

Department of Health and Human Services

**OFFICE OF  
INSPECTOR GENERAL**

**THE NATIONAL INSTITUTES OF  
HEALTH, DIVISION OF  
FINANCIAL ADVISORY SERVICES  
DID NOT ALWAYS ESTABLISH  
FINAL INDIRECT COST RATES IN  
ACCORDANCE WITH FEDERAL  
REQUIREMENTS**

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# *Office of Inspector General*

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## Report in Brief

Date: May 2018

Report No. A-04-17-04059

U.S. DEPARTMENT OF HEALTH & HUMAN SERVICES  
**OFFICE OF INSPECTOR GENERAL**



### Why OIG Did This Review

The Department of Health and Human Services (HHS), National Institutes of Health (NIH), Division of Financial Advisory Services (DFAS), is the cognizant Federal agency responsible for negotiating and establishing indirect cost rates for for-profit organizations that receive the majority of their Federal awards from HHS.

In 2015, the HHS Office of Inspector General (OIG) determined that DFAS had a large backlog of unfinalized indirect cost rates that may have contributed to the untimely closeout of contracts totaling \$25 billion at the Centers for Medicare & Medicaid Services. In 2016, the Government Accountability Office identified weaknesses in the design of DFAS's internal controls for establishing indirect cost rates.

Our objective was to determine whether DFAS established final indirect cost rates for applicable organizations in accordance with Federal requirements.

### How OIG Did This Review

Our audit covered 1,187 final indirect cost rate agreements that DFAS established for organizations during fiscal years 2012 through 2016. We selected a sample of 15 rate agreements—3 rate agreements for each year of the audit period; reviewed the DFAS case files containing the proposals and work papers associated with each sampled rate agreement; interviewed auditors and supervisors assigned to the proposals; and determined the extent to which DFAS complied with Federal requirements for reviewing, negotiating, and establishing final indirect cost rates.

## The National Institutes of Health, Division of Financial Advisory Services Did Not Always Establish Final Indirect Cost Rates in Accordance With Federal Requirements

### What OIG Found

DFAS did not always establish final indirect cost rates for applicable organizations in accordance with Federal requirements during our audit period. DFAS had procedures to assess the allowability, allocability, and reasonableness of proposed indirect costs and identified unallowable costs that were excluded in its negotiations of rate agreements; however, DFAS did not always obtain adequate data demonstrating that (1) organizations' proposed indirect costs were allowable, allocable, and reasonable in accordance with the Federal Acquisition Regulation (FAR) and (2) proposed direct cost bases were appropriate for the fair distribution of indirect costs to cost objectives; DFAS may not have established indirect cost rates as promptly as practical after receiving proposals; and DFAS used indirect cost rate ceilings in situations not covered by the FAR.

DFAS did not always comply with Federal requirements for establishing indirect cost rates because neither NIH nor HHS had adequately defined the extent of DFAS's roles and responsibilities as a cognizant Federal agency for indirect cost rates.

### What OIG Recommends and NIH Comments

We make several recommendations to DFAS to clarify its roles and responsibilities as a cognizant Federal agency for indirect cost rates and to update its policies and procedures to comply with Federal requirements. Refer to the report for the full text of our recommendations.

In written comments on our draft report, NIH did not concur with our recommendations. NIH stated that it believed that significant corrective actions have already taken place, such as adding two new branches devoted to indirect cost rates within its organization and rolling out procedures for assessing risk in determining the adequacy of indirect cost rate proposals. NIH also provided technical comments on our draft report that we have incorporated into this report as appropriate.

We maintain that our findings and recommendations are correct. However, we partially revised our first recommendation based on NIH's comments.

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## INTRODUCTION

### WHY WE DID THIS REVIEW

In fiscal year (FY) 2016, the Department of Health and Human Services (HHS) awarded contracts to commercial organizations (organizations) totaling more than \$5.8 billion. Indirect costs often make up a significant portion of Federal award costs.<sup>1</sup> The HHS, National Institutes of Health (NIH), Division of Financial Advisory Services (DFAS), is the cognizant Federal agency responsible for negotiating and establishing indirect cost rates for for-profit organizations that receive the majority of their Federal awards from HHS.<sup>2</sup>

In 2015, the Office of Inspector General (OIG) determined that DFAS had a large backlog of unfinalized indirect cost rates that may have prevented the timely closeout of contracts at the Centers for Medicare & Medicaid Services (CMS). In 2016, the Government Accountability Office (GAO) identified certain weaknesses in the design of DFAS's internal controls for establishing indirect cost rates.

### OBJECTIVE

Our objective was to determine whether DFAS established final indirect cost rates for applicable organizations in accordance with Federal requirements.

### BACKGROUND

#### Indirect Costs

Federal regulations define indirect costs as costs that remain to be allocated after all direct costs for an organization have been determined. Indirect costs represent costs that are not readily identifiable with specific contracts, grants, or other activities (cost objectives) of an organization. Organizations must accumulate indirect costs by logical cost groups (indirect cost pools) with due consideration of the reasons for incurring those costs. Organizations must group indirect costs to allow for an allocation base (direct cost base) that is common to all cost objectives to which the grouping is to be allocated.<sup>3</sup>

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<sup>1</sup> Unless otherwise specified in this report, "indirect cost rates" include all types of rates that DFAS negotiates with organizations, such as general and administrative rates, overhead rates, fringe benefit rates, and other negotiated rate types. "Organizations" in this report refer to domestic, for-profit organizations that receive Federal contracts, Federal financial assistance awards (e.g., grants), or a combination of both Federal contracts and grants.

<sup>2</sup> Health and Human Services Acquisition Regulation (HHSAR) 342.705(b).

<sup>3</sup> Federal Acquisition Regulation (FAR) 31.203(b) and (c).

Federal awarding agencies use indirect cost rates applied to appropriate direct cost bases to reimburse indirect costs under cost-reimbursement contracts and to determine progress payments under fixed-price contracts.<sup>4</sup> There are two general rate types: billing rates and final indirect cost rates. Billing rates, also known as provisional rates, are based on cost estimates derived from historical data and anticipated needs for a future fiscal period. Final indirect cost rates are derived from actual, allowable costs an organization incurs during a fiscal period.<sup>5</sup> Federal agencies use final indirect cost rates to close out cost-reimbursement contracts. Figure 1 on the next page is an example of an indirect cost rate calculation for a hypothetical organization.

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<sup>4</sup> These rates may also be used to reimburse indirect costs under Federal financial assistance awards, i.e., grants and cooperative agreements.

<sup>5</sup> FAR 42.704 and 42.705.



**Figure 1: Example of an Indirect Cost Rate Calculation for a Hypothetical Organization**

The indirect cost rate is calculated by dividing the total indirect costs by total direct costs.<sup>6</sup> For example, from the table below:

$$\frac{\text{Indirect Costs } \$1,800,000}{\text{Direct Costs } \$3,000,000} = \text{Indirect Cost Rate } 60\%$$

Indirect Costs	Total Costs		Adjustments for Unallowable Costs		Total Allowable
Professional Services	\$500,000	–	\$100,000	=	\$400,000
Admin. Salaries	\$1,000,000	–	\$100,000	=	\$900,000
Supplies	\$100,000	–	\$50,000	=	\$50,000
Other Indirect Costs	\$600,000	–	\$150,000	=	\$450,000
<b>Total Indirect Costs</b>	<b>\$2,200,000</b>		<b>\$400,000</b>		<b>\$1,800,000</b>

Direct Costs	Federal Award 1	Federal Award 2	Commercial Activities	Total
Salaries	\$250,000	\$750,000	\$1,100,000	\$2,100,000
Travel	\$25,000	\$8,000	\$117,000	\$150,000
Other Direct Costs	\$100,000	\$150,000	\$500,000	\$750,000
<b>Total Direct Costs</b>	<b>\$375,000</b>	<b>\$908,000</b>	<b>\$1,717,000</b>	<b>\$3,000,000</b>

Total Costs	Direct Costs		Indirect Cost Allocation (60% of Direct Costs)		Total Costs
Federal Award 1	\$375,000	+	\$225,000	=	\$600,000
Federal Award 2	\$908,000	+	\$544,800	=	\$1,452,800
Commercial Activities	\$1,717,000	+	\$1,030,200	=	\$2,747,200
<b>Total</b>	<b>\$3,000,000</b>		<b>\$1,800,000</b>		<b>\$4,800,000</b>

<sup>6</sup> To simplify, we used “total direct costs” as the direct cost base for this example; however, the direct cost base does not have to be total direct costs in all cases.

In each Federal Department, a single Federal agency, with cognizant auditors, is responsible for establishing final indirect cost rates for an organization through audits of indirect cost rate proposals and negotiations with the organization.<sup>7</sup> Organizations that have cost reimbursement contracts must submit adequate final indirect cost rate proposals to the cognizant auditor within 6 months of the end of the organization's FY.<sup>8, 9</sup> Cognizant auditors must audit the rate proposals and prepare an advisory audit report so that final indirect cost rates can be negotiated.<sup>10</sup> The established final indirect cost rates are binding across all Federal agencies and contracting offices.<sup>11</sup>

Additionally, Federal agencies responsible for negotiating indirect cost rates on behalf of the Government are usually responsible for administering Cost Accounting Standards (CAS).<sup>12</sup>

HHS has two offices that establish final indirect cost rates: Cost Allocation Services,<sup>13</sup> which handles indirect cost rates for not-for-profit organizations, and DFAS, which handles indirect cost rates for for-profit organizations.<sup>14</sup>

### **Division of Financial Advisory Services**

DFAS, located in Rockville, Maryland, is the cognizant Federal agency for indirect costs for approximately 400 organizations that receive the majority of their Federal awards from HHS. DFAS can have a staff of up to 36 employees, including a Director (Supervisory Auditor), a Deputy Director, 5 Branch Chiefs (Supervisory Auditors), and up to 29 auditors.<sup>15</sup>

When DFAS receives an adequate final indirect cost rate proposal from an organization,<sup>16</sup> including a certificate of final indirect costs, DFAS management assigns the proposal to a DFAS

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<sup>7</sup> FAR 42.703-1(a).

