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Improving the F&A Rate-Setting Process with the Federal Government

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INTRODUCTION

The Council on Governmental Relations (COGR) is an association of over 180 research universities and affiliated academic medical centers and research institutes, which together account for over 90 percent of the federally-funded basic research conducted by Research Universities and institutions. COGR concerns itself with the influence of federal regulations, policies and practices on the performance of research and other sponsored activities carried out at COGR member institutions.

The Federal Cost Reimbursement Perspectives Series comprises several policy discussions that address issues relevant to Federal cost reimbursement policy, including the reimbursement of facilities and administrative (F&A, or commonly referred to as indirect) costs. As appropriate, the discussions advocate for either a revision or a more rational implementation of Federal cost reimbursement policies and practices applicable to financial research administration.

This is the second paper in the series. The first, *Federal Funding Agency Limitations on Cost Reimbursement: A Request for Consistency in the Application of Federal Guidelines*, was released in November 2010. That paper identified financial reimbursement policies imposed by Federal funding agencies that are inconsistent with official federal guidelines and result in the significant under-recovery of federal funds by Research Universities and institutions. The Appendix to that paper included examples of Federal agencies and/or programs where arbitrary agency policies result in financial burden for research institutions.

THE GOVERNMENT ACCOUNTABILITY OFFICE (GAO) AND THE F&A RATE-SETTING PROCESS

This paper, *Improving the F&A Rate-Setting Process with the Federal Government*, agrees with and reinforces several recommendations made in the Government Accountability Office (GAO) study entitled: *University Research: Policies for the Reimbursement of Indirect Costs Need to be Updated* (GAO-10-937). The GAO study looked at a number of topics specific to the F&A reimbursement process and provided six recommendations to the Director of the Office of Management and Budget (OMB) and the Secretary of Defense. Recommendations to the Secretary of Defense, specific to internal DOD administrative practices, are not shown. The three GAO recommendations to OMB are shown below:

- *Identify methods to ensure that the rate-setting process is applied consistently at all schools, regardless of which agency has rate cognizance. This would include identifying ways to ensure that differences in cognizant rate-setting agencies' approaches, goals, policies, and practices do not lead to unintended differences in schools' rate reductions for indirect costs.*

- *Clarify the roles and responsibilities of federal agencies (including DOD, HHS, and OMB) in accepting applications and reevaluating the eligibility of schools to receive the utility cost adjustment.*
- *Reexamine and determine whether reimbursing administrative costs at a maximum rate of 26 percent achieves the appropriate level of cost control and achieves the government's objective that the federal government bears its fair share of total costs.*

This paper primarily addresses the first GAO recommendation and includes a brief comment on the second recommendation. The third recommendation, while supported by COGR, is not addressed in this paper. The GAO report can be accessed at: <http://www.gao.gov/products/GAO-10-937>.

FEDERAL GUIDANCE FOR ESTABLISHING F&A RATES

There are two federal agencies that have F&A rate-setting responsibilities (i.e., “cognizance”) for colleges and universities: 1) Division of Cost Allocation, Department of Health and Human Services (DCA/HHS), and 2) Office of Naval Research, Department of Defense (ONR/ DOD). OMB Circular A-21, *Cost Principles for Educational Institutions*, consists of the regulations governing the determination of costs associated with federal grants, contracts and other agreements with Higher Education institutions. Circular A-21 is formally codified in the Code of Federal Regulations (2 CFR, Part 220). Note, the *Cost Principles for Non-Profit Organizations* (OMB Circular A-122, codified under 2 CFR, Part 230) and *Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Hospitals* (Appendix E to 45 CFR, Part 74) include guidance similar to Circular A-21, and both are relevant to the discussions that follow.

