards, and, as we recommend, it should not be changed to the additive option merely because unanticipated income materializes.

We are recommending that HHS amend its departmentwide grant related income regulations to provide that interest earned on the federal share of funds not pending disbursement for program purposes be returned. HHS referred to our September 30, 1983, decision in B-196794, wherein we stated that interest earned on grant funds recovered by a grantee is governed by the provisions on applicable credits in the various sets of federal grant and contract cost principles. HHS noted that its regulations adopt the provisions regarding applicable credits to which we referred in our September 30 decision. HHS stated that our proposal that HHS amend its regulations was inconsistent with this decision and asked us to resolve the inconsistency.

The September 30 decision identified the category into which the interest falls, that is, an applicable credit. We then stated that applicable credits are to be applied to allowable costs, and to the extent not offset by allowable grant costs, the interest as well as the recovered grant funds are to be returned to the federal government. The effect of the September 30 decision is to allow grantees to use the interest earned as "applicable credits" against allowable costs up to the amount authorized for the grant, in lieu of drawing down additional funds from the grantor agency.

In the HHS examples we cite in the report, there were no more allowable grant costs against which the interest could be applied. Therefore, the amount earned must be returned to the Treasury. This result is consistent with our conclusion in the September 30 decision that any grant funds in excess of allowable costs must be returned to the United States. HHS' regulations regarding applicable credits do not address the disposition of such grant funds when there are no more allowable costs against which the applicable credits may be applied. Accordingly, we continue to recommend that HHS amend its regulations to provide that such funds must be returned to the United States to the extent that they are in excess of allowable costs.

HHS stated that if our recommendation is retained, it would concur but would not make changes in its regulations until after OMB completes its review of the grants administration policy circulars. We believe that the changes should be made without further delay because the issue of interest earned on funds not pending disbursement is not a policy issue. Any delays would result in continued retention by grantees of funds to which the federal government is entitled under existing law.

HHS concurred with our recommendation to review and remove a conflict between HHS's departmentwide regulations and OHDS' regulations on the proper option to use for certain income

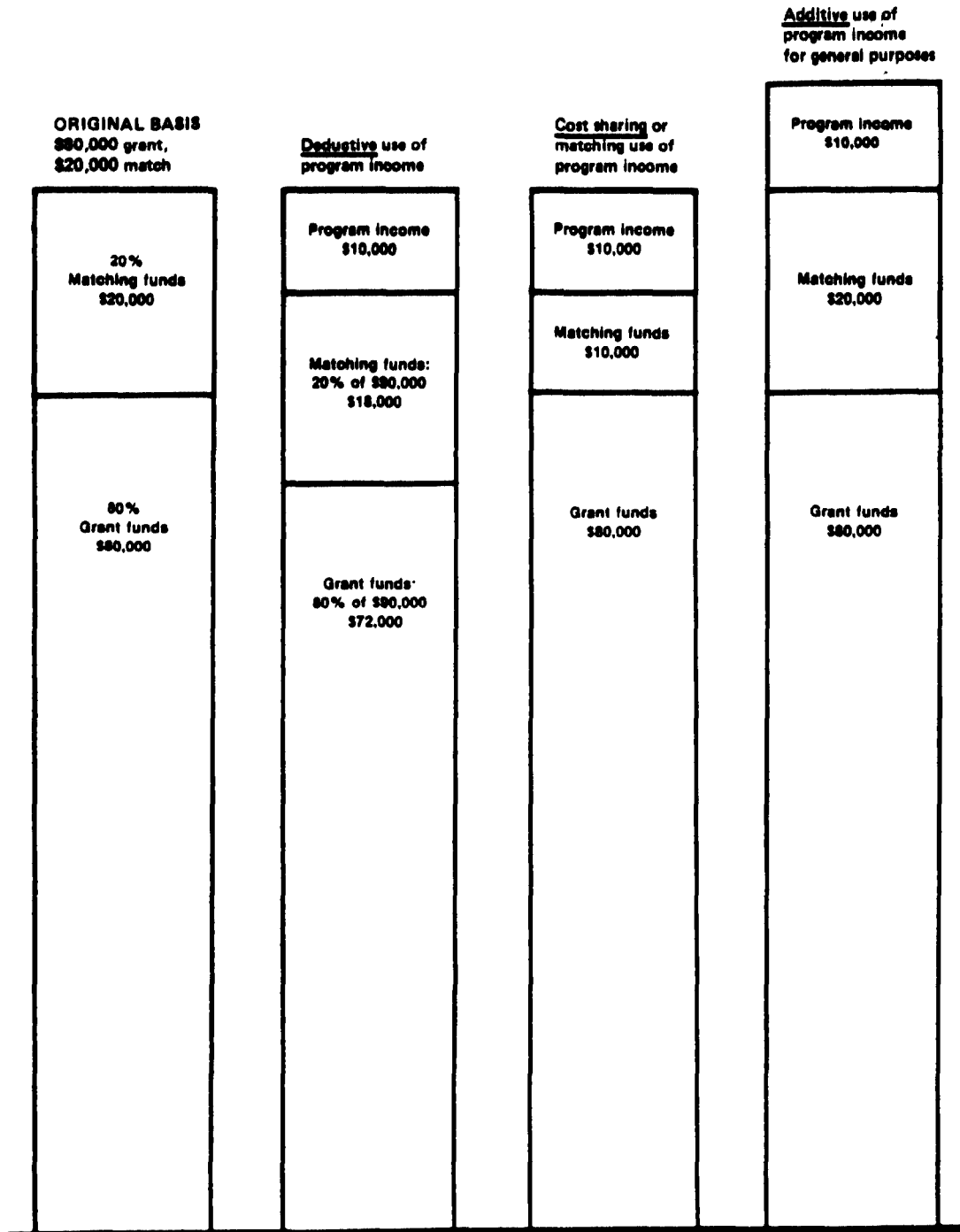
generated under the Older Americans Act. HHS said that corrective action is in process.