<sup>8</sup> FAR 42.705-1(b)(1)(ii) or 42.705-2(b)(1).

<sup>9</sup> Organizations that have applicable HHS financial assistance awards are generally subject to the requirements of either the HHS Grants Policy Statement or the NIH Grants Policy Statement, as applicable.

<sup>10</sup> FAR 42.705-1(b)(2) or 42.705-2(b)(2)(i).

<sup>11</sup> FAR 42.703-1(a).

<sup>12</sup> 48 CFR § 9903.201-7.

<sup>13</sup> Located within the HHS Program Support Center.

<sup>14</sup> HHSAR 342.705.

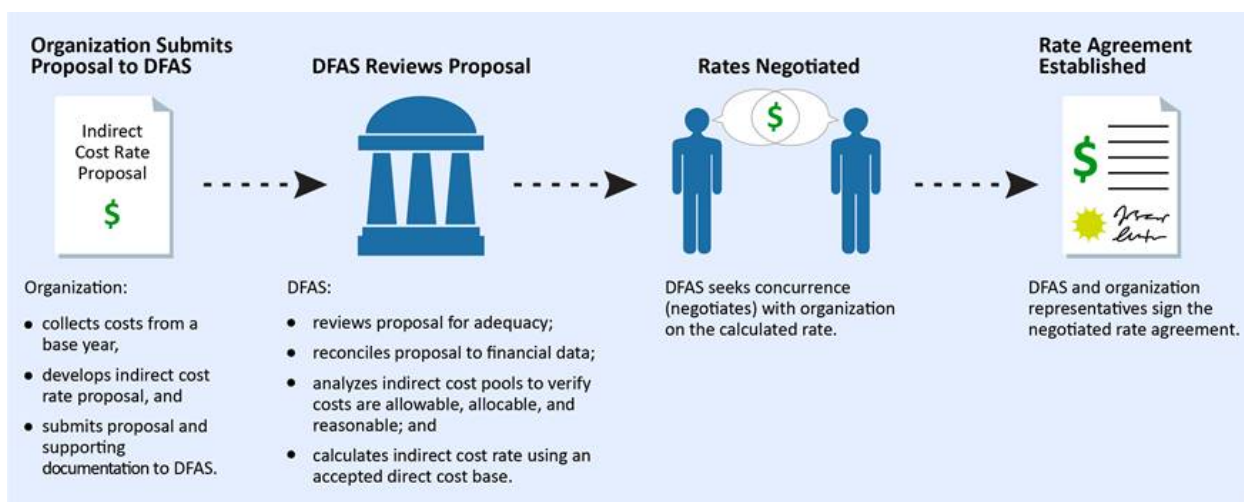
<sup>15</sup> As of February 2017, DFAS had 14 vacant positions: the Deputy Director, a Branch Chief, and 12 auditors.

<sup>16</sup> FAR 52.216-7(d)(2)(iii) defines the content of adequate final indirect cost rate proposals.

auditor for review and analysis, and then the auditor negotiates with the organization and comes to an agreement on proposed rates. According to NIH policies and procedures,<sup>17</sup> DFAS auditors are required to (1) check the mathematical accuracy of the rate proposals; (2) reconcile proposals to financial statements, accounting records, and other supporting schedules; (3) analyze costs in cost pools for significant changes from the organization’s prior year and allowability, reasonableness, and allocability in accordance with the FAR; (4) analyze direct cost bases for consistency with Federal award funding to determine, for example, whether the direct cost base is large enough to cover an organization’s Federal awards and for equitable distribution of costs; and (5) obtain additional documentation to help resolve questionable items, determine recommended rates, and seek concurrence with the organizations.

If an organization concurs with DFAS’s recommended rates, DFAS establishes a rate agreement, signed by both a DFAS supervisory auditor (usually the Director) and a representative of the organization. Figure 2 illustrates the process DFAS used to review and establish final indirect cost rate agreements during our audit period.

**Figure 2: DFAS’s Process for Establishing Final Indirect Cost Rate Agreements**



The rate agreement contains the rate information to be used on all applicable Federal awards to the organization and includes the negotiated rates and types (provisional or final), FYs to which the rates apply, and a description of the cost elements included in the direct cost base (against which the rates are to be multiplied to determine allowable indirect costs).

During our audit period, DFAS established an average of 237 final indirect cost rate agreements per year. It had 420 open indirect cost rate proposals at the start of our audit period (October

<sup>17</sup> During the audit period, NIH’s policies and procedures related to establishing indirect cost rates were limited to a single chapter from its policy manual. DFAS also used a collection of informal standard operating procedures (SOPs) for indirect cost rates, such as review steps, checklists, work paper templates, and flowcharts.

2011) and 800 open indirect cost rate proposals at the end of the audit period (September 2016).

### **Problems and Weaknesses at DFAS Cited in Federal Reports**

OIG and GAO reports<sup>18, 19</sup> cited problems and weaknesses associated with DFAS's processes for the establishment of final indirect cost rates. In 2015, OIG noted that DFAS reported a lack of resources, senior staff turnover, and large backlog of open indirect cost proposals as barriers that had contributed to the untimely closeout of \$25 billion worth of contracts at CMS.

In 2016, GAO cited internal control weaknesses at DFAS, including a lack of adequate policies and procedures in its indirect cost rate-setting process.<sup>20</sup> GAO's report also showed that in FY 2015, NIH alone funded research projects at organizations totaling \$864 million, of which \$231 million (27 percent) was for indirect costs.<sup>21</sup>

The problems and weaknesses associated with indirect costs and amounts of Federal award funding at organizations could increase risk of noncompliance with Federal requirements for establishing indirect cost rates by DFAS and increase risk of financial harm to the Federal Government's interests.

### **HOW WE CONDUCTED THIS REVIEW**

Our audit covered the 1,187 final indirect cost rate agreements<sup>22</sup> that DFAS established for organizations during FYs 2012 through 2016 (audit period). We used DFAS's Commercial Rate Agreement Distribution Services (C-RADS) database and an internal DFAS spreadsheet to identify final indirect cost rate agreements established during the audit period. We selected 15 rate agreements for review. Specifically, we selected three rate agreements that were finalized

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<sup>18</sup> *CMS Has Not Performed Required Closeouts of Contracts Worth Billions*, OEI-03-12-00680, December 2015.

<sup>19</sup> *Agencies Involved in the Indirect Cost Rate-Setting Process Need to Improve Controls*, GAO-16-616, September 2016.

<sup>20</sup> GAO's audit focused on the design of internal controls over the indirect cost rate-setting process and did not review the operational effectiveness of DFAS's internal controls. During our audit fieldwork, DFAS issued three new SOPs in response to GAO's recommendations and planned to issue two more SOPs in December 2017. DFAS has pushed back the release date for those SOPs to June 2018. Our audit testing only considered DFAS's internal controls in effect during our audit period.

<sup>21</sup> GAO sourced these data to the NIH Office of Extramural Research. These data do not include all organizations for which DFAS establishes indirect cost rates and may include organizations for which NIH is not cognizant. This information is only an example used to illustrate the proportion of indirect costs to direct costs under Federal awards. DFAS did not track the amount of indirect costs it reviewed in a given year and was not able to readily determine the amount of indirect costs, in total, for which it was responsible during the audit period.

<sup>22</sup> For the purposes of this report, we will refer to items in our sample as "rate agreements"; however, DFAS's rate agreements often included rates for 2 or more FYs of an organization.

during each of the 5 years of our audit period; reviewed the DFAS case files containing the proposals and DFAS work papers associated with each sampled rate agreement; interviewed auditors and supervisors assigned to the proposals; and determined the extent to which DFAS complied with Federal requirements for reviewing, negotiating, and establishing final indirect cost rates. The scope of this audit did not include independently verifying the allowability of any proposed costs. Accordingly, we also could not conclude whether negotiated indirect cost rates were reasonable or appropriate.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix A contains the details of our audit scope and methodology and Appendix B contains Federal requirements.

## FINDINGS

DFAS did not always establish final indirect cost rates for applicable organizations in accordance with Federal requirements during our audit period. DFAS had procedures to assess the allowability, allocability, and reasonableness of proposed indirect costs and identified unallowable costs that were excluded in its negotiations of rate agreements; however, DFAS:

- did not always obtain adequate data demonstrating that the organizations' proposed:
  - indirect costs were allowable, allocable, and reasonable in accordance with the FAR and
  - direct cost bases were appropriate for the fair distribution of indirect costs to the cost objectives;
- may not have established indirect cost rates as promptly as practical after receiving proposals; and
- used indirect cost rate ceilings in situations not covered by the FAR.<sup>23</sup>

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<sup>23</sup> Properly established indirect cost rate ceilings limit the amount the Government is obligated to pay for indirect costs under contracts (FAR 42.707(c)(1)).

DFAS did not always comply with Federal requirements for establishing indirect cost rates because neither NIH<sup>24</sup> nor HHS<sup>25</sup> had adequately defined the extent of DFAS's roles and responsibilities as a cognizant Federal agency for indirect costs. Therefore, DFAS implemented policies and procedures that did not address all of the indirect cost rate requirements of the FAR,<sup>26</sup> including the need to conduct audits of indirect cost rate proposals, promptly establish final indirect cost rates, and use indirect cost rate ceilings appropriately.

As a result, DFAS may have established indirect cost rates during the audit period that did not always fairly distribute indirect costs to benefiting cost objectives, including cost objectives associated with Federal grants and contracts. If the indirect cost rates that DFAS established were understated because of inappropriate rate ceilings, organizations' non-federally funded activities may have borne more than their fair share of indirect costs, and the financial interests of the organizations may have been harmed. Alternatively, if the indirect cost rates that DFAS established were not based on allowable costs with appropriate direct cost bases, federally funded activities may have borne more than their fair share of indirect costs, and the financial interests of the Federal Government may have been harmed. In addition, when DFAS did not promptly establish indirect cost rates, it may have affected Federal agencies' and organizations' ability to meet mission or project goals.

