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FEDERALLY SPONSORED  
RESEARCH

Indirect Costs Charged by  
Selected Universities

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



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Mr. Chairman and Members of the Subcommittee:

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

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

In summary, we identified numerous deficiencies in the cost allocation methods and charging practices at the three universities. In some cases, we found problems that the university, the university's external auditors, or the cognizant audit agency had already reviewed but had not questioned. These problems occurred because (1) certain OMB Circular A-21 criteria were inadequate for determining which types of costs should be allowed or how costs should be properly allocated among the different university functions; (2) universities generally lacked adequate systems and internal controls to ensure that only allowable indirect costs were charged to the government; and (3) lax oversight practices by the cognizant federal agencies resulted in universities claiming excessive indirect costs.

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

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

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

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

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

### BACKGROUND

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

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

In contrast, HHS typically uses a predetermined fixed-rate scheme; that is, the agency negotiates a fixed rate with the school for generally a 2- or 3-year period, on the basis of prior year incurred costs. Because this negotiated rate is not later audited or adjusted for actual costs, the schools following this approach may over-recover or under-recover their actual indirect costs.

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

We generally examined the most recent indirect cost proposal at each of the three schools reviewed. Our objective was to determine whether the types of mischarges and misallocations of costs we reported on in March were also occurring at schools other than Stanford and, if so, to determine the causes and types of actions that might be needed to correct them. Our review was not intended to determine what the actual indirect cost rate should be for each of the three universities. At MIT, the Defense Contract Audit Agency (DCAA), which has audit responsibility for all ONR-cognizant schools, is currently in the process of auditing MIT's indirect costs for fiscal years 1986 through 1990<sup>4</sup>. Therefore, we primarily reviewed DCAA's ongoing audit work and results. Further information on the details of the work performed at each of these universities can be found in appendix I.

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

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

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

UNALLOWABLE AND QUESTIONABLE  
COSTS CHARGED TO FEDERAL RESEARCH

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

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

In addition, Harvard Medical's review of administrative accounts, as well as external audits that used sampling techniques, identified a total of \$1.8 million in unallowable or questionable costs; of this total \$254,000 was allocated to the government. These costs included those that were incurred at the central Harvard University level, as well as at the Medical School. We reviewed the same sample of transactions and identified an additional \$894,000 in unallowable or questionable costs, of which \$75,000 was allocated to the government. These included costs for such items as alumni publications, extra pension costs for a non-Medical School dean, and excessive athletic facility costs.

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

At Berkeley, we identified about \$736,000 in unallowable or questionable transactions, \$66,000 of which was allocated to the government. These included costs that were incurred at the central University of California level, as well as at the Berkeley campus. These included about \$300,000 for furniture and decorating items for the University's residence halls, items which should have been

charged directly to other institutional activities. In addition, other unallowable or questionable items charged included alumni publications; Berkeley High School's graduation, which was held at the University; and 150 football tickets for potential University donors.

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

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

#### IMPROPER ALLOCATIONS OF COSTS TO FEDERAL RESEARCH

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

#### Space Allocations

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

At Harvard Medical, many of the federal and nonfederal research projects share the same space, and HHS found that Harvard Medical allocated the space between, and thus developed separate rates for, both kinds of research. By doing so, a disproportionately higher share of space costs was assigned to federal research, despite the fact Harvard Medical officials could

not support the basis for this distinction. As part of their ongoing negotiations with HHS, Harvard Medical agreed to combine federal and nonfederal research into a single rate. This resulted in a \$700,000 reduction in the indirect costs allocated to the government.

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

### Special Studies

OMB Circular A-21 allows universities to allocate certain costs on the basis of a cost analysis study if the study demonstrates a more equitable distribution of costs. All three universities performed utility studies to attempt to justify higher allocations of costs to research. Basically, these studies measured actual utility consumption to calculate weighting factors that were then used to allocate utility costs. These weighting factors served to allocate proportionately more costs to space, such as research labs, which use more energy. DCAA found problems with MIT's utility study which it will report on in its 1990 audit report. Although we found no problem with the application of Berkeley and Harvard Medical's studies to utility costs, we did find several problems with their application to nonutility costs.