The rules for determining F&A rate cognizance (as well as switching cognizance) are defined in Circular A-21, section G11a., and specify that: “*Cost negotiation cognizance is assigned to the Department of Health and Human Services (HHS) or the Department of Defense's Office of Naval Research (DOD), normally depending on which of the two agencies (HHS or DOD) provides more funds to the educational institution for the most recent three years.*” While there are some exceptions to how this rule is implemented, in general, it is the basis for determining F&A rate cognizance. Consequently, because the National Institutes of Health (NIH, and part of HHS) funds the highest volume of federally sponsored research, most higher education institutions are assigned to the DCA/HHS for F&A rate cognizance. Note, however, approximately forty institutions are assigned to ONR/DOD.

Also, Circular A-21, sections G4, G5, and G6 define the types of rates that can be established. Pre-determined rates (G4) are the most common type of rate, and as specified in Circular A-21: “*... negotiation of predetermined rates for F&A costs for a period of two to four years should be the norm in those situations where the cost experience and other pertinent facts available are deemed sufficient to enable the parties involved to reach an informed judgment as to the probable level of F&A costs during the ensuing accounting periods.*”

Pre-determined rates normally are derived from a “base year” F&A rate proposal, which is used to establish pre-determined rates for two to four years going forward (e.g., data from the fiscal year ending June 30, 2010 is used to set rates for fiscal years ending June 30, 2012 through June 30, 2015). Once pre-determined rates are agreed upon with either DCA or ONR, they are formalized into an “F&A Rate Agreement” and, unless there is a highly unusual or exceptional situation, predetermined rates cannot be adjusted.

Fixed with carry forward rates (G5) are used at selected institutions only, and are more common to ONR cognizant institutions. ONR has regularly established this type of rate for many institutions under their cognizance, but over the past decade, ONR has transitioned to pre-determined rates. The key premise to the fixed with carry forward rate is that on a periodic (normally, annual) basis, the F&A rate that was used for recovery in a prior year is “finalized” to determine if the prior year recovery represented an over- or under- recovery. As specified in Circular A-21: “... *the over or under recovery for that year may be included as an adjustment to the F&A cost for the next rate negotiation.*”

Provisional and final rates (G6), as stated in Circular A-21, are applicable in this situation: “*Where the cognizant agency determines that cost experience and other pertinent facts do not justify the use of predetermined rates, or a fixed rate with a carry forward, or if the parties cannot agree on an equitable rate, a provisional rate shall be established.*” Provisional and final rates present an institution with risk – if the provisional rate that was utilized over a period of time is reduced, the institution may be required to adjust prior charges to their federal awards or write a check to the Federal government to account for the over-recovery. In practice, provisional and final rates are utilized when the term of the institution’s rate agreement expires and new rates are not yet established.

HOW F&A RATES ARE ESTABLISHED

The DCA and ONR each have unique organizational models and different processes for establishing F&A rates. The DCA is comprised of four regional offices (New York, Washington D.C., Dallas, and San Francisco) with a National Director that oversees the four regional offices. Institutions that have DCA cognizance are assigned to one of the four regions based on geographical location. As mentioned previously, most higher education institutions are assigned to the DCA for F&A rate cognizance, and approximately forty institutions are assigned to ONR. With a more limited portfolio of institutions, which are geographically dispersed across the entire country, ONR functions as a single, national office.

An institution with DCA cognizance submits an F&A rate proposal to its applicable region and DCA staff conduct a detailed desk review of the proposal. If the institution has a volume of federally sponsored research that the DCA determines is significant, the DCA most likely will schedule an on-site review after the desk review. In December 2006, the DCA published an internal document entitled the *DCA Best Practices Manual For Reviewing College and University Long-Form Facilities & Administrative Proposals*. While not meant to supersede OMB Circular A-21, it does include policy interpretations and it is used to guide DCA staff in their reviews (note: COGR disagreed with several of the DCA interpretations in the DCA Manual, and in December 2007, COGR published *An Analysis of F&A Proposal Review and Negotiation Topics from the DCA Best Practices Manual – COGR Interpretations*). After the desk review and prior to an on-site review, DCA staff normally will request additional data in order to achieve a more complete understanding of specific areas of the proposal.