We also observed that DFAS may not have been meeting responsibilities for administering CAS, when applicable. We discuss this observation in the "Other Matters" section later in this report.

### **DFAS DID NOT VERIFY THAT INDIRECT COST RATES WERE BASED ON ADEQUATE PROPOSALS, ALLOWABLE COSTS, OR APPROPRIATE DIRECT COST BASES**

For 13 of our 15 sampled rate agreements,<sup>27</sup> DFAS established final indirect cost rate agreements without ensuring that indirect cost rate proposals contained one or more of the following:

- sufficient data supporting the adequacy of the proposals,

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<sup>24</sup> NIH's Office of Acquisition Management and Policy (OAMP) is the office responsible for DFAS oversight.

<sup>25</sup> HHS's Office of the Assistant Secretary for Financial Resources (ASFR) is responsible for establishing acquisition policies and procedures including the HHSAR for HHS.

<sup>26</sup> The primary indirect cost rate responsibilities for cognizant agencies are found under FAR subparts 42.7 and 52.216-7.

<sup>27</sup> Instead of DFAS, independent accounting firms audited the remaining two sampled rate agreements under a CMS contract arrangement. Although we reviewed these 2 rate agreements as part of our sample of 15, we found no deficiencies in those 2 rate agreements within the scope of our audit. Additionally, rather than issuing one rate agreement in our sample as a final rate agreement, DFAS issued it as a provisional rate agreement, pending the organization's fulfillment of a non-Federal audit requirement. DFAS used the procedures for establishing a final rate agreement for this sample item, so we included it in our sample results.

- indirect costs that were allowable and adequately supported in accordance with the FAR, or
- direct cost bases that were appropriate for the fair distribution of indirect costs to applicable cost objectives.

As a result, DFAS may have established indirect cost rates during the audit period that did not fairly distribute indirect costs to cost objectives of Federal awards.

### **DFAS Did Not Obtain All Required Data Supporting the Adequacy of Indirect Cost Rate Proposals**

The “Allowable Cost and Payment” clause of the FAR states that final indirect cost rate proposals submitted to cognizant auditors must include adequate supporting data.<sup>28, 29, 30</sup>

For six of the nine sampled rate agreements subject to the “Allowable Cost and Payment” clause,<sup>31</sup> DFAS established final indirect cost rates without obtaining and reviewing one or more data elements that the “Allowable Cost and Payment” clause requires to be part of an adequate final indirect cost rate proposal.<sup>32</sup>

DFAS did not always obtain one or more of the following data elements from organizations:

- schedules of direct costs by contract and subcontract, schedules of claimed indirect expenses, and subsidiary schedules of direct costs broken down by Federal and

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<sup>28</sup> FAR 52.216-7(d)(2)(i) through (iii).

<sup>29</sup> See Appendix B for a list of required data elements.

<sup>30</sup> The “Allowable Cost and Payment” clause was revised June 30, 2011, to include the specific data elements of an adequate indirect cost rate proposal. Before that, FAR 42.705-1(b) directed organizations to refer to the Defense Contract Audit Agency’s (DCAA’s) “Model Incurred Cost Proposal,” which contained the same data elements as those specified in the June 30, 2011, revision to the “Allowable Cost and Payment” clause (FAR 52.216-7(d)(2)(iii)).

<sup>31</sup> Six organizations in our sample had received only financial assistance awards, so they were not subject to the “Allowable Cost and Payment” clause. There are no equivalent Federal regulations that specify the data elements necessary to determine the adequacy of final indirect cost rate proposals for organizations that receive only financial assistance awards. Therefore, we consider requiring the same types of data elements contained in the “Allowable Cost and Payment” clause for those organizations to be a “best practice” for consistency in determining the adequacy of final indirect cost rate proposals.

<sup>32</sup> The FAR states that the required content of proposals and supporting data will vary depending on such factors as business type, size, and accounting system capabilities (42.705-1(b)(1)(i) and 42.705-2(b)(1)). We have limited our discussion to the supporting data elements that applied to the organizations in our sample.

non-Federal costs;<sup>33</sup>

- reconciliations of payroll information from the Internal Revenue Service (IRS) Form 941 to total labor costs;<sup>34</sup> or
- decisions, agreements, and approvals of accounting and organizational changes.<sup>35</sup>

These data elements are not optional; the FAR requires them to be part of indirect cost rate proposals.<sup>36</sup> They provide insights and assurances about an organization's cost activities and practices that are necessary for establishing appropriate final indirect cost rates.

For example, schedules that contain claimed direct costs and indirect costs and the breakdown of Federal and non-Federal costs<sup>37</sup> in direct cost bases show how indirect costs will be fairly distributed to cost objectives, including those cost objectives that are federally funded.<sup>38</sup> DFAS management stated that it had obtained detailed listings of all Federal awards, subawards, and related FY expenditures but did not give a reason why it did not obtain the breakdown of Federal and non-Federal costs needed to determine whether the proposed indirect cost rates resulted in a fair distribution of indirect costs to Federal awards.

Similarly, reconciliations of proposed labor costs to payroll information that organizations report to the IRS (on Form 941)<sup>39</sup> provide assurance of the reliability of the cost data that organizations provide to cognizant auditors. DFAS management stated that it did not require

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<sup>33</sup> FAR 52.216-7(d)(2)(iii)(H).

<sup>34</sup> FAR 52.216-7(d)(2)(iii)(L).

<sup>35</sup> FAR 52.216-7(d)(2)(iii)(M).

<sup>36</sup> FAR 52.216-7(d)(2)(iii) states that adequate indirect cost rate proposals must include the listed data elements unless the cognizant Federal agency official otherwise specifies what is required. Supplementary information from the Federal Register (FR) states that these data elements are required as a minimum standard for an adequate indirect cost rate proposal and that the clause provides flexibility on what is required depending on, for example, the complexity or size of a contractor (76 FR 31402). DFAS had no written policy or justification for excluding certain data elements specified at FAR 52.216-7(d)(2)(iii).

<sup>37</sup> These are the "government participation percentages" of the direct cost base amounts referenced at FAR 52.216-7(d)(2)(iii)(H).

<sup>38</sup> Additional discussion of direct cost bases appears below.

<sup>39</sup> FAR 52.216-7(d)(2)(iii)(L).



labor cost data that organizations reported to the IRS because DFAS was not an audit agency and it did not have cognizance over direct costs.

Finally, information about accounting and organizational changes that organizations made<sup>40</sup> during the fiscal period of a rate proposal tells cognizant auditors of matters that can affect proposed indirect cost rates, such as the organizations' treatment of direct and indirect costs. DFAS management stated that, in general, organizations updated DFAS on any accounting or organizational changes in cover letters or attachments to rate proposals, so DFAS did not request this information separately.

DFAS published on a public website its submission requirements for indirect cost rate proposals; the website also listed the supporting data that organizations were required to include in the proposals. At the time of our audit, DFAS had updated the website to require that organizations with Federal contracts submit indirect cost rate proposals in accordance with the "Allowable Cost and Payment" clause requirements.<sup>41</sup>

### **DFAS Did Not Always Verify That Proposed Indirect Costs Were Allowable and Adequately Supported**

Costs under Federal awards to organizations are allowable only when reasonable; allocable; and in compliance with accounting principles, contract terms, and other limitations. An organization must also maintain adequate supporting documentation showing that it had incurred the costs and that the costs complied with FAR requirements.<sup>42</sup> The FAR states that indirect cost rate proposals must be based on actual cost experience and that supplemental data may be required, including audited financial statements and other financial data, Federal and State income tax returns, and minutes from board of directors meetings.<sup>43</sup>

Among its procedures, DFAS tested the allowability of proposed costs by tracing costs to financial records, comparing costs to prior periods, and comparing costs to baselines; however, DFAS did not always verify that indirect costs included in final indirect cost rate proposals were allowable in accordance with FAR requirements. For example:

- For 10 of the 15 sampled rate agreements, DFAS did not test any transactions to verify that organizations had incurred the proposed costs or that proposed costs were supported by documentation adequate to show that the costs were allowable. Only 3 of the 15 sampled rate agreements showed that DFAS obtained supporting

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<sup>40</sup> FAR 52.216-7(d)(2)(iii)(M).

<sup>41</sup> For organizations that received only financial assistance awards, DFAS required other data elements that were not specific to the "Allowable Cost and Payment" clause.

<sup>42</sup> FAR 31.201-2(a) and (d).

<sup>43</sup> FAR 52.216-7(d)(2)(ii); 52.216-7(d)(2)(iv)(F), (K), and (M).

documentation in the form of invoices, contractual agreements for consulting or other professional services, or similar documentation to determine cost allowability. DFAS management told us that DFAS did not routinely request this type of supporting documentation because DFAS was not a Government auditing agency that conducts audits; however, DFAS management stated that DFAS auditors could request supporting documentation to better understand proposed costs and to verify compliance with FAR requirements.

- For 10 of the 15 sampled rate agreements, organizations had provided DFAS with unaudited financial data in support of proposed rates.<sup>44</sup> Organizations are not required to provide audited financial data; however, audited financial data are more reliable than unaudited data. DFAS management told us that DFAS auditors normally attempt to obtain additional assurances about indirect costs through an organization's tax returns and through increased testing of an organization's financial transactions. For our sampled rate agreements, however, DFAS generally used similar procedures to test proposed costs regardless of whether the costs were based on audited or unaudited financial data. DFAS had not obtained tax returns for any of the rate agreements in our sample.
- For 7 of the 15 sampled rate agreements, DFAS did not corroborate any assertions that the organizations had made about the allowability of proposed costs. For these seven rate agreements, the data supporting the rate proposals were limited to data generated by the organizations. These data generally consisted of financial reports generated from the organizations' accounting systems, completed questionnaires and templates, and email responses to DFAS inquiries. The information DFAS received was unverified, and DFAS did not otherwise seek to corroborate the information through any independent third parties. As a result, the cost data that DFAS received often lacked assurances and may not have been reliable.

