Memorandum

Date MAY 17 1993

From Bryan B. Mitchell
Principal Deputy Inspector General

Subject Department of Health and Human Services Hospital Cost Principles for Federally Sponsored Research Activities (A-01-92-01528)

To Elizabeth M. James
Acting Assistant Secretary
for Management and Budget

Attached are two copies of the United States Department of Health and Human Services (HHS), Office of Inspector General's report entitled "Department of Health and Human Services Hospital Cost Principles for Federally Sponsored Research Activities." Our primary objective was to determine whether HHS established hospital cost principles for federally sponsored research activities (known as OASC-3) was outdated and thus, whether the recent changes to reimbursement rules contained in Office of Management and Budget (OMB) Circular A-21, Cost Principles for Educational Institutions, should be extended to all research hospitals.

The OASC-3, which has not been revised in nearly 2 decades, does not always provide clear guidance for determining what types of costs should be allowed and how costs should be allocated. This results in hospitals making interpretations which expand the types and amounts of costs which could potentially be included in their indirect cost rate proposals.

We recommended that the Assistant Secretary for Management and Budget (ASMB) modernize and strengthen the hospital cost principles by either: (1) revising OASC-3, where applicable, to be consistent with Circular A-21; or (2) working with OMB to extend Circular A-21 coverage to all hospitals. The ASMB generally concurred with our recommendation.

We would appreciate your views and the status of any further actions taken or contemplated on our recommendations within the next 60 days.

To facilitate identification, please refer to Common Identification Number A-01-92-01528 in any correspondence related to this report. If you have any questions or would like to discuss this matter, please call me or have your staff contact Daniel W. Blades, Assistant Inspector General for Public Health Service Audits, at (301) 443-3582.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

DEPARTMENT OF HEALTH AND HUMAN SERVICES HOSPITAL COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH ACTIVITIES

MAY 1993 A-01-92-01528

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

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From Bryan B. Mitchell
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Subject Department of Health and Human Services Hospital Cost Principles for Federally Sponsored Research Activities (A-01-92-01528)

To Elizabeth M. James
Acting Assistant Secretary
for Management and Budget

This management advisory report summarizes the results of our review of hospital cost principles applied to research activities funded through Federal grants and contracts. Our objectives were to: (1) review the Department of Health and Human Services (HHS) established hospital cost principles for federally sponsored research activities, Principles for Determining Costs Applicable to Research and Development Under Grants and Contracts With Hospitals, contained in the Code of Federal Regulations (C.F.R.), Title 45, Part 74, Appendix E (commonly known as OASC-3); and (2) determine whether OASC-3 cost principles are still applicable and adequate and thus, whether the recent changes to reimbursement rules contained in Office of Management and Budget (OMB) Circular A-21, Cost Principles for Educational Institutions, should be extended to all research hospitals.

The evolving reimbursement rules contained in Circular A-21 apply to Federal research funds awarded directly to educational institutions. There are no Governmentwide cost principles for those hospitals which receive direct research funding from Federal sources. In 1967, HHS (then Department of Health, Education, and Welfare (HEW)) developed its own cost principles, contained in OASC-3, for hospitals which received direct research funding.

The OASC-3 was originally published over 25 years ago when the research environment and Federal funding rules were less complex. In view of the recent disclosures of excessive and extravagant indirect costs at colleges and universities, OMB took steps to clarify and strengthen policy relative to costs for research activities at colleges and universities. Recent Office of Inspector General (OIG) reviews have disclosed the potential for similar excessive and extravagant indirect costs at research hospitals. In our view, the hospital cost principles should be revised to address the potential for excessive and extravagant costs and HHS' focus on tightening controls over administrative costs. Further, hospital cost principles need to be modernized to address the changing

research environment and changes in accounting and business practices. As such, HHS continues to maintain cost principles for hospitals that use terminology and principles that are not consistent with OMB's evolving Governmentwide cost principles contained in Circular A-21 and do not reflect the changing research and cost reimbursement environment.

We are recommending that the Assistant Secretary for Management and Budget (ASMB), act to modernize and strengthen the cost principles applicable to hospitals by either: (1) revising the OASC-3, where applicable, to be consistent with Circular A-21 (see EXHIBIT A for specific principles requiring revision); or (2) working with OMB to extend Circular A-21 coverage to all research hospitals.

In response to our draft report, the ASMB generally concurred with the basic recommendation in the report that the research cost principles for hospitals should be updated and made more consistent with the cost principles for universities in Circular A-21. The ASMB intends to revise the principles when the revisions of Governmentwide cost principles for universities and State and local governments are finalized by OMB.

BACKGROUND

The Federal Government sponsors hospital research and development through grants and contracts. This process includes a system of reimbursement of costs, both direct and indirect. Direct costs are those costs that can be identified with a particular sponsored research project, patient care or instruction function or other institutional activity. Direct research costs include such items as the salaries of the investigators and project-specific research equipment and materials. Conversely, indirect costs are not specifically identifiable with a particular project or activity and include such costs as utility expenses, depreciation of building and equipment, and general hospital administration costs. Indirect costs are recovered by applying a negotiated indirect cost rate to each sponsored agreement.

Funding for research activities is provided to hospitals either directly by Federal agencies or indirectly through affiliated colleges and universities. The HHS provides approximately 99 percent of the direct research funding to hospitals nationally. In Fiscal Year (FY) 1991, the National Institutes of Health (NIH) awarded over $524 million in grants and contracts to hospitals for federally sponsored research. While 205 research hospitals received NIH research funding nationally, only 13 received more than $10 million in total funding (representing 66 percent of the total NIH research and grants funding awarded directly to hospitals). Further, only

32 hospitals received more than $3 million in total NIH research funding, representing 85 percent of the total grants and contracts awarded by NIH directly to hospitals (see EXHIBIT B).

