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WASHINGTON, D.C. 20548

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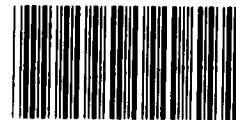
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DECEMBER 16, 1982

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The Honorable Strom Thurmond
United States Senate

RELEASED



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Dear Senator Thurmond:

Subject: South Carolina's Objection to a Letter-of-Credit Procedure Used by the Department of Health and Human Services (GAO/AFMD-83-1)

In your April 5, 1982, letter you asked us to consider the propriety of the "delay-of-drawdown" letter-of-credit procedure being implemented for public assistance programs by the Department of Health and Human Services (HHS). You asked us to consider this matter in light of the South Carolina State Treasurer's opinion that this procedure would require him to issue "bogus" checks. Specifically, you asked us to respond to three questions.

To provide you a thorough response, we discussed the issues posed by your questions with officials in HHS's Division of Cash Management Policy and Procedures and reviewed correspondence between HHS and State officials. We also met with the treasurer, auditor, and comptroller general of the State of South Carolina to better understand their views. To determine how HHS's cash management procedures affect programs at the State level, we interviewed officials of South Carolina's Department of Social Services. We discussed cash management with representatives of the Office of Management and Budget and the Department of the Treasury. Finally, we researched the legality and propriety of the delayed drawdown procedure. The review was performed in accordance with generally accepted government audit standards.

Cash management problems have a long history in the Federal Government and much effort has gone into attempts to solve those problems. However, because of the recent high interest rates and the increased need to find new sources of revenue, cash management procedures have been given a more important role at both the Federal and State levels. To reduce borrowing and resultant interest cost, the Federal Government has put more pressure on agencies to better manage cash. One area in which cash management techniques have been improved is that of Federal agencies providing cash to grantees.

The Intergovernmental Cooperation Act of 1968 (Public Law 90-577) requires that Federal departments and agencies minimize the amount of cash being advanced. To accomplish this objective

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and provide better cash management, the Treasury Department has issued guidelines and the Office of Management and Budget has issued circulars stressing that cash should be withdrawn from the Treasury no sooner than necessary.

Below are responses to each of your questions. In addition, we have provided more detailed information on letter-of-credit procedures for your use.

Question 1

"Does the Federal or the State Government bear the legal responsibility in the event that a delay-of-drawdown letter-of-credit is not backed by a transfer of Federal payment from the U.S. Treasury?"

Answer

If funds are not available to cover a State check for whatever reason, the State as drawer of the check is responsible. However, if fault for the nonavailability of funds lies with the Federal Government, then the Federal Government is liable to the State for the Federal portion of the check.

Question 2

"Is the delay-of-drawdown procedure 'highly irregular and questionable by accepted accounting and legal standards,' as stated by South Carolina's Treasurer?"

Answer

The delay-of-drawdown letter-of-credit procedure is proper with regard to accepted legal standards. Accounting standards as established by the National Council on Governmental Accounting are not being violated because they do not address, or apply, to cash management procedures.

Question 3

"Is there any evidence of this new procedure having created problems with other States, or is this a problem peculiar to South Carolina?"

Answer

States other than South Carolina have encountered problems in implementing the delay-of-drawdown letter-of-credit procedure. Officials of several States including California, Florida, Texas, Alabama, and Louisiana have written to Health and Human Services Secretary Richard S. Schweiker to advise him that, because of State constitutional or statutory provisions requiring that money be in

an account before checks are written against it, their States cannot use the delay-of-drawdown procedure. However, other States including Massachusetts, Maryland, Missouri, and Virginia have implemented the delay-of-drawdown procedure despite similar statutory or constitutional provisions. Sixteen States have decided not to implement this procedure. Of the remaining States, according to HHS, 29 have implemented it and 5 have indicated either "firm" or "tentative" commitment.