HHS also agreed to revise its financial forms for reporting program income and has submitted for OMB approval, a revised PHS-FSR that HHS believes meets our concerns. HHS added that because the reporting problems HHS is encountering are not unique to HHS, it would be preferable for OMB to make a governmentwide revision of the FSR. We made such a recommendation to OMB and it has agreed to review the FSR.

HHS concurred with our recommendation on enforcing regulations requiring the return of interest earned by nonstate agencies on advanced federal funds and said it will make changes in its grant payment system early in 1984 that should improve monitoring and enforcement.

HHS also provided some technical comments, and we incorporated them where appropriate in the report. We are referring to OMB HHS' proposed definition of grant-related income which we believe OMB should consider during its current study of the grants administration circulars.

## USE OF PROGRAM INCOME



Source: Department of Health and Human Services



## DEPARTMENT OF HEALTH &amp; HUMAN SERVICES

Office of Inspector General

Washington, D C 20201

NOV 29 1983

Mr. Philip A. Bernstein  
Director, Human Resources  
Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Bernstein:

The Secretary asked that I respond to your request for our comments on your draft of a proposed report "Department of Health and Human Services Should Improve Its Policies and Practices on Grant-Related Income." The enclosed comments represent the tentative position of the Department and are subject to reevaluation when the final version of this report is received.

We appreciate the opportunity to comment on this draft report before its publication.

Sincerely yours,

Richard P. Kusserow  
Inspector General

Enclosure

COMMENTS OF THE DEPARTMENT OF HEALTH AND HUMAN SERVICES ON THE COMPTROLLER GENERAL'S DRAFT REPORT, "DEPARTMENT OF HEALTH AND HUMAN SERVICES SHOULD IMPROVE ITS POLICIES AND PRACTICES ON GRANT-RELATED INCOME"

General Note

In several of our comments below, we state our intent to amend our Departmentwide grants administration regulations (45 CFR Part 74). Such amendments, of course, are subject to OMB review under E.O. 12291

OMB is currently conducting an interagency review of OMB Circular A-102, one of the two OMB grants administration circulars implemented by our regulations. We understand that OMB will probably make a similar review of the other grants administration circular (OMB Circular A-110). The results of these reviews are expected to be new Executive Branch policies on grants administration, and the HHS regulatory changes referred to in our comments will be made only after issuance of those new policies and only if in conformity with them.