### **DFAS Did Not Always Verify That Direct Cost Bases Were Appropriate**

In determining an indirect cost rate, a cognizant auditor must establish whether the proposed direct cost base is appropriate.<sup>45</sup> That is, the direct cost base must include all appropriate costs, whether allowable or unallowable, to ensure a fair distribution of indirect costs to an organization's cost objectives.<sup>46</sup> The direct cost base must include all appropriate costs

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<sup>44</sup> Two rate proposals included the results of audits of Federal expenditures in accordance with HHS non-Federal audit requirements; however, DFAS did not use the audited data for analyzing the rate proposals.

<sup>45</sup> FAR 52.216-7(d)(1).

<sup>46</sup> FAR 31.203(c) and (d).

because organizations apply approved indirect cost rates to these direct costs to calculate indirect costs charged to Federal awards.

For 13 of the 15 sampled rate agreements,<sup>47</sup> DFAS did not verify that direct cost bases included all associated direct costs. DFAS reviewed whether proposed direct cost base amounts were consistent with amounts from a previous year, whether fringe benefits were computed properly (including any adjustments resulting from approved fringe benefit rates), and whether direct cost bases were large enough to include all Federal awards that an organization had received. However, DFAS did not always adequately assess the association between direct costs and indirect costs, whether direct cost bases included all allowable and unallowable costs, or whether the breakdown of Federal and non-Federal costs in the base ensured a fair distribution of indirect costs to the cost objectives.

#### *DFAS Did Not Always Adequately Assess the Relationship Between Direct Costs and Indirect Costs*

DFAS did not always adequately assess the relationship between costs included in direct cost bases and costs in indirect cost pools. DFAS procedures require auditors to compare proposed direct cost bases with a previous year and ask organizations about noted differences, verify that bases were consistent with bases used to fund grants or contracts if there was no previous year base, verify that fringe benefits in the base were computed properly, and verify that the base appeared large enough to include all Federal awards of the organization if the base contained estimated costs. However, DFAS procedures did not require that its auditors determine whether the relationship between costs included in indirect cost pools and costs included in direct cost bases was appropriate to ensure that indirect costs would be fairly distributed to Federal awards.

For example, DFAS allowed significant amounts of consultant costs in the General and Administrative (G&A) direct cost bases for six rate agreements that we reviewed. It was not clear whether consultant costs were common to the G&A cost objectives in these rate agreements, and DFAS had not documented any analysis to address this question.

Consultants that are effectively independent contractors for an organization may not generate a significant amount of G&A costs (costs that generally apply to the overall operation of an organization, such as rent, accounting and legal fees, and office supplies). Direct costs that are not common to the cost objectives of an indirect cost pool distort the distribution of indirect costs when applied to final indirect cost rates. Therefore, it may have been inappropriate for organizations to include those G&A costs in the direct cost bases.

Without a proper assessment of the relationship between costs of the indirect cost pools and costs in the direct cost bases, DFAS may have allowed direct cost bases to include costs, such as

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<sup>47</sup> Some rate agreements had more than one deficiency, so the numbers discussed in this section do not add to 13.

consultant costs, that resulted in the unfair distribution of indirect costs to federally funded cost objectives and, as a result, harmed the financial interests of the Federal Government.

*DFAS Did Not Always Adequately Assess Whether Direct Cost Bases Included All Appropriate Costs, Whether Allowable or Unallowable*

For 10 rate agreements, as previously discussed in this report, DFAS had not obtained audited financial data or other reliable data (e.g., third-party source documentation) that could corroborate proposed costs, including costs in the direct cost bases. Without reliable, corroborated cost data, DFAS had limited assurance that the direct costs included in the proposed base reflected all appropriate costs. If organizations did not include all appropriate direct costs in direct cost bases, either intentionally or unintentionally, and DFAS approved rates based on the uncorroborated direct cost data it received, indirect cost rates could have been overstated and caused financial harm to the Government's interests.

Additionally, for at least one rate agreement, DFAS had not verified that unallowable costs were properly included in a direct cost base. The organization's financial records showed approximately \$890,000 in unallowable costs; however, neither the organization nor DFAS ensured that appropriate costs were added to the direct cost base.<sup>48</sup> By not including the appropriate amount of unallowable costs in the direct cost base, the organization's indirect cost rate was likely overstated and resulted in an unfair distribution of indirect costs to final cost objectives in the organization's Federal awards.

*DFAS Did Not Always Adequately Assess the Breakdown Between Federal and Non-Federal Costs in Direct Cost Bases*

As previously discussed in this report, DFAS did not require organizations to provide data detailing the breakdown of Federal and non-Federal costs included in direct cost bases;<sup>49</sup> therefore, DFAS did not have these data to analyze.<sup>50</sup>

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<sup>48</sup> Some costs appeared to have been recorded to direct cost accounts and other costs to indirect cost accounts. If DFAS had conducted an analysis to determine which costs were appropriate to include in the direct cost base, it could have addressed this issue.

<sup>49</sup> FAR 52.216-7(d)(2)(iii)(H).

<sup>50</sup> For one rate agreement, the organization included this data element in its indirect cost rate proposal. Other rate proposals contained some evidence related to the breakdown of Federal and non-Federal direct costs (for example, percentages of U.S. Government sales); however, those data were produced for the purpose of executive compensation analysis, not for analyzing direct cost bases. In addition, we determined that this information was not reliable because it did not always reconcile with other financial data the organizations provided.

By consistently analyzing the breakdown of Federal and non-Federal costs in proposed direct cost bases, DFAS could gain additional assurance that indirect costs are being fairly distributed between cost objectives of Federal awards and other cost objectives of the organizations.

### **DFAS MAY NOT HAVE ESTABLISHED INDIRECT COST RATES PROMPTLY**

The FAR states that the appropriate Government representative and the organization must establish final indirect cost rates as promptly as practical after receipt of the organization's proposal.<sup>51</sup>

DFAS may not have always established indirect cost rates as promptly as practical after it received final indirect cost rate proposals. For our sampled rate agreements, it took between 30 and 900 days, with an average of 506 days, for DFAS to establish final indirect cost rates. However, it was not always clear why it took longer for DFAS to establish certain rates.

A likely significant factor affecting the amount of time DFAS needed to establish rates was that DFAS often issued a single rate agreement that covered multiple FYs of an organization. For 12 rate agreements in our sample of 15, DFAS's rate agreements included between 2 and 6 FYs of final rates. When DFAS received rate proposals covering multiple FYs, it reviewed each proposal first and then issued a single rate agreement that included rates for each applicable FY.<sup>52</sup> DFAS also reviewed proposed provisional rates at the same time it reviewed final indirect cost rate proposals. Although reviewing multiple FYs may have increased efficiencies overall in DFAS's establishment of rate agreements, these factors likely increased the time it took DFAS to establish some rate agreements.

Other factors that may have negatively affected DFAS's promptness for establishing indirect cost rates were:

- organizations did not always provide to DFAS in a timely manner the information it needed to complete its reviews, and it was not always clear when DFAS determined that proposals were adequate for review;
- the complexity of rate proposals varied considerably, with some organizations proposing several different rate types (for example, fringe benefit, G&A, overhead, subcontract handling, etc.) and others proposing only one rate type;

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<sup>51</sup> FAR 52.216-7(d)(2)(ii).

<sup>52</sup> It was not clear why organizations had not always submitted final indirect cost rate proposals within the 6-month period following the expiration of each of its FYs as required by the FAR (42.705-1(b)(1)(ii) or 42.705-2(b)(1)) or whether DFAS had any responsibility for determining whether organizations were delinquent in submitting final rate proposals, notifying organizations when final rate proposals were due, or taking any other actions to ensure organizations were aware of their responsibilities.

- DFAS did not have a mechanism for tracking key milestones in its rate review process; and
- DFAS had staffing shortages: 40 percent of available positions were vacant at the time of our audit fieldwork.

In addition, if DFAS had not promptly established indirect cost rates, it may have affected Federal agencies' and organizations' ability to meet mission or project goals. Delays in establishing final indirect cost rates can affect the timely closeout of Federal awards<sup>53</sup> and could be harmful to the interests of the Federal Government or to those organizations that do business with the Federal Government. For example, when an organization's final indirect cost rates are lower than the provisional rates during a fiscal period, a downward cost adjustment may be necessary. If DFAS does not promptly establish final indirect cost rates, the Government is unable to promptly recover overpaid costs.<sup>54</sup> Likewise, if an organization receives higher final indirect cost rates than provisional rates during a period, an upward cost adjustment may be warranted. An organization could be harmed by delays in receiving reimbursements for upwardly adjusted costs.

#### **DFAS MAY HAVE USED INDIRECT COST RATE CEILINGS IN SITUATIONS NOT COVERED BY THE FEDERAL ACQUISITION REGULATION**

The FAR states that final indirect cost rate ceilings may be negotiated and specified in contracts when (1) there is no recent or past record of incurred indirect costs at an organization; (2) an organization's indirect cost rates have rapidly increased, but its sales volume has declined; or (3) an organization uses lower indirect cost rates to enhance its competitive position. When the Government properly establishes ceiling rates, it is not obligated to pay amounts in excess of the negotiated ceiling rates.<sup>55</sup>

DFAS may have used final indirect cost rate ceilings in situations not covered by the FAR without justification. From our sample of 15 rate agreements, 5 were subject to maximum ceiling rates that DFAS had established under prior agreements for provisional indirect cost rates. DFAS had not always documented reasons for using rate ceilings in the case files for the sampled rate agreements.<sup>56</sup> DFAS management told us that, before December 2015, it had

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<sup>53</sup> Files for contracts requiring settlement of indirect cost rates should be closed within 36 months of the month in which the contracting officer receives evidence of physical completion (FAR 4.804-1(a)(3)).