ADDITIONAL INFORMATION
ON LETTER-OF-CREDIT PROCEDURES

The Intergovernmental Cooperation Act of 1963 provides that Federal departments and agencies responsible for administering grant-in-aid programs shall schedule the transfer of grant funds so as to minimize the time between transfer of such funds from the U.S. Treasury and their disbursement by a State. The theory behind the act was that by controlling the release of grant funds, agencies could preclude State grantees from earning excessive interest on grant advances. While the act allows States to keep any interest earned on grant-in-aid funds pending disbursement for program purposes, it was not intended to create a financial windfall. In order to provide equity between Federal and State needs for funds, and also a basis for sound cash management, States should not be required to fund Federal programs with their own funds, nor should the Federal Government be required to advance funds prematurely, incurring additional borrowing costs and losing interest unnecessarily.

If Federal funds were always properly released, States would hold a minimum of Federal cash excess to their needs. However, studies by GAO and the Joint Financial Management Improvement Program have shown that drawdown of Federal funds by States has not always kept Federal cash balances to a minimum.

A Federal agency establishes a letter-of-credit when it expects to have a continuing relationship for at least a year with an organization receiving cash advances of at least \$120,000 from Federal grants or other programs. The recipient organization agrees to draw on this letter-of-credit only for its immediate cash requirements in carrying out the purpose of the funded program. So that funds are not drawn before actual need, the Treasury Department advocates that Federal agencies use one of two delayed draw techniques: the "checks-paid" procedure or the delay-of-drawdown procedure. A discussion follows of these techniques, HHS's efforts to use them, and the resulting reaction from some States.

Delay-of-drawdown and checks-paid procedures

The delay-of-drawdown and checks-paid letter-of-credit procedures are cash management techniques used to provide funds for

Federal public assistance programs, some of which are jointly funded by Federal and State governments. These procedures are authorized by Treasury Circular No. 1075, Fourth Revision (31 CFR 205). Under the delay-of-drawdown procedure, cash withdrawal is delayed until after the States issue checks to the payees. States are then advanced cash in increments based on historical check clearance patterns. Under the checks-paid procedure, cash withdrawal is delayed until the checks issued for program disbursement are presented to the recipient organization's bank for payment. Since this procedure results in a zero balance account at the bank, it is customary to compensate the bank for this service.

Status of implementation
of delay-of-drawdown procedure

HHS originally intended to implement the checks-paid technique in all States because this procedure virtually eliminates recipients' accumulation of cash in excess of immediate needs. However, because not all States were in favor of this technique and because of the technical issues posed in implementing it, HHS decided instead to implement the delay-of-drawdown technique as an interim measure.

In 1980, HHS began a 3-year program to implement delayed drawdown procedures in all the States beginning with the 10 receiving the most Federal funds. The next 20 largest recipient States were scheduled for fiscal 1981 and the rest for fiscal 1982. The status of implementation as of September 1, 1982, is shown in the following table.

<u>Status</u> <u>(note a)</u>	<u>Number</u> <u>of States</u>	<u>State statutory/</u> <u>constitutional problems</u>	
		<u>Yes</u>	<u>No</u>
Implemented	29	8	21
Committed:			
Firm	2	0	2
Tentative	3	1	2
Declined	<u>16</u>	<u>15</u>	<u>1</u>
Total	<u>50</u>	<u>24</u>	<u>26</u>

a/Data supplied by HHS's Division of Cash Management Policy and Procedures.

Major points argued by States that encounter statutory and/or constitutional problems in implementing the delay-of-drawdown procedure are as follows:

- It requires them to write checks or warrants without sufficient funds already in the bank accounts to cover them ("bogus" checks).
- It deprives States of income from interest they might otherwise earn on Federal funds drawn in advance.
- It sometimes requires States to use their own money temporarily to finance Federal programs, thus losing interest on that money because HHS is slow in issuing supplemental awards. 1/
- Implementation would be costly to the States.
- HHS has been unreasonable in not showing more regard for State constitutional and statutory provisions.