The on-site review can cover a variety of issues specific to the institution's F&A rate proposal and normally includes a review of how the institution identified research space in its proposal. Because the facilities portion of the F&A rate (e.g., depreciation, interest, operations and maintenance) is uncapped and dependent on how the institution allocated/assigned space to research and other functions of the institution, the DCA may sample selected academic departments to determine if the research space survey is accurate. Based on the desk and on-site reviews, DCA staff then is prepared to work with the institution to establish F&A rates. This final step is described later.

An institution with ONR cognizance submits an F&A rate proposal to the ONR Indirect Cost Branch in Arlington, Virginia and ONR engages the Defense Contracting Audit Agency (DCAA) to conduct an audit of the proposal. Rather than using the DCA “detailed review” model, the DCAA conducts an audit of the F&A rate proposal and focuses on many of the same items as the DCA. In the case of DCAA, there are over one-hundred offices located throughout the country and the DCAA office responsible for the audit normally will be the office most geographically convenient. On-site reviews by DCAA auditors are scheduled as appropriate, and in some cases, the highest volume research institutions house on-campus DCAA auditors. The DCAA audit concludes with a formal audit report that is issued to ONR, and ONR then is responsible for conducting negotiations to establish federally approved F&A rates.

The final step for both DCA and ONR cognizant institutions, establishing F&A rates, often is referred to as the “negotiation” phase. The aim of the final step should be to establish F&A rates that are based on the actual costs incurred by the institution. If an institution can document, support, and adequately respond to any findings applicable to the proposed F&A rate, it is a reasonable expectation that this rate be accepted and approved in the institution’s F&A Rate Agreement. If findings by the DCA or the DCAA suggest the proposed F&A rate requires a downward adjustment, the normal course of action is for the institution to respond to the findings. In order for the process to be effective, it is important that all findings are presented to the institution in a clear and transparent manner, prior to the negotiation of rates. The institution should have an opportunity to respond to the findings and the institutional responses should be taken into consideration. If there are disagreements in the adequacy of the institution’s responses, there should be an agreement between both parties as to what next steps are necessary in order to establish F&A rates.

Though the DCA and ONR have practices and processes unique to each, in general, the F&A rate-setting cycle can be viewed as follows:



Some universities in the research community have come to perceive the negotiation phase as an obtuse and confusing process. Regardless of an institution’s ability to support the proposed F&A rate – one that is well-documented and can be defended after close scrutiny – some have found the current process to involve an unnecessarily contentious negotiation prior to the establishment of F&A rates.

Each DCA office and the ONR national office approaches the negotiation phase based on historical practices and the unique culture of each entity. Some research institutions are comfortable with the process of how their rates have been established, while others have been frustrated with a sense of “arbitrariness” in the negotiation phase. One observation is that the ONR model appears to be more predictable and results in establishment of F&A rates that are closer to the F&A rates proposed by the institution. This was articulated in the GAO Study (page 13):

*Across all schools, wide variation was identified in proposed rates, negotiated rates, and in the difference between the proposed and negotiated rates at schools receiving DOD research funding in fiscal year 2007. **The difference between the proposed and negotiated rates was significantly larger for schools that negotiate with HHS [DCA] than for those that negotiate with DOD [ONR] [emphasis added].** Differing policies and procedures employed by the two cognizant rate-setting agencies, including, for example, different approaches and differing use of rate types, may explain some of this variation.*

It should be noted that ONR works with a much smaller cohort of institutions than DCA and that all institutions with ONR cognizance establish rates directly with the ONR national office – this may explain some of the enhanced predictability and consistency for institutions that have ONR cognizance.