<sup>54</sup> The Government's ability to recover overpaid costs is subject to the requirements of the Contract Disputes Act, which establishes a statute of limitations for any such recovery attempts (41 USC § 7103(a)(4)(A)).

<sup>55</sup> FAR 42.707(b)-(c).

<sup>56</sup> Although we found justification for using a cost rate ceiling in only one DFAS case file from our sampled rate agreements, justifications for establishing rate ceilings may have been included in prior-year case files when DFAS

been a longstanding practice at DFAS to establish rate ceilings with organizations as part of indirect cost rate negotiations but that it no longer used this practice.

DFAS may have placed organizations at a disadvantage when establishing indirect cost rate ceilings in situations not covered by the FAR. Specifically, rate ceilings may have harmed certain organizations that would have otherwise received a higher final indirect cost rate. For example, for one sampled rate agreement, DFAS established an indirect cost rate that had been subject to a rate ceiling; however, DFAS's analysis showed that DFAS would have accepted a higher rate had there not been a rate ceiling in place. The lower rate that DFAS established based on the rate ceiling resulted in approximately \$700,000 in unallocable indirect costs for the organization, a small, disadvantaged business.<sup>57</sup> DFAS management told us that DFAS had not been concerned about this because the organization had accepted the rate ceiling as part of the negotiation process.<sup>58</sup> DFAS also told us that it had not explored how small businesses, in particular, would absorb costs in situations like this.

### **DFAS ROLES AND RESPONSIBILITIES HAVE NOT BEEN ADEQUATELY DEFINED**

DFAS did not always comply with Federal requirements for establishing indirect cost rates because neither NIH nor HHS had adequately defined the extent of DFAS's roles and responsibilities as a cognizant Federal agency for indirect costs.

HHS guidance regarding DFAS's roles and responsibilities for indirect cost rates is found in the HHSAR, and that guidance states that DFAS must establish indirect cost rates and similar rates for use in contracts awarded to organizations.<sup>59</sup>

NIH guidance regarding DFAS's roles and responsibilities, last updated in 2006, states that DFAS will (1) determine provisional indirect cost rates that can be used for funding purposes for organizations new to NIH that do not have rates negotiated with a Federal agency, (2) negotiate provisional and final rates with organizations that receive the preponderance of their Federal

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had established provisional rates. Case files associated with prior-year provisional rates were not part of our sampled rate agreements.

<sup>57</sup> Businesses that are qualified under the Small Business Administration are eligible for Federal awards set aside exclusively for small businesses.

<sup>58</sup> DFAS had established final indirect cost rates with the organization within the previous 2 years of establishing the rate agreement in our sample.

<sup>59</sup> HHSAR 342.705(b).

awards from HHS, and (3) issue rate agreements and disseminate rate information to Federal award officials.<sup>60</sup>

HHS and NIH guidance did not clarify how DFAS should implement indirect cost rate requirements of the FAR. For example, procedures for determining indirect cost rates require the auditing of final indirect cost rate proposals and the production of corresponding audit reports;<sup>61</sup> however, neither HHS nor NIH guidance specified how DFAS, which considers itself a nonaudit agency, could comply with either of those requirements, especially in view of the professional auditing standards and principles that would apply.

Managers at DFAS told us that the agency used, among other standards, government auditing standards as guidelines to the extent possible and that its auditors applied professional accounting and auditing knowledge consistent with those standards during reviews of indirect cost proposals. DFAS had not, however, incorporated those standards into its written policies and procedures, which would have ensured that they were followed more consistently. Moreover, neither HHS and NIH guidance nor DFAS's written procedures adequately addressed requirements for (1) determining the adequacy of final indirect cost rate proposals in accordance with the FAR's "Allowable Cost and Payment" clause; (2) assessing the allowability of proposed costs, in particular by verifying that costs have been adequately documented and that direct cost bases are appropriate for the equitable distribution of indirect costs to applicable cost objectives; (3) promptly establishing final indirect cost rates; or (4) determining appropriate situations for establishing final indirect cost rate ceilings.

## RECOMMENDATIONS

We recommend that DFAS:

- update its policies and procedures to:
  - conform to applicable requirements and best practices for determining the adequacy of final indirect cost rate proposals,
  - require consideration of all FAR requirements for assessing the allowability of proposed costs including the support of proposed costs with adequate documentation and the appropriateness of data elements within direct cost bases for the fair distribution of indirect costs to applicable cost objectives, and
  - define reasonable periods for promptly establishing final indirect cost rates;

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<sup>60</sup> *NIH Manual, chapter 7610, September 11, 2006.*

<sup>61</sup> FAR 42.705-2 (b)(2)(i).



- ensure that indirect cost rate ceilings are properly applied for current or future rate proposals in which rate ceilings had been established under provisional rate agreements;
- work with ASFR and OAMP, as applicable, to:
  - clarify the extent of DFAS's roles and responsibilities as a cognizant Federal agency for establishing final indirect cost rates and
  - formally adopt a set of professional auditing standards, such as generally accepted government auditing standards; and
- seek approval from appropriate authorities if it intends to deviate from any pertinent requirements of the FAR.

**NATIONAL INSTITUTES OF HEALTH COMMENTS AND  
OFFICE OF INSPECTOR GENERAL RESPONSE**

In written comments on our draft report, NIH did not concur with our recommendations. We summarize those comments below. NIH believes that since the audit period, significant corrective actions have already taken place, including DFAS's:

- adoption of DCAA's model for incurred cost data submissions;
- efforts to reduce its backlog of open indirect rate proposals by using a risk-based approach for establishing indirect cost rates, using administrative closeout procedures for certain contracts and grants, and requesting resources to manage its increased workload;
- addition of two new branches to its organization that are devoted to indirect cost rates; and
- rollout of procedures for assessing risk in determining the adequacy of indirect cost rate proposals.

NIH also provided technical comments on our draft report, which we have incorporated into this report as appropriate. We summarize NIH's general comments below and include them in their entirety as Appendix C.

For the reasons detailed below, we maintain that our findings and recommendations are correct. However, after considering NIH's comments, we added language to our first recommendation to specify that NIH should update its policies and procedures to conform to applicable requirements and best practices for determining the adequacy of final indirect cost

rate proposals and removed a recommendation with regard to updating its policies and procedures on the use of indirect cost rate ceilings.

## **POLICIES AND PROCEDURES**

### **National Institutes of Health Comments**

NIH stated that DFAS will further update its SOPs to ensure clarity, consistency, and proper documentation of its verification process for the fair distribution of indirect costs to applicable cost objectives. However, NIH stated that it did not concur with our recommended changes to DFAS's policies and procedures for the following reasons:

- NIH stated that DFAS had created formal, written SOPs in 2017 to assess the completeness and adequacy of indirect cost rate proposals in accordance with Federal requirements. NIH noted that the SOPs include standardized checklists, detailed guidance, and standards to document DFAS's review of proposed costs.
- NIH stated that DFAS's SOPs include the review of adequate supporting documentation, such as audited financial statements, tax returns, accounting system questionnaires, and personnel policy manuals.
- NIH stated that, in recognition of the importance of establishing final indirect cost rates in a timely manner, DFAS has been enhancing and streamlining its review procedures, developing and implementing a risk assessment process, providing additional training to its auditors, and developing a web-based system for tracking the due dates for indirect cost proposals. Additionally, NIH noted that DFAS had been timely in its establishment of rate agreements in our audit based on the 36-month timeframe the FAR allows for closing out contracts. NIH also stated that workforce challenges such as employee turnover and an inability to hire highly trained professionals limited DFAS's ability to establish reasonable periods for setting final indirect cost rates in its policies and procedures.

### **Office of Inspector General Response**

We maintain that NIH should update its policies and procedures to fully address requirements for determining the adequacy of final indirect cost rate proposals, assessing the allowability of proposed costs, and promptly establishing final indirect cost rates.

NIH did not indicate whether DFAS's new SOPs addressed Federal requirements regarding the content of adequate indirect cost rate proposals. As noted in our report, the FAR states that certain basic data elements are required, unless otherwise specified by the cognizant agency

for indirect cost rates;<sup>62</sup> but it was DFAS's practice to never require some of the basic data elements. Policies and procedures to ensure that DFAS consistently obtains and reviews the basic data elements indicated in the FAR would provide greater assurance that organizations' final indirect cost rates fairly distribute indirect costs to cost objectives.

Additionally, we agree that SOPs requiring that DFAS auditors review data sources, such as audited financial statements and tax returns, would provide DFAS with more reliable data to analyze proposed costs; however, NIH did not indicate whether DFAS's SOPs would require its auditors to assess whether organizations' costs had been adequately documented, especially in cases in which audited financial data may not be available. Furthermore, NIH did not address whether DFAS's SOPs would have additional requirements for determining the appropriateness of direct cost bases to ensure the equitable distribution of indirect costs to applicable cost objectives.

Finally, we agree that DFAS's efforts to enhance and streamline its review procedures, usage of risk assessments, and other actions taken or planned may help ensure the prompt establishment of final indirect cost rate agreements; however, the workforce challenges DFAS faces should not prevent it from defining reasonable periods for the prompt establishment of final indirect cost rate agreements. In addition to FAR requirements that cognizant agencies establish final indirect cost rates as promptly as practical, a GAO standard requires that management define the objectives of an entity in specific and measurable terms to enable it to identify, analyze, and respond to risks related to achieving those objectives.<sup>63</sup> Without specific, measurable periods for the establishment of final indirect cost rate agreements, DFAS is unable to appropriately measure how well it is meeting its mission, goals, and objectives.

## **INDIRECT COST RATE CEILINGS**

### **National Institutes of Health Comments**

NIH stated that it did not concur with our recommendation to ensure that indirect cost rate ceilings associated with current or future rate proposals be properly applied, because a legal opinion DFAS received in October 2015 on the use of final indirect cost rate ceilings caused it to entirely discontinue the practice in January 2016.