HHS's response to these arguments may be summarized as follows:

- States are not being asked to write checks with insufficient funds because a letter of credit is the equivalent of cash.
- HHS has a responsibility to ensure good cash management so that neither the States nor the Federal Government benefits from cash available for public assistance programs.
- While supplemental awards are sometimes delayed, some supplementals are negative; that is, they are downward adjustments of previous awards found to be excessive. Therefore, the net effect of late supplemental awards on cash flow may be slight.
- The increased administrative costs to the States will be small and will be shared with the Federal Government.
- HHS has shown a willingness to grant a delay in implementation of 60 days following the close of the next regular session of the State legislature, to give States time to adjust their laws to accommodate the new procedure.

Other Government agencies have supported the need for better management of Federal disbursements. For example, the Office of

1/Supplemental awards increase or decrease the award authority that was previously granted to the State based on a more current determination of the amount of funds needed.

Management and Budget has stated that the delay-of-drawdown technique conforms to good management practice and is an equitable procedure. Furthermore, GAO has recommended in the past that HHS strengthen its cash management procedures and has encouraged the States to remove legal or administrative impediments to effective use of letters of credit.

DELAYED DRAWDOWN TECHNIQUES
ARE ACCEPTABLE CASH MANAGEMENT DEVICES
UNDER FEDERAL LAW

We believe that the delay-of-drawdown and checks-paid letter-of-credit techniques are completely legal cash management devices under Federal law. A check written by an authorized State official and funded by the Federal Government through one of these techniques is in effect backed by adequate funds. Through these two techniques, established by Federal regulation and already used by some Federal agencies, the Federal Government is seeking legitimately to reduce borrowing costs without jeopardizing the States' ability to fully fund public assistance programs.

Recipients of Federal grants are given letters-of-credit in conjunction with their awards for the purpose of carrying out Federal programs. Federal regulations unequivocally provide that if a State draws on its letter-of-credit for legitimate grant purposes, it will receive the appropriate amount of money. The letter-of-credit is therefore the equivalent of cash.

When an authorized official from a State having a line of credit with any Federal agency signs a check in good faith for a legitimate Federal program purpose, the Federal Government is committed to fund its portion of the payment. If funds are not available, for whatever reason, in a State's bank account in time to cover its check, the State, as drawer of the check, is responsible. However, if the Federal Government is responsible for the nonavailability of the funds, it would be liable to the State for that amount, but it would not be liable to the payee of a State check.

Delayed drawdown techniques
may conflict with State laws

Some States, including South Carolina, have constitutional or statutory provisions which may be interpreted in ways that inhibit or prevent their use of delayed drawdown cash management techniques. Essentially, these provisions require that sufficient funds be available in appropriate accounts when checks are written or issued.

In such cases a State's ability to use these techniques, in the absence of a specific waiver or modification of State law, may depend on an interpretation of the intent of such law. If the intent is to ensure that sufficient funds are available to the State

when checks are written or issued--that is, to prevent an overdraft--this condition would appear to be satisfied by both the delay-of-drawdown and the checks-paid techniques since, under these procedures, the Federal Government guarantees that the money will be available when it is needed. However, if the law is interpreted to mean that the funds must be physically present in a designated account before checks are issued, then the State can do either of two things if it wishes to continue participation in the Federal program. It can (1) amend the law to exempt the Federal portion of payments from this requirement or (2) advance its own funds initially and be reimbursed later by the Federal Government.

We are aware that use of the delayed drawdown procedure may create a problem for some States. However, while State officials must obey their own State laws, HHS and other Federal agencies are required by Federal law to schedule payments so as to minimize Federal borrowing and payment of interest. For some States the reimbursement method might be the only way to satisfy both State law and Federal regulations.

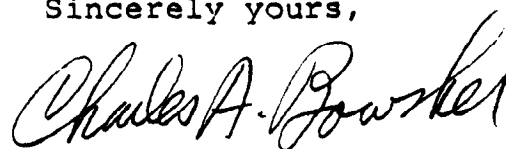
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We have discussed the contents of this report with officials of the Office of Management and Budget, HHS, and the Department of the Treasury and their comments were considered in preparing it.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from its date. At that time we will send copies to interested parties and make copies available to others upon request.

We appreciate the opportunity to be of assistance to you in this matter. Please let us know if you have any questions or need additional assistance.

Sincerely yours,



Comptroller General
of the United States