Fortunately, many stakeholders from both the Federal government and research institutions have recognized a maturity of the F&A rate-setting process. This has been driven by several factors, for example: the “standard format” for proposal submissions (Circular A-21, Exhibit C, Documentation Requirements for F&A Rate Proposals) has resulted in consistent audit trails and documentation; improved guidance from the DCA has helped to standardize some aspects of the research space survey; and sophisticated software applications have automated significant portions of the rate calculation. Consequently, F&A rate proposals have become even better in terms of quality and accuracy and are, therefore, more defensible. This, in turn, continues to enhance the credibility of the F&A rates that are established. Regardless of cognizance, the model to strive for is one that is transparent, unambiguous, and collaborative between the Federal government and Research Universities and institutions. The recommendations that follow can be used as the foundation for further improvement to the F&A rate-setting process.

RECOMMENDATIONS TO IMPROVE THE F&A RATE-SETTING PROCESS

The following Recommendations are made with the recognition that OMB, DCA, ONR, and the Research University community have enjoyed a productive and positive relationship over many decades. The leadership and staff from each federal agency are hard-working professionals and they do their jobs well. Consequently, the recommendations are not directed at agency personnel, but instead, are premised on the need to increase predictability and consistency in how F&A rates are established. Agreement on important practices for rate-setting will instill more predictability and consistency into the rate-setting process.

1. **Periodic policy consultation between representatives from DCA, ONR, OMB, other applicable Federal entities, and Research Universities is necessary.** OMB Circular A-21 provides a basis for policy consistency across the four regions of the DCA and ONR. The DCA *“Best Practices Manual”*, though not specific to ONR, also informs policy interpretations. While COGR objected to a number of policy interpretations in the DCA Manual, the DCA Manual coupled with the subsequent *“COGR Interpretations”* provide an initial platform for consistent policy interpretation. Policies that are communicated, understood and agreed upon by the Federal government and research institutions are an important attribute of a functional F&A rate-setting process. We propose periodic meetings and communications between the parties listed above to address issues and concerns related to the F&A rate-setting process.
2. **Establishing F&A rates should be guided by a transparent documentation of the proposed F&A rate and the potential F&A rate adjustments.** OMB Circular A-21 requires that institutions structure their F&A rate proposals in compliance with a “standard format” (Circular A-21, Exhibit C, Documentation Requirements for F&A Rate Proposals), which provides detailed audit trails and a comprehensive statement of the proposed F&A rate. The proposed F&A rate is then reviewed and/or audited according to the protocols unique to DCA and ONR. While the format for potential adjustments proposed by DCA and ONR/DCAA need not include the same amount of detail as the institution’s F&A rate proposal (according to the DCA *“Best Practices Manual”*, DCA staff summarize all potential adjustments for internal records), a formal document that summarizes the proposed adjustments and that is shared with the institution prior to

establishing F&A rates will enhance the transparency and clarity of the F&A rate-setting process. We propose that a basic format for a formal document be developed through the periodic consultation and meetings process described in Recommendation 1.