### **Office of Inspector General Response**

We maintain that DFAS should take steps to ensure that it does not subject any current or future proposals to potentially inappropriate indirect cost rate ceilings. DFAS should do this specifically for cases in which an existing ceiling rate has been established under a provisional rate agreement between the organization and DFAS either during or before our audit period.

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<sup>62</sup> The FAR allows for some flexibility about the data elements required based on the situation (e.g., the complexity and size of an organization).

<sup>63</sup> *Standards for Internal Control in the Federal Government*, GAO-14-704G, 2014, OV2.17.

Although DFAS stated it has discontinued its practice of using final indirect cost rate ceilings, it is not clear how DFAS plans to handle those ceilings established under provisional rate agreements before its change in practice when it negotiates the associated final indirect cost rates.

## **ROLES AND RESPONSIBILITIES**

### **National Institutes of Health Comments**

NIH stated that it did not concur with our recommendation to work with ASFR and OAMP, as applicable, to clarify its roles and responsibilities for establishing final indirect cost rates and to adopt a set of professional auditing standards, because DFAS's roles and responsibilities were already clarified and there was no requirement for DFAS to adopt a set of auditing standards.

NIH stated that in 2001 the Secretary of Health and Human Services authorized NIH to undertake HHS-wide cognizance and indicated that HHSAR identified DFAS as being responsible for establishing indirect cost rates for organizations.

In addition, NIH stated that DFAS is not an audit agency, it does not perform audits, and there is no requirement for it to formally adopt a set of professional auditing standards, such as generally accepted government auditing standards. NIH noted that DFAS can adopt generally accepted government auditing standards if it is able to obtain the authority, staffing, and other resources from HHS necessary to become an audit agency.

### **Office of Inspector General Response**

We maintain that DFAS should work with ASFR and OAMP, as applicable, to clarify its roles and responsibilities and that it should formally adopt professional auditing standards to ensure that it fully complies with Federal requirements for establishing final indirect cost rates for organizations.

The Office of Personnel Management classifies the DFAS personnel responsible for establishing final indirect cost rates as auditors. Further, as stated in our report, the FAR requires that cognizant agencies conduct audits of indirect cost rate proposals that result in advisory audit reports. Contrary to these requirements, DFAS did not conduct audits, did not review indirect cost rate proposals in accordance with any formal auditing standards, and did not produce advisory audit reports. Consequently, DFAS was not compliant with the requirements of the FAR in 13 of the 15 rate agreements we reviewed.

Generally accepted government auditing standards contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results.<sup>64</sup> By adopting a framework such as generally accepted government

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<sup>64</sup> *Government Auditing Standards*, 2011, GAO-12-331G, paragraphs 1.05 and 1.06.

auditing standards to conduct audits of final indirect cost rate proposals, DFAS can ensure accountability for the allowability of indirect costs that organizations claim under Federal awards. As an alternative, NIH should seek to obtain a clear deviation from the audit requirements found in the FAR.

## **FEDERAL ACQUISITION REGULATION DEVIATIONS**

### **National Institutes of Health Comments**

NIH stated that it did not concur with our recommendation to seek approval from appropriate authorities if it intends to deviate from any pertinent requirements of the FAR because DFAS has not deviated, and does not anticipate deviating, from any pertinent requirements of the FAR.

NIH said that 40 percent of our sample involved commercial organizations that had received only grants and that FAR criteria should not have been used to evaluate those organizations. NIH further stated that grantees follow 45 CFR part 75, except for cost principles, which follow 48 CFR § 31.2. NIH noted that our report did not cite any specific examples of DFAS deviating from pertinent requirements of the FAR or any effect from the deviations.

### **Office of Inspector General Response**

We maintain that DFAS should seek approval from appropriate authorities if it intends to deviate from requirements of (1) FAR 42.705-1 (b)(2) or 42.705-2 (b)(2)(i), as applicable, which state that cognizant agencies will audit indirect cost proposals that result in advisory audit reports, or (2) FAR 52.216-7(d)(2)(iii), which states that indirect cost proposals must contain certain data elements to be considered adequate. As DFAS representatives have stated, and as NIH has acknowledged in its written response to our draft report, DFAS does not perform audits of indirect cost rate proposals, and it had not required all of the data elements listed in FAR 52.216-7(d)(2)(iii) for applicable organizations during our audit period.

We have revised our report to clarify that, although grants are not subject to the FAR clause at 52.216-7(d)(2)(iii), holding those organizations to the same standards would represent a best practice that DFAS should follow as those data elements represent baseline information for auditing an indirect cost rate proposal. There are no Federal requirements for submissions of indirect cost rate proposals for organizations that receive only grants. We recognize that the definition of “non-Federal entities,” to which the requirements of 45 CFR part 75 apply, does not include organizations, although we note that those requirements may be incorporated into specific grant terms and conditions for applicable organizations. Therefore, DFAS can and should require applicable organizations that receive only grants to provide the same types of data as organizations that receive contracts to ensure a consistent approach across DFAS’s establishment of indirect cost rates.

## OTHER MATTERS

### RESPONSIBILITIES FOR ADMINISTERING COST ACCOUNTING STANDARDS

The FAR Appendix states that CAS requirements must, to the maximum extent practicable, be administered by the cognizant Federal agency responsible for a contractor, usually the Federal agency responsible for negotiating indirect cost rates, and that Federal agencies must prescribe regulations and establish internal policies and procedures governing how agencies will administer the requirements of CAS-covered contracts. Furthermore, the CFR states that internal agency policies and procedures must provide for the designation of the agency office(s) or officials responsible for administering CAS under CAS-covered contracts at each contractor business unit.<sup>65</sup>

HHS did not publish regulations or establish internal policies and procedures governing how agencies will administer the requirements of CAS contracts, including whether DFAS was responsible for administering CAS under any CAS-covered contracts with organizations for which DFAS had cognizance of indirect cost rates.

Although none of the organizations in our sample had CAS-covered contracts,<sup>66</sup> we observed that DFAS policies and procedures did not address issues related to administering CAS requirements. DFAS required only that organizations identify whether any contracts were subject to full or modified CAS coverage<sup>67</sup> on an Indirect Cost Rate Proposal Submission form.

DFAS management cited DFAS's lack of audit authority as a reason it cannot perform certain activities related to CAS, such as determining the adequacy of Disclosure Statements for organizations that have CAS-covered contracts. Disclosure Statements describe the cost accounting practices of an organization, including methods of distinguishing direct costs from indirect costs and the basis for allocating indirect costs. DFAS management stated that it would acquire the services of the DCAA<sup>68</sup> if DFAS needed audit services related to reviews of, for example, Disclosure Statements.

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<sup>65</sup> 48 CFR §§ 9903.201-7(a) and (b).

<sup>66</sup> Generally, CAS applies to organizations that receive a contract valued at more than \$50 million, net CAS-covered contracts valued at more than \$50 million in the preceding accounting period (full CAS coverage), or contracts worth more than \$7.5 million (modified CAS coverage).

<sup>67</sup> Full CAS coverage requires that the organization comply with all CAS requirements. Modified CAS coverage includes only certain CAS requirements.

<sup>68</sup> DCAA is responsible for performing audit services related to Department of Defense contracts; however, it can also provide audit services under agreements with civilian Federal agencies.

## APPENDIX A: AUDIT SCOPE AND METHODOLOGY

### SCOPE

Our audit covered all final indirect cost rate agreements that DFAS established with organizations from October 1, 2011, through September 30, 2016. DFAS's C-RADS database and an Excel spreadsheet used to track DFAS's indirect cost rate proposals showed that DFAS had established 1,187 final indirect cost rate agreements during our audit period. We limited our review of internal controls to those controls related to DFAS's processes for establishing final indirect cost rates.

The scope of this audit did not include independently verifying the allowability of any proposed costs. Accordingly, we could not conclude whether negotiated indirect cost rates were reasonable or appropriate.

We performed our fieldwork from May through December 2017.

### METHODOLOGY

To accomplish our audit objective, we:

- reviewed laws and regulations applicable to cognizant Federal agencies responsible for establishing final indirect cost rates;
- reviewed DFAS's organizational structure, including the organizational chart, position descriptions, staffing levels, and workload requirements;
- reviewed HHS and DFAS policies, procedures, and other written guidance DFAS used for establishing indirect cost rates;
- interviewed the DFAS Director and the OAMP Associate Director to obtain additional information on DFAS's processes;
- compared to the supporting data specified in the FAR the types of supporting data DFAS required for determining the adequacy of indirect cost rate proposals;
- selected a systematic sample<sup>69</sup> of 15 final indirect cost rate agreements from the population of 1,187 rate agreements, as tracked by DFAS, that included 3 rate agreements from each FY of the audit period;

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<sup>69</sup> Systematic sampling is a procedure by which a sample is selected from the population on the basis of a uniform interval between sampling units, such as every fifth sample unit, after a random starting point has been determined. Systematic sampling does not allow for the extrapolation of results to the sampling population.

- interviewed auditors and supervisory auditors assigned to the rate proposals associated with our sampled rate agreements;
- reviewed the final indirect cost rate agreement files for sampled agreements to assess whether:
  - DFAS received timely rate proposals from applicable organizations;
  - DFAS received all required supporting data to determine that indirect cost rate proposals were adequate as defined by the FAR;
  - proposed costs were traceable to supporting financial data and proposed rates were mathematically accurate;
  - DFAS followed up with organizations to identify reasons for large variances between any proposed cost elements and cost elements that DFAS had approved in a prior year proposal or cost projections if no prior rate agreement had been established;
  - DFAS used procedures that adequately addressed FAR requirements for determining whether proposed costs were allowable;
  - DFAS used procedures that adequately addressed whether direct cost bases were appropriate for fairly distributing indirect costs to applicable cost objectives; and
  - DFAS reviewed, negotiated, and issued rate agreements as promptly as practical; and
- discussed the results of our audit with DFAS officials.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



## APPENDIX B: FEDERAL REQUIREMENTS

### **Federal Acquisition Regulation, Subpart 4.804-1, Closeout by the Office Administering the Contract**

“(a) [Time] standards for closing out contract files are as follows . . . (3) Files for contracts requiring settlement of indirect cost rates should be closed within 36 months of the month in which the contracting officer receives evidence of physical completion.”