GAO Recommendation

We recommend that the Secretary of Health and Human Services direct the Office of Procurement and Assistance Policy to amend HHS' department-wide regulations on grant-related income to provide that income under all options be spent before Federal funds, unless the granting agency authorizes deferral to a later period.

Department Comment

We will amend our regulations to respond to concerns raised by the GAO report in this matter but we do not concur in this specific recommendation.

The regulations already include the recommended rule for two of the three alternatives for general program income -- the deduction and matching alternatives. To prevent possible abuses by grantees, however, we will amend our regulations to provide that, under these alternatives, if the granting agency does authorize deferral of use of income until a specific later period, the income so carried over must be used in that period before grant funds.

We disagree with GAO only with respect to applying their recommendation to the third alternative use of grant related income, the so-called additive alternative. In such instances (which occur only if HHS prior approval is obtained) grantees are authorized to use the income they have generated only for purposes which further the objectives of the Federal statute under which the grant was made. However, the costs borne by the income would not be those for which the Federal grant funds may be spent. For example, income could be used to pay the borrowing costs (interest) incurred by the grantee. In such

situations, we do not believe it makes sense to require income to be spent before the Federal funds. Since income under the additive alternative would only be for statutory purposes beyond those for which Federal dollars could be spent (not in lieu of Federal funds), no delay of the need or use of Federal funds would occur, as GAO believes, if such income was required to be spent first.

#### GAO Recommendation

We recommend that the Secretary of Health and Human Services direct the Office of Procurement and Assistance Policy to amend HHS's department-wide regulations on grant-related income to provide that all types of grant-related income including sales proceeds and interest be reported.

#### Department Comment

We concur that reporting of two of the classes of this income should be required. We do not concur regarding reporting of a third class, and we do not concur that our regulations should be amended on this matter.

Specifically, we agree that a grantee should be required to include general program income and interest on grant funds on its financial reports to HHS. However, we believe that the requirement to do so, like similar requirements, properly belongs on the forms themselves and not in the regulations.

As explained in our response below to a later recommendation, we have proposed changes to OMB to ensure that general program income is properly reported on PHS Financial Status Reports.

With respect to interest, there is already a line and instructions for reporting this income on OMB's Federal Cash Transactions Report (SF 272, line 13.a). Early in 1984, HHS' main grant and contract payment system will adopt a modified version of the SF 272 which will contain the line for reporting interest. The SF 272, rather than the Financial Status Report, as the body of the GAO report suggests, is the appropriate report for reporting interest. It is required quarterly or, when grants are very large, monthly rather than often only annually (as for the Financial Status Report).

We disagree with this GAO recommendation as it applies to sales proceeds (or market value) of equipment and real property when the property is no longer to be used for authorized purposes.

By way of background, we point out that, in general, a grantee may acquire such property only with the prior approval of the HHS granting agency. Once a grantee acquires equipment, the grantee must use it for activities that are or have been Federally funded, maintain it in good condition, inventory it at least once every two years, and keep accurate property records, subject to audit, showing location, use, and condition. There are also rules governing use of real property. The requirement to remit funds applies, upon final disposition, to equipment with a unit acquisition cost of \$1,000 or more and to real property.

We think the recommended reporting requirements are unnecessary since a grantee must remit the funds whether or not reports are required. More importantly, we are not able to impose such requirements. Full reporting would require detailed property reports from the grantee for many years and long after the completion of the original project; OMB circulars prohibit us from imposing such property requirements.

#### GAO Recommendation

We recommend that the Secretary of Health and Human Services direct the Office of Procurement and Assistance Policy to amend HHS' department-wide regulations on grant-related income to provide that when the deductive option is used, grant budgets should not be allowed to increase merely because unexpected program income was generated.

#### Department Comment

We do not concur. We will, however, amend our regulations to clarify the effect HHS intends for this alternative.

This recommendation seems to be based on the belief that this alternative should have the effect that, under it, any general program income earned in excess of the amount anticipated at the time of award must be used to reduce the size of the grant. This was not our intent in drafting this alternative. Nor would we wish this alternative to have this effect.

We will first explain our view of this alternative.