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

Berkeley also allocated the cost of its energy conservation office using utility study factors. Likewise, Harvard Medical used the results of its utility study to allocate the depreciation costs for electrical, plumbing, heating, ventilation, and air conditioning equipment. Because none of these costs, including the utility maintenance costs, were included in the utility studies, they should not have been allocated on the basis of the utility study results. Since utility study factors weight costs more



heavily toward research, using these factors for nonutility costs resulted in a higher proportion of costs being allocated to research without justification. By using these factors, Berkeley allocated an additional \$76,000 to federal research, while Harvard Medical allocated an additional \$174,000.

### Memorandums of Understanding

As you may recall from our previous testimony, Stanford's allocation process was largely driven by memorandums of understanding (MOUs) that had been accepted and approved by ONR. MIT--the other ONR school we reviewed--also had several MOUs that affected its allocation methods. Interestingly, DCAA issued a report in early February 1991 stating it had reviewed all 10 of MIT's MOUs and had determined that "in all cases, the contractor is in compliance with the terms of the MOUs and that the bases for the MOUs are reasonable." This analysis was incorporated into DCAA's audit report of MIT's 1986 actual costs, which DCAA issued on February 28, 1991. After the March 1991 hearings on Stanford, DCAA withdrew its report and reopened its audit. As of this month, DCAA officials informed us that they had identified \$4.8 million in questioned costs to the government relating to several of the MOUs.

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

While the two HHS schools we reviewed, Harvard Medical and Berkeley, did not have any written MOUs, HHS allowed some allocation methodologies that deviated from Circular A-21. These allowed methods could be considered "unwritten" MOUs. For example, A-21 requires depreciation and use allowance costs to be allocated on a building-by-building basis. However, Berkeley allocated its equipment costs by department and, in addition, did not sample all departments. Therefore, the allocations do not comply with A-21 requirements and would not necessarily be accurate even if they were in compliance. The HHS negotiator told us he was aware of this allocation method but did not consider it a problem because he did not consider the equipment costs to be material. We believe the costs are significant, however, since about \$5 million in equipment costs were allocated to federal research, even though we could not determine what portion was affected by this method.

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

#### OTHER INDIRECT COST PROBLEMS

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

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

I should note that while we found numerous problems with Berkeley's indirect cost proposal, in addition to those already mentioned, not all of the problems we found were in Berkeley's favor. Unlike the other schools we reviewed, Berkeley made some mistakes that actually ended up in the government's favor by allocating fewer costs to the government than it would have without these mistakes. These mistakes included, for example, minor calculation errors in the utility study, use of the wrong utility factors in the proposal, and misallocation of some operation and

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

maintenance costs. While these serve to offset some of the dollar amounts that were in Berkeley's favor, of greater concern is the weakness in internal controls and other checks that should prevent or detect such errors.

#### CAUSES OF PROBLEMS NOTED

Mr. Chairman, the problems identified resulted from breakdowns in several key areas of the system dealing with indirect costs. First, Circular A-21 criteria were inadequate for determining the types of allowable costs and how those costs should be properly allocated among university functions. These inadequacies occurred because some principles in A-21 were vague, inconsistent, or absent altogether. For example, until OMB's recent revision to Circular A-21, university officers' housing costs were not identified as unallowable charges to the government.