### **Federal Acquisition Regulation, Subpart 31.201-2, Determining Allowability**

(a) A cost is allowable only when the cost complies with all of the following requirements:

- (1) Reasonableness.
- (2) Allocability.
- (3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
- (4) Terms of the contract.
- (5) Any limitations set forth in this subpart. . . .

(d) A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

### **Federal Acquisition Regulation, Subpart 31.203, Indirect Costs**

(b) After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to intermediate or two or more final cost objectives . . . .

(c) The contractor shall accumulate indirect costs by logical cost groupings with due consideration of the reasons for incurring such costs. The contractor shall determine each grouping so as to permit use of an allocation base that is common to all cost objectives to which the grouping is to be allocated. The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives. . . .

(d) All items properly includable in an indirect cost base shall bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the allocation of G&A

costs, the contractor shall include in the base all items that would properly be part of the cost input base, whether allowable or unallowable, and these items shall bear their pro rata share of G&A costs.

**Federal Acquisition Regulation, Subpart 42.703-1, Indirect Cost Rates, General, Policy**

“(a) [Final indirect] cost rates shall be binding on all agencies and their contracting offices. . . .”

**Federal Acquisition Regulation, Subpart 42.705-1, Contracting Officer Determination Procedure**

(a) Applicability and responsibility. Contracting officer determination shall be used for . . .

(1) Business units of a multidivisional corporation under the cognizance of a corporate administrative contracting officer . . . .

(2) Business units not under the cognizance of a corporate administrative contracting officer, but having a resident administrative contracting officer . . . .

(3) For [other] business units . . . the contracting officer (or cognizant Federal agency official) will determine whether the rates will be contracting officer or auditor determined.

(b) Procedures.

(1) In accordance with the Allowable Cost and Payment clause at 52.216-7, the contractor is required to submit an adequate final indirect cost rate proposal to the contracting officer (or cognizant Federal agency official) and to the cognizant auditor.

(i) The required content of the proposal and supporting data will vary depending on such factors as business type, size, and accounting system capabilities. . . .

(ii) Each contractor is required to submit the final indirect cost rate proposal within the six-month period following the expiration of each of its fiscal years. . . .

(iii) Upon receipt of the proposal—

(A) The cognizant auditor will review the adequacy of the contractor’s proposal for audit in support of negotiating final indirect cost rates. . . .

(iv) The proposal must be supported with adequate supporting data, some of which may be required subsequent to finding that the proposal is adequate for audit in support of negotiating final indirect cost rates. . . .

(2) Once a proposal has been determined to be adequate for audit in support of negotiating final indirect cost rates, the auditor will audit the

proposal and prepare an advisory audit report to the contracting officer (or cognizant Federal agency official). . . .

### **Federal Acquisition Regulation, Subpart 42.705-2, Auditor Determination Procedure**

(a) Applicability and responsibility.

(1) The cognizant Government auditor shall establish final indirect cost rates for business units not covered in 42.705-1(a).

(2) In addition, auditor determination may be used for business units that are covered in 42.705-1(a) when the contracting officer (or cognizant Federal agency official) and auditor agree that the indirect costs can be settled with little difficulty and any of the following circumstances apply:

(i) The business unit has primarily fixed-price contracts, with only minor involvement in cost-reimbursement contracts.

(ii) The administrative cost of contracting officer determination would exceed the expected benefits.

(iii) The business unit does not have a history of disputes and there are few cost problems.

(iv) The contracting officer (or cognizant Federal agency official) and auditor agree that special circumstances require auditor determination.

(b) Procedures.

(1) The contractor shall submit to the cognizant . . . auditor a final indirect cost rate proposal in accordance with 42.705-1(b)(1).

(2) Once a proposal has been determined to be adequate for audit in support of negotiating final indirect cost rates, the auditor shall—

(i) Audit the proposal and prepare an advisory audit report . . .;

(ii) Seek agreement on indirect costs with the contractor;

(iii) Prepare an indirect cost rate agreement conforming to the requirements of the contracts. . . .

### **Federal Acquisition Regulation, Subpart 42.707, Cost-Sharing Rates and Limitations on Indirect Cost Rates**

(b)

(1) Other situations may make it prudent to provide a final indirect cost rate ceiling in a contract. Examples of such circumstances are when the proposed contractor—

(i) Is a new or recently reorganized company, and there is no past or recent record of incurred indirect costs;

(ii) Has a recent record of a rapidly increasing indirect cost rate due to a declining volume of sales without a commensurate decline in indirect expenses; or

(iii) Seeks to enhance its competitive position in a particular circumstance by basing its proposal on indirect cost rates lower than those that may reasonably be expected to occur during contract performance, thereby causing a cost overrun.

(2) In such cases, an equitable ceiling covering the final indirect cost rates may be negotiated and specified in the contract.

(c) When ceiling provisions are utilized, the contract shall also provide that—

(1) The Government will not be obligated to pay any additional amount should the final indirect cost rates exceed the negotiated ceiling rates, and

(2) In the event the final indirect cost rates are less than the negotiated ceiling rates, the negotiated rates will be reduced to conform with the lower rates.

### **Federal Acquisition Regulation, Subpart 52.216-7, Allowable Cost and Payment**

(d) Final indirect cost rates.

(1) Final annual indirect cost rates and the appropriate bases shall be established . . . for the period covered by the indirect cost rate proposal.

(2)

(i) The Contractor shall support its proposal with adequate supporting data.

(ii) The proposed rates shall be based on the Contractor's actual cost experience for that period. The appropriate Government representative and the Contractor shall establish the final indirect cost rates as promptly as practical after receipt of the Contractor's proposal.

(iii) An adequate indirect cost rate proposal shall include the following data unless otherwise specified by the cognizant Federal agency official:

(A) Summary of all claimed indirect expense rates, including pool, base, and calculated indirect rate.

(B) General and Administrative expenses (final indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts).

(C) Overhead expenses (final indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts) for each final indirect cost pool.

- (D) Occupancy expenses (intermediate indirect cost pool). Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts) and expense reallocation to final indirect cost pools.
- (E) Claimed allocation bases, by element of cost, used to distribute indirect costs.
- (F) Facilities capital cost of money factors computation.
- (G) Reconciliation of books of account (i.e., General Ledger) and claimed direct costs by major cost element.
- (H) Schedule of direct costs by contract and subcontract and indirect expense applied at claimed rates, as well as a subsidiary schedule of Government participation percentages in each of the allocation base amounts.
- (I) Schedule of cumulative direct and indirect costs claimed and billed by contract and subcontract.
- (J) Subcontract information. Listing of subcontracts awarded to companies for which the contractor is the prime or upper-tier contractor (include prime and subcontract numbers; subcontract value and award type; amount claimed during the fiscal year; and the subcontractor name, address, and point of contact information).
- (K) Summary of each time-and-materials and labor-hour contract information, including labor categories, labor rates, hours, and amounts; direct materials; other direct costs; and, indirect expense applied at claimed rates.
- (L) Reconciliation of total payroll per IRS form 941 to total labor costs distribution.
- (M) Listing of decisions/agreements/approvals and description of accounting/organizational changes.
- (N) Certificate of final indirect costs (see 52.242-4, Certification of Final Indirect Costs).
- (O) Contract closing information for contracts physically completed in this fiscal year (include contract number, period of performance, contract ceiling amounts, contract fee computations, level of effort, and indicate if the contract is ready to close).

(iv) The following supplemental information is not required to determine if a proposal is adequate, but may be required during the audit process . . . .

- (F) Certified financial statements and other financial data (e.g., trial balance, compilation, review, etc.). . . .
- (K) Federal and State income tax returns. . . .

(M) Minutes from board of directors meetings. . . .

**48 CFR § 9903.201-7, Cognizant Federal Agency Responsibilities**

(a) The requirements of part 9903 shall, to the maximum extent practicable, be administered by the cognizant Federal agency responsible for a particular contractor organization or location, usually the Federal agency responsible for negotiating indirect cost rates on behalf of the Government . . . .

(b) Federal agencies shall prescribe regulations and establish internal policies and procedures governing how agencies will administer the requirements of CAS-covered contracts. . . . Internal agency policies and procedures shall provide for the designation of the agency office(s) or officials responsible for administering CAS under the agency’s CAS-covered contracts at each contractor business unit. . . .

**HHS Acquisition Regulation, Subpart 342.705 (b), Final Indirect Cost Rates**

“[DFAS] shall establish indirect cost rates, fringe benefit rates, and similar rates for use in contracts awarded to commercial organizations.”

**NIH Manual, Chapter 7610, Establishment of Overhead Rates for Use in the Award and Administration of Contracts and Grants With Commercial Organizations, Part E, Responsibilities and Procedures, Section 4, Division of Financial Advisory Services**

a. The DFAS will (1) determine provisional indirect cost rates that can be used for funding purposes for commercial organizations new to NIH which do not have rates negotiated with a federal agency, (2) negotiate provisional and final rates with commercial contractors and grantees which receive the preponderance of their federal awards from DHHS, and (3) issue a Negotiation Agreement and disseminate negotiated rate information to contracts and grants officials. The Negotiation Agreement will be signed by the Director, DFAS, and will be binding upon all contracts and grants officials.

**Government Auditing Standards, December 2011, Chapter 6: “Field Work Standards for Performance Audits, Overall Assessment of Evidence”**

6.72 Evidence has limitations or uncertainties when the validity or reliability of the evidence has not been assessed or cannot be assessed, given the audit objectives and the intended use of the evidence. . . . When the auditors identify limitations or uncertainties in evidence that is significant to the audit findings and conclusions, they should apply additional procedures, as appropriate. Such procedures include . . . seeking independent, corroborating evidence from other sources. . . .