We call this alternative the "deduction" alternative for general program income because, as explained in the regulations, the grantee, under it, in contrast to the "matching" alternative, deducts the income from total allowable costs and third-party in-kind contributions to determine the amount to which the maximum Federal share percentage will be applied. Another way of describing this alternative is that, under it (1) income is applied to allowable costs and (2) the costs paid by the income do not count as required matching if there is a matching requirement.



To be allowable, costs must be for activities within the scope of the grantee's approved project or program and meet the other standards for allowability in the applicable set of Federal grant-and-contract cost principles.

To be allowable, it is not necessary that costs be budgeted. Nor is there any general rule, in the cost principles or elsewhere, that costs exceeding the amount of costs in the budget (when there is a budget) are, per se, unallowable. This would be true only if the nature of the approved activity is such that increasing the size of the budget constitutes in itself a change in the scope of the approved activity.

Consequently, under this alternative, the grantee may use income either to reduce the amount of Federal and other funds needed or to pay costs beyond the amount budgeted, provided the costs are allowable. This was precisely our intent.

It is true that the alternative may correspond to a combination rather than only one of the alternatives listed in OMB Circulars A-102 and A-110, but we believe that it is an acceptable implementation of those circulars.

This alternative is the standard alternative for HHS grants. It applies and is the only alternative available if the other grant terms are silent on general program income. And it is always available to the grantee, even if the other grant terms also permit other alternatives.

We will now explain why we wish to continue this approach rather than make the change recommended by GAO.

Basically, we believe that this alternative, as presently written, is very well suited to our programs and policy objectives. In most of our programs, we wish to encourage, not discourage, our grantees to earn general program income and increase services and activities under their grants. Seldom would our purposes be served by an alternative reducing a grant rather than allowing the grantee to increase the size of the supported activity with general program income. This would be the effect of changing the deduction alternative as recommended by GAO.

We also point out that the recommended change could be subject to challenge in a major group of our grant programs, those in which funds are allotted to grantees (principally States) according to a statutory formula. This would be so because, under the changed alternative, the amount allotted to a grantee would be subject to reduction based upon a factor (program income) not included in the statutory formula.

Thus, if we followed the report's recommendation, we would have drastically changed program income rules which would be very unsuited to our programs and objectives. Instead, we intend to amend our regulations to clarify the effect HHS intends by this alternative.

GAO Recommendation

We recommend that the Secretary of Health and Human Services direct the Office of Procurement and Assistance Policy to amend HHS' department-wide regulations on grant-related income to provide that interest earned on the Federal share of funds not pending disbursement for program purposes be returned.

Department Comment

We concur in this recommendation if it is retained after GAO resolves the inconsistency noted below in our technical comment on page 11. As noted above, the changes will be made following completion of OMB's review of its grants administration policy circulars.

GAO Recommendation

We recommend that the Secretary of Health and Human Services direct the Office of Procurement and Assistance Policy and OHDS to review and, where appropriate, revise their regulations and policies on the options available to grantees for using program income to ensure that they reflect statutory requirements, and to clarify them to remove internal conflicts.

Department Comment

We concur.

There is already in process a revision of the OHDS Discretionary Grants Administration Manual that will remove a conflict with the income policy in the Departmentwide regulations in 45 CFR Part 74 (see 47 FR 44474, October 7, 1982). The conflict arose because the Manual was published before the current policy in the regulations.

We will direct OHDS to send an information memorandum to AoA grantees explaining that, for income subject to Section 307(a)(13)(C)(ii) of the Older Americans Act, the provisions in that Act concerning use of the income applies and not the provisions in the Departmentwide regulations or the general AoA policy on the use of program income. An amendment to the Departmentwide regulations is not necessary since they already provide that they do not apply where inconsistent with Federal statutes (45 CFR 74.4).

GAO Recommendation

We recommend that the Secretary of Health and Human Services direct PHS and OHDS, in concert with the Office of Procurement and Assistance Policy, to revise their financial reporting forms to provide for reporting on the source, amount, and disposition of all grant-related income.