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

Last, we believe that lax oversight practices by ONR and HHS were contributing factors. At the schools visited, we found instances in which both agencies failed to adequately review their assigned universities' indirect cost proposals or claims to detect and remove unallowable and/or unallocable costs. For example, ONR officials were lax in performing their responsibilities by not always requesting audits on a timely basis and by entering into MOUs that resulted in improper over-allocations of indirect costs to the government. DCAA, which is responsible for auditing the ONR schools, was in many cases years behind in performing requested audits. For example, DCAA did not complete its audit of MIT's 1986 costs until February 1991, and it is currently re-auditing those costs as well as those for 1987 through 1990<sup>6</sup>. In addition, DCAA did not always review cost submissions for unallowable items in sensitive accounts, such as the President's House accounts. According to the HHS Director of the Division of Cost Allocation, HHS negotiators spend their limited time examining the broader allocation process rather than looking at individual cost transactions, and often negotiate reductions in universities' proposed indirect cost rates which he believes more than compensate for any unallowable costs not identified by their negotiators. As an example of the results of this process, Berkeley's proposed rate of 59 percent was negotiated down to 49 percent, equivalent to a reduction in indirect costs of about \$8 million. However, we found

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

several allocation problems, as well as unallowable cost charges, at Berkeley which had not been identified by the negotiator.

#### ACTIONS TAKEN OR PLANNED

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

At the university level, HHS and DCAA reported to you in May 1991 that some institutions had begun their own reviews of indirect costs and would be returning millions of dollars to the government or reducing proposals or claims that had already been submitted. Since the March 1991 hearings, Stanford University has directly repaid about \$1,351,000 to the government and has made additional adjustments to the carry-forward totalling \$596,000, for a total reduction to date of \$1,947,000. Similarly, MIT has repaid \$778,000 for unallowable or inappropriate expenses. Harvard Medical has made net reductions totalling \$248,000 to its proposed 1991 indirect cost rate since submitting its original proposal. Stanford and the three additional schools we reviewed have also started planning for or have already implemented modifications to their accounting systems to better segregate allowable from unallowable costs and have begun training programs to better educate their employees on the federal cost principles.

OMB, recognizing the shortcomings of Circular A-21, issued a major revision to it in October 1991. This revision, which is the first in 5 years, further defines and limits allowable indirect costs. Among other things, the revision clarifies and disallows certain types of costs that had previously been paid to universities. For example, we reported to you in March on costs

such as flowers, sterling silverware, cedar closets and other expenses incurred for the Stanford University President's home. Circular A-21 had been silent on whether such costs were allowable. The new revision to A-21 now clearly disallows the housing and personal living costs of institutions' officers. More significantly, Circular A-21 now limits reimbursement for administrative expenses to 26 percent, which OMB has estimated will reduce federal reimbursements by \$80 million to \$100 million a year.

### CONCLUSIONS

In conclusion, Mr. Chairman, the actions that have been and are being taken appear to be appropriate interim steps. However, they alone are not sufficient to prevent future occurrences of the same kinds of abuses noted in these hearings without a commitment of a substantial amount of resources, both by the universities and the cognizant agencies. Furthermore, both the Congress and the administration have expressed concern about rising indirect costs and the impact these costs have on the government's ability to fund a growing array of university research activities. Both are complicated issues that need to be addressed.

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

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

OBJECTIVES, SCOPE, AND METHODOLOGY

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

At MIT, the Defense Contract Audit Agency (DCAA) is currently auditing incurred costs for fiscal years 1986 through 1990<sup>7</sup>. Therefore, we primarily reviewed DCAA's ongoing audit work and results. At Harvard Medical, we focused our review on its fiscal year 1991 proposal, which is based on actual 1989 costs. This proposal is still under negotiation and appeal with the Department of Health and Human Services (HHS), thus we also considered some of HHS' findings. In conjunction with its proposal, Harvard Medical had also hired an outside accounting firm to review its administrative accounts to identify and eliminate any unallowable or inappropriate transactions. We reviewed the accounting firm's results, as well as the firm's sampling methodology. Some of the costs in Harvard Medical's proposal were actually incurred at the central Harvard University level, then allocated out to the various schools, such as the Medical School. Our findings reflect only the dollar effect from the Medical School; the true effect to the government would be somewhat higher since the government also pays for portions of costs at the other Harvard University schools conducting federal research.