#### **41 USC § 7103, Time for Submitting Claims**

(a)(4)(A) In general, [e]ach claim by a contractor against the Federal Government relating to a contract and each claim by the Federal Government against a contractor relating to a contract shall be submitted within 6 years after the accrual of the claim.

APPENDIX C: NATIONAL INSTITUTES OF HEALTH COMMENTS



DEPARTMENT OF HEALTH & HUMAN SERVICES

Public Health Service

National Institutes of Health  
Bethesda, Maryland 20892

TO: Gloria L. Jarmon  
Deputy Inspector General for Audit Services, HHS

FROM: Director, NIH

DATE: March 29, 2018

SUBJECT: NIH Comments on Draft Report, *The National Institutes of Health, Division of Financial Advisory Services Did Not Always Establish Final Indirect Cost Rates in Accordance with Federal Requirements* (A-04-17-04059)

Attached are the National Institutes of Health's (NIH) comments on the draft Office of Inspector General (OIG) report, "*The National Institutes of Health, Division of Financial Advisory Services Did Not Always Establish Final Indirect Cost Rates in Accordance with Federal Requirements*" (A-04-17-04059).

The NIH appreciates the audit conducted by the OIG and the opportunity to provide clarifications on this draft report. If you have questions or concerns, please contact Meredith Stein in the Office of Management Assessment at 301-402-8482.

**/s/ Francis S. Collins, M.D., Ph.D.**

Francis S. Collins, M.D., Ph.D.

Attachments



**GENERAL COMMENTS OF THE NATIONAL INSTITUTES OF HEALTH (NIH) ON THE DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) OFFICE OF INSPECTOR GENERAL (OIG) DRAFT REPORT ENTITLED: “THE NATIONAL INSTITUTES OF HEALTH, DIVISION OF FINANCIAL ADVISORY SERVICES DID NOT ALWAYS ESTABLISH FINAL INDIRECT COST RATES IN ACCORDANCE WITH FEDERAL REQUIREMENTS” (A-04-17-04059)**

The National Institutes of Health (NIH) appreciates the review conducted by the Office of Inspector General (OIG) and the opportunity to provide clarifications on this draft report. The NIH respectfully submits the following general comments.

The OIG’s audit covered final indirect cost rate agreements that the Division of Financial Advisory Services (DFAS) established with organizations from October 2011 through September 2016. Since that time, the NIH believes that significant corrective actions have already taken place.

To strengthen the internal controls in the indirect cost rate function and to use quality information to make informed decisions, DFAS adopted the Defense Contract Audit Agency (DCAA) Incurred Cost Electronically (ICE) model for incurred cost data submission in 2016, in addition to several standardized checklists used in prior years, to determine whether a proposal is adequate. The DCAA ICE model includes, among other items, various cost schedules, subcontract information, and information on contracts that would be ready for closeout.

In an effort to reduce the backlog, DFAS has on-going efforts such as a risk-based approach for establishing indirect cost rates, identifying contracts and grants that can be administratively closed, establishing multi-year rates under a single rate agreement, and requesting adequate resources to manage the increased workload. In April 2016, DFAS analyzed its organizational structure and added two new branches and branch chiefs devoted to indirect cost rates. The additional two branches focus on specific OPDIVs and the branches coordinate efforts through a customer liaison to better meet each customer's needs.

In 2017, DFAS rolled out detailed procedures to make the risk assessment concurrently when determining that a proposal is adequate. Factors that DFAS considers when conducting a risk assessment include whether a specific risk was identified by an external source such as a contracting/grant officer or an independent accounting firm, business system deficiencies, prior experience with the grantee/contractor, and auditable dollar value (ADV), among others.

DFAS is fully committed to strengthening internal controls over the indirect cost rate function.

**OIG Recommendation 1:** Update DFAS policies and procedures to:

- Conform to applicable requirements for determining the adequacy of final indirect cost rate proposals,
- Require consideration of all FAR requirements for assessing the allowability of proposed costs including the support of proposed costs with adequate documentation and the appropriateness of data elements within direct cost bases for the fair distribution of indirect costs to applicable cost objectives,
- Define reasonable periods for promptly establishing final indirect cost rates, and

**GENERAL COMMENTS OF THE NATIONAL INSTITUTES OF HEALTH (NIH) ON THE DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) OFFICE OF INSPECTOR GENERAL (OIG) DRAFT REPORT ENTITLED: “THE NATIONAL INSTITUTES OF HEALTH, DIVISION OF FINANCIAL ADVISORY SERVICES DID NOT ALWAYS ESTABLISH FINAL INDIRECT COST RATES IN ACCORDANCE WITH FEDERAL REQUIREMENTS” (A-04-17-04059)**

- Include the factors to be considered when deciding to use final indirect cost rate ceilings.

**NIH Response:**

The NIH does concur that DFAS should update their internal Standard Operating Procedures (SOPs). DFAS will further update the SOPs to ensure clarity, consistency, and proper documentation of its verification process for the fair distribution of indirect costs to applicable cost objectives by June 2018.

The NIH does not concur with the OIG’s four suggested elements of what the DFAS policies and procedures should contain.

In 2017, DFAS created formal, written indirect cost rate (ICR) policies and procedures (internal SOP documents) to assess the completeness and adequacy of the indirect cost rate proposals in accordance with the federal and U.S. Department of Health and Human Services (HHS) Acquisition and grant requirements.

The SOPs include standardized checklists and detailed guidance and standards to document the data review for assessing the allowability of proposed costs including the support of proposed costs with adequate documentation, such as audited financial statements, tax returns, accounting system questionnaires, Personnel Policy Manual, etc.

DFAS recognizes the importance of establishing final indirect cost rates in a timely manner and has been diligently working on enhancing and streamlining current review procedures, developing and implementing a formal, documented risk assessment process as well as continuing to provide additional training to the auditors.

FAR 4.804-1(a)(3) calls for timely closeout of contracts needing settlement of indirect cost rates to occur within 36 months of evidence of physical completion. The report states that the highest is 900 days or 30 months and the average is 506 days or 17 months. On average, DFAS is timely and even for the longest duration, DFAS is current and in compliance with the FAR. In addition, DFAS is developing a web-based system that will establish a tracking system to account for when indirect cost proposals are due from organizations; the anticipated implementation date is June 2018.

Workforce challenges, such as employee turnover and inability to hire highly trained professionals, limit DFAS’ ability to establish reasonable periods for establishing final indirect cost rates in its policies and procedures.

**GENERAL COMMENTS OF THE NATIONAL INSTITUTES OF HEALTH (NIH) ON THE DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) OFFICE OF INSPECTOR GENERAL (OIG) DRAFT REPORT ENTITLED: “THE NATIONAL INSTITUTES OF HEALTH, DIVISION OF FINANCIAL ADVISORY SERVICES DID NOT ALWAYS ESTABLISH FINAL INDIRECT COST RATES IN ACCORDANCE WITH FEDERAL REQUIREMENTS” (A-04-17-04059)**

DFAS requested and received a legal opinion on the use of final indirect cost rate ceilings in October 2015 and entirely discontinued the practice effective January 2016. DFAS communicated this information to the OIG during the data gathering phase of the audit.

**OIG Recommendation 2:** Ensure that indirect cost rate ceilings associated with current or future rate proposals are properly applied.

**NIH Response:**

The NIH does not concur with the OIG recommendation because it is no longer relevant.

DFAS requested and received a legal opinion on the use of final indirect cost rate ceilings in October 2015 and entirely discontinued the practice effective January 2016. DFAS communicated this information to the OIG during the data gathering phase; DFAS considers this recommendation closed.

**OIG Recommendation 3:** Work with ASFR and OAMP, as applicable, to:

- clarify the extent of DFAS’s roles and responsibilities as a cognizant Federal agency for establishing final indirect cost rates and
- formally adopt a set of professional auditing standards, such as generally accepted government auditing standards.

**NIH Response:**

The NIH does not concur with the OIG recommendation because the HHS Acquisition Regulation (HHSAR) already clarifies DFAS’ roles and responsibilities and there is no requirement for DFAS to adopt a set of auditing standards.

The HHSAR 342.705(b) refers to HHS as the Cognizant Federal Agency, and DFAS as being the organization that shall establish indirect rates. Additionally, the memorandum from HHS Secretary Tommy Thompson dated December 21, 2001, authorized the NIH to undertake HHS-wide cognizance of the commercial indirect cost rate function. DFAS is the only HHS organization negotiating Indirect Cost Rates for commercial organizations for more than 20 years.

DFAS is not an audit agency and does not perform audits; hence there is no requirement for DFAS to formally adopt a set of professional auditing standards, such as generally accepted government auditing standards (GAGAS). If DFAS is able to obtain the authority, staffing and other resources from HHS necessary to become an audit agency, then DFAS can adopt GAGAS.

**GENERAL COMMENTS OF THE NATIONAL INSTITUTES OF HEALTH (NIH) ON THE DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) OFFICE OF INSPECTOR GENERAL (OIG) DRAFT REPORT ENTITLED: “THE NATIONAL INSTITUTES OF HEALTH, DIVISION OF FINANCIAL ADVISORY SERVICES DID NOT ALWAYS ESTABLISH FINAL INDIRECT COST RATES IN ACCORDANCE WITH FEDERAL REQUIREMENTS” (A-04-17-04059)**

**OIG Recommendation 4:** Seek approval from appropriate authorities if it intends to deviate from any pertinent requirements of the FAR.

**NIH Response:**

DFAS does not concur with this recommendation. DFAS has not and does not anticipate deviating from any pertinent requirements of the FAR. The NIH agrees that approval from appropriate authorities is needed if an organization intends to deviate from any pertinent requirements of the FAR.

Forty percent of the OIG’s selected sample were for commercial organizations that had only grants, no contracts. Hence, using only FAR criteria to evaluate these organizations is incorrect; grantees follow 45 CFR Part 75, except for cost principles which follow 48 CFR, Subpart 31.2. The report does not cite any specific examples where DFAS has deviated from any pertinent requirements of the FAR or any impact of the alleged deviation.