3. **Rate increases should not be artificially limited.** If an institution can support a rate increase, this should be achievable through the rate-setting process. The GAO report (page 16) provided this example: “... *one school we surveyed stated that HHS officials told them that 2 percentage points would be the most that their rate could increase over the previous negotiated rate.*” While the GAO report continued by stating that the National Director of the DCA, once informed of this matter, ordered the practice to be discontinued, there remains some evidence that artificial limitations on the level of a rate increase still exist. While there may be exceptional situations where a supported rate increase cannot be implemented on an immediate basis, those situations should be documented clearly by the DCA or ONR and the institution should be satisfied with the documentation and the process that was utilized.
4. **Maintaining objective and consistent treatments in rate development methodologies (e.g., useful lives for depreciable assets) should be an ongoing goal.** Rate development methodologies, such as determining the useful lives for depreciable assets, are important drivers of the F&A rates calculated by research institutions. OMB Circular A-21 does not provide specific guidance on all methodologies. The DCA “*Best Practices Manual*” and the “*COGR Interpretations*” provide guidance, but these do not represent official policy guidance. In situations where official guidance does not exist, periodic policy consultation (as suggested in Recommendation 1) is a necessary element in striving for consistent treatment by all DCA regions and ONR. Furthermore, when there is a disagreement on a rate development methodology that the institution believes is compliant with the OMB cost principles, the institution should have an available procedure to elevate the disagreement (see Recommendation 5 below). Objective and consistent treatments by the four regions of DCA and ONR on the most significant rate development methodologies will instill more predictability and consistency into the F&A rate-setting process.
5. **Strong central leadership must be available to resolve exceptional situations.** The organizational structures of both the DCA and ONR are conducive to handling exceptional situations. The DCA has a National Director that oversees the four regional offices. ONR, with a more limited portfolio of institutions, functions as a single, national office. Consequently, rate methodologies and establishment of F&A rates for institutions with ONR cognizance inherently should be more consistent. In the case of the DCA, it is understood that each region will embody a unique style and culture and that this creates some risk of differences in practices across the four DCA regions. However, when there is an exceptional situation or an impasse in the rate-setting process, research institutions should have access to strong central leadership so that the issues in question can be addressed in an objective, fair, and timely manner.
6. **If the National office cannot settle an unresolved negotiation, the Appeals Process should be fully understood by all parties.** Only in the most rare and unusual circumstances should an institution invoke the appeals process. The DHHS Procedures of the Departmental Grant Appeals Board are codified in the Code of Federal Regulations (45 CFR, Subtitle A, Part 16) and the DOD appeals process is implemented through contract appeals protocols defined in the Federal Acquisition Regulations (FAR) or in other applicable guidance mechanisms. However, there is uncertainty as to how the appeals process should be triggered, the role of OMB (if any), and whether or not the type of rate an institution has (e.g., predetermined versus provisional)

should be considered in the appeals process. Again, invoking the appeals process should be the rare exception, but clarity as to how the process would work should be understood.

7. **The 1.3% Utility Cost Adjustment (UCA) immediately should be made applicable to each higher education institution that does not currently receive it.** The GAO report asked OMB to “[c]larify the roles and responsibilities of federal agencies (including DOD, HHS, and OMB) in accepting applications and reevaluating the eligibility of schools to receive the [UCA] ...”. The GAO recommendation is consistent with OMB Circular A-21, Section F4, which states: “Beginning on July 1, 2002, Federal agencies shall reassess periodically the eligibility of institutions to receive the UCA.” COGR recommends that OMB issue a memo that states that all institutions currently not receiving the UCA are eligible to be issued an amended rate agreement that recognizes the UCA. Many of the highest volume research institutions in the country already receive the 1.3% UCA, so the national shift of dollars from direct to F&A should be minimized.

COGR maintains that implementation of the recommendations will facilitate the key principles of fairness, equity, and transparency, while also reinforcing the productive Federal Government-University partnership. Improvement of the F&A rate-setting process will provide research institutions with enhanced confidence that the F&A rates established through the rate-setting process are fair and provide the appropriate level of F&A reimbursement. Consequently, this will help to ensure the ongoing and significant investments in the essential and necessary research infrastructure.

CONCLUDING THOUGHTS

Implementation of COGR’s first six Recommendations will infuse the F&A rate-setting process with more consistency and fairness – this is in-line with the GAO’s first recommendation to OMB: *“Identify methods to ensure that the rate-setting process is applied consistently at all schools, regardless of which agency has rate cognizance. This would include identifying ways to ensure that differences in cognizant rate-setting agencies’ approaches, goals, policies, and practices do not lead to unintended differences in schools’ rate reductions for indirect costs.”*

Implementation of the seventh recommendation, extending the 1.3% UCA to all institutions, will correct a blatant inequity that currently exists in the F&A rate-setting process. Furthermore, this will address the GAO’s second recommendation to OMB: *“Clarify the roles and responsibilities of federal agencies (including DOD, HHS, and OMB) in accepting applications and reevaluating the eligibility of schools to receive the utility cost adjustment.”*

COGR and its member institutions have enjoyed a productive relationship with OMB, DCA, and ONR for many years, and implementation of the seven Recommendations will be an important step to maintain the positive working relationships.