We reviewed Berkeley's fiscal year 1990-92 proposal, which is based on actual 1988 costs. This proposal had already been negotiated and closed at a lower rate than Berkeley proposed--resulting in a difference of approximately \$8 million. Like Harvard Medical, some of the costs in Berkeley's proposal were incurred at the University of California (UC) level, then allocated to the nine UC campuses, including Berkeley. While our findings

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

reflect the impact to the government at Berkeley, the true effect to the government would be higher since all of the central UC costs are allocated to each of the nine UC campuses, portions of which are paid for by the government through each school's indirect cost rates.

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

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

EXAMPLES OF UNALLOWABLE OR QUESTIONABLE  
COSTS CHARGED TO FEDERAL RESEARCH

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

UNALLOWABLE COSTS

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

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

- Other costs. Harvard Medical charged \$89,300 for a portion of the university's athletic facilities' costs, even though Harvard Medical also included the subsidized cost of employee memberships in a local health club. It also charged \$42,200 for recruiting a new faculty member, which included paying the points and mortgage payments on a condominium, and \$4,950 resulting from duplicate printing bills paid. For these three items, Harvard Medical allocated \$29,629 to the government.

- Legal Fees. Circular A-21 states that for costs to be allowable they must, among other things, be given consistent treatment through application of those generally accepted accounting principles appropriate to the circumstances. One such principle includes the matching of



costs to the benefitting time period. Harvard Medical incurred \$564,069 in legal fees in negotiating a 3-year union contract, most of which was paid in the proposal year. Rather than allocating these expenses over the term of the contract, the University recorded the expenses in the proposal year, thus inflating the proposal for the future years. Only one-third of the legal fees should be allowed in the proposal year, while the excess costs of \$275,891, should be disallowed from the proposal. Of the excess, \$9,656 was allocated to the government.

- Alumni Activities. Circular A-21 specifically disallows costs incurred for alumni activities; yet Berkeley spent \$10,000 in postage costs for the "CalReport," an alumni publication. Berkeley also charged its subscription to Harvard Magazine, Harvard's alumni publication, to indirect costs. Similarly, Harvard Medical spent \$65,401 for special alumni mailings. For these transactions, these schools allocated over \$4,000 to federal research.
- Public Relations Activities. Circular A-21 disallows costs incurred for general public relations activities. Berkeley donated \$500 for a community festival, \$1,594 to send representatives to a University of California at Los Angeles (UCLA) convocation and to a California State University at Los Angeles (Cal State-L.A.) inauguration. It also spent \$2,907 on three events for high school students, and \$290 to send representatives to two dinners sponsored by special interest groups. For these activities, Berkeley allocated over \$900 to the government.
- Travel Expenses. Harvard Medical charged \$7,330 for governing board travel costs on two trips, one examining issues related to election of university officials and the second to study investment and divestment in South Africa. The University of California (UC) charged \$2,600 for UC's former president and his wife to fly first class to attend a dedication of student housing named after him. Since these individuals are not UC employees and there is no necessary benefit to either Berkeley or the other eight schools in the UC system, the entire trip is unallowable. The portion of cost allocated to the government for these two trips was \$315.

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

In addition, UC charged \$14,881 for chartered aircraft on 5 trips, 4 of which originated and ended within California. Four of the trips involved only one passenger, the fifth two passengers, and no justification was provided for the chartered aircraft for any of the trips. For these, the government charges, applicable only to Berkeley, was \$365.