Department Comment

We concur, with the following exceptions and qualifications:

1. It is frequently not until long after a grant is over that the grantee makes final disposition of property. Therefore, we do not concur in the portion of this recommendation concerning the reporting of sales proceeds or market value of this property on financial reporting forms, since they are submitted only during and at the end of the grant.
2. We believe that sources of income (or how the income was earned) may not be needed for some programs and, in most cases, need be required only if the sources or means are different from those identified in the application or State plan.
3. "Reporting on . . . disposition" we understand means identifying which alternatives the income was used under, how much for each, and, for income used under the additional costs alternative, the purposes for which the income was used (when used during the period of grant support).
4. Our ability to comply with this recommendation depends upon OMB approval of the necessary changes to the reporting forms.

The Department has recently submitted to OMB a revised SF 269 (Financial Status Report) for use by PHS that we believe meets GAO's concerns on this issue.

We believe that, instead of individual agency modifications of the SF 269 in order to improve reporting of general program income, it would be preferable for OMB to make a Governmentwide revision of the form. The income reporting problems HHS is encountering are not unique to HHS, and grantees would benefit from a standardized approach in this area.

GAO Recommendation

We recommend that the Secretary of Health and Human Services direct PHS and OHDS to enforce their regulations requiring non-State grantees to return interest earned on advanced Federal funds.

Department Comment

We concur. We will direct PHS and OHDS to continue to use all available means to monitor and enforce compliance with the interest rules.

As explained in our comment on page 2 above, early in 1984, HHS' main grant payment system will begin requiring a Federal cash transactions report form that will provide for reporting of interest. This should improve monitoring and enforcement.

Technical Comments

General. The report refers frequently to HHS' Office of Procurement and Assistance Policy. This is a component of the Office of the Assistant Secretary for Management and Budget, and it would be more appropriate to refer to that office or to that Assistant Secretary.

Appendix I, page 1--"Grant-related income is any money received by grantees during the course of operating federally assisted programs."

This definition has the effect of incorrectly including third-party grants and cash gifts. To correct this inaccuracy, we suggest that "received" be changed to "earned." We also think the definition will be more accurate if "during the course of operating" is changed to "under."

Appendix I, page 7--"The printout showed that unreported income, as identified in the audit reports, totaled over \$13.4 million for the 2-year period."

In the audit resolution process, HHS operating components have concluded that, based on these findings, \$10.1 million in grant funds should be returned to HHS. Subject to appeal by the grantees to HHS' Grant Appeals Board, the components are taking action to recover this amount. We believe that the report should point this out.

Appendix I, page 9--"The Public Health Service's Financial Status Report (PHS-FSR) is similar to OMB's FSR, except that it provides somewhat better instructions and provides an expanded line 12 for reporting program income used under the additive option. Nevertheless, a Community Mental Health Center grantee in New York did not report about \$4.5 million in program income to PHS because, as the grantee told us, he did not know how to show program income on the reporting form."

We think the GAO ought to point out that apparently the grantee did not think of requesting technical assistance from PHS. On every grant award notice, PHS identifies two people from whom the grantee may request such assistance.

Appendix I, page 11--"Interest earned in these circumstances generally is required to be returned in accordance with the provisions of 31 U.S.C. 3302 Revised. HHS's regulations do not address the disposition of interest earned under these circumstances." The examples cited in the report to illustrate what GAO has in mind deal with recovered funds being held prior to repayment to the Federal Government.

In Decision B-196794, September 30, 1983, the Comptroller General concluded that interest earned on grant funds recovered by a grantee or subrecipient from a third party is governed by the provisions on applicable credits in the various sets of Federal grant and contract cost principles. HHS' regulations in Subpart Q of 45 CFR Part 74 adopt those principles for virtually all HHS grants other than block grants. Thus, there is an inconsistency between the draft report and the September 30 decision, and we think GAO should resolve this inconsistency in the final report.

Appendix I, page 12--"Our review of HHS Inspector General reports issued in calendar years 1980 and 1981 showed that HHS auditors identified 68 cases in which interest was earned on Federal funds but was not reported or returned to HHS. The auditors calculated the interest earned was just over \$1 million."

In the audit resolution process, HHS operating components have concurred in \$959,475 of these findings and, subject to appeal by the grantees to HHS' Grant Appeals Board, are taking action to obtain this amount. We believe that the report should point this out.

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