- Fund-raising Activities. Circular A-21 states that costs of organized fund-raising and similar expenses incurred solely to raise capital or obtain contributions are unallowable. Berkeley spent \$3,300 to purchase 150 football tickets to give to potential donors, \$580 of which was allocated to the government. Harvard Medical also spent \$8,296 in preparing a history on endowed professorships. For this, \$290 was allocated to federal research.
- Advertising Expenses. OMB Circular A-21 specifies that the only advertising costs allowed are those necessary to meet the requirements of a sponsored agreement, such as recruiting personnel, procuring goods and services, and disposing of surplus materials. At Berkeley, we found three transactions totaling \$912 for advertising for scholarship applications, a sexual harassment workshop, and graduate division office hours. Of this total, \$160 was allocated to the government for these expenses.
- Entertainment and Miscellaneous Expenses. Circular A-21 states that costs incurred for amusement, social activities, and entertainment are unallowable. Harvard Medical charged \$7,336 for events sponsored by Harvard Neighbors, a social organization, of which \$257 was allocated to the government. In Berkeley's student services pool, we found charges totaling \$931 for an undergraduate retreat and for room rental and catering for a student party. We also found an expense of \$850 for a desk which should have been capitalized. Since only a small portion of student services at Berkeley is allocated to the government, \$45 was allocated to the government for these items.

#### QUESTIONABLE COSTS

- Officers' Housing Costs. Since March, when we testified on the excessive costs associated with Stanford University's President's university-owned residence, much attention has been given to this area by all parties concerned. OMB's recent revision to Circular A-21 now makes such costs unallowable. While these costs were not specifically

unallowable at the time the proposals we reviewed were prepared, some of the costs charged do appear inappropriate. For example, part of the costs that MIT repaid included \$174,000 in costs charged to the president's house account for such items as liquor purchases, flowers, and art, for which the government paid \$120,492. Berkeley charged \$155,415 to the account for its chancellor's residence, of which \$27,260 was allocated to federal research. These charges included, for example, linens, floral arrangements, and other household items.

Harvard's auditors found about \$114,000 in unallowable costs associated with the president's residence, of which \$4,000 was allocated to federal research. These costs were included in the proposal reductions we discussed earlier. In addition, we found three transactions totaling \$20,229, for the president's travel, car, and publication of the President's Report, which is distributed to members of the community. For these, federal research was allocated \$708.

- Dues and Memberships. Harvard Medical spent \$2,875 for dues and memberships to various organizations, such as the Association of American Universities, for which the government was allocated \$101.
- Other costs. Harvard Medical included legal fees for 12 legal matters, such as fees incurred in the sale of property in New York and defending a sex discrimination suit brought against the Harvard Business School, in its indirect cost proposal. These items totalled \$246,925, for which \$8,642 was allocated to the government.

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

EXAMPLES OF IMPROPER ALLOCATIONS OF  
COSTS TO FEDERAL RESEARCH

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

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

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

- Equipment Depreciation/Use Allowance. Berkeley charges depreciation on certain classes of its equipment and use allowances on others. We found errors in its depreciation calculations that resulted in \$6,700 overallocated to federal research. In addition, we found inaccuracies in the equipment data base that Berkeley used to calculate its indirect costs; we also found that it did not reconcile with the equipment inventory. For the errors in the equipment inventory, \$136,000 had been overallocated to the government.

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

- Operation and Maintenance (O&M) costs. We found several problems in the way Berkeley allocated its O&M costs. For example, certain costs were allocated on the basis of total costs rather than on assigned space, as Circular A-21 specifies, and certain costs were erroneously allocated to departments that do not benefit from those costs. As a result of this, a net total of \$287,000 was actually underallocated to the government.
- Utility Study. At Berkeley, we found that wrong utility factors from its utility study were used in preparing its proposal. We also found minor miscalculations used to arrive at the factors in the utility study itself. Had these errors not occurred, an additional \$96,000 would have been allocated to the government.
- Library Pool. Berkeley allocated most of its library costs on a basis inconsistent with A-21, without conducting a special study or otherwise providing adequate justification. As a result, its proposal allocated \$3.5 million more to the government than would have been allowed had the university used the standard Circular A-21 method. HHS did not accept Berkeley's allocation of library costs in negotiating the indirect cost rate.
- Other allocation errors. We found that Berkeley also made other misallocations of costs because of a programming error. This resulted in \$24,000 overallocated to the government.

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