There is no readily available data relative to the amount of research funding provided indirectly to hospitals owned by or affiliated with educational institutions. Available data shows that NIH awarded $4.6 billion to educational institutions in FY 1990. A portion of the research funding awarded to educational institutions would have been conducted at hospitals administered (i.e, owned or affiliated) by the educational institution. While Circular A-21 applies to funds awarded to the educational institution, regardless of where the research is conducted, there are no Governmentwide cost principles for those hospitals which receive direct research funding from Federal sources.

In 1967, HHS (then HEW) developed hospital cost principles contained in OASC-3, for research activities. The HHS-published hospital cost principles are codified at 45 C.F.R. 74, Appendix E. The OASC-3 prescribes the general policies and guidelines applicable to costs charged to federally funded research grants with hospitals.

Indirect costs are reimbursed based on a hospital's negotiated indirect cost rate(s), subject to statutory or administrative limitations or exclusions, as part of the total costs of individual awards. Hospitals periodically prepare an indirect cost rate proposal representing a previous year's actual allowable costs and negotiated indirect cost rates. The OMB has not formally assigned cognizance to a Federal agency to act on behalf of all Federal agencies in negotiating and approving indirect cost rates with hospitals. Since HHS provides the preponderance of federally sponsored research funding to hospitals, HHS, ASMB assumed responsibility for negotiations with hospitals.

The HHS established cost principles were amended three times since their 1967 issuance: (1) in 1969, to modify the simplified method for determining indirect cost rates for small institutions; (2) in 1970, to issue policies and procedures for establishing patient care rates; and (3) in 1974, to incorporate prior amendments and other changes. The ASMB proposed a revision to the OASC-3 in December 1983, to update the hospital cost principles to closely reflect current terminology and principles used by OMB for other institutions. The 1983 Notice of Proposed Rulemaking, however, was not issued by HHS.

While the Medicare program has issued cost principles for use by hospitals, these principles were developed to determine

patient care costs and not the cost of medical research. To provide for general consistency, the OASC-3 requires that direct and indirect costs of research programs be identified as a cost center for the cost finding and step-down requirements of the Medicare program. Further, the Medicare cost report (an accumulation of a hospital's costs for Medicare reporting purposes) is the starting basis for the preparation of the hospital's indirect cost rate proposal for research.

In light of the high level of congressional, administration, agency, media and public interest in indirect costs, OMB, in October 1991, revised Circular A-21 cost principles applicable to federally sponsored research agreements at colleges and universities. These revisions were in response to disclosures of the charging of unallowable and unallocable costs to federally sponsored research activities and were aimed at providing additional guidelines to clarify policy and to stop abuses. On December 9, 1992, the OMB published a notice of proposed rulemaking which contains further revisions to Circular A-21. The proposed changes are expected to help define, clarify, and simplify cost principles for colleges and universities involved in research.

Recent OIG reviews of general and administrative and fringe benefit costs under the Medicare program at hospitals revealed the potential for similar claiming for reimbursement of unallowable, unreasonable and unallocable general and administrative costs under federally sponsored research. While these reviews focused on the allowability, reasonableness and allocability of general and administrative and fringe benefit costs under Medicare, the identified questionable costs could also affect Federal research activities. In this respect, the cost data for the indirect cost rate proposal for research flows from the Medicare cost report.

SCOPE AND METHODOLOGY

The objectives of our review were to: (1) review the OASC-3, the cost principles which apply to federally sponsored research activities at research hospitals; and (2) determine whether OASC-3 cost principles are still applicable and adequate and thus, whether the recent changes to reimbursement rules contained in OMB Circular A-21 should be extended to all research hospitals. To accomplish our objectives, we:

(1) reviewed the cost principles contained in the OASC-3 for research activities conducted at hospitals, and compared the OASC-3 with the Governmentwide cost principles stipulated for colleges and universities (OMB Circular A-21);

(2) determined through analysis and evaluation whether OASC-3 cost principles were still applicable and adequate and identified those areas which require strengthening and updating;

(3) discussed our objectives and the need for consistent and up-to-date cost principles for hospitals with ASMB, Office of Grants Management;

(4) reviewed ASMB's December 1983 Notice of Proposed Rulemaking relating to updating OASC-3;

(5) reviewed audit reports for recent reviews of general and administrative and fringe benefit costs under Medicare at hospitals to identify those cost categories which may require strengthening; and

(6) reviewed NIH and National Science Foundation data relative to the level of Federal funding awarded directly to research hospitals.

Our review was conducted during July-September 1992, at the Office of Audit Services' Regional Office in Boston, Massachusetts. We provided the ASMB a draft report for comment on January 28, 1993. The ASMB's comments are summarized below and appended in their entirety to this report (see APPENDIX).

RESULTS OF REVIEW

The OASC-3 hospital cost principles applicable to federally sponsored research activities do not always provide clear guidance to hospitals when there are questions relating to the allowability or allocability of certain costs. As a result, hospitals have made interpretations over the years which expanded the types and amounts of costs which could potentially be included in indirect costs. This parallels the conditions existing, as recently as 1991, in the college and university arena. The OMB, however, moved to address the changing research environment at colleges and universities by revising Circular A-21 in October 1991. Similar to the situation at colleges and universities, up-to-date hospital guidelines are needed to clarify policy, ensure consistency in the treatment of costs between hospitals and colleges and universities and stop the charging of extravagant or potentially unallowable or unallocable costs.

The significant increase in costs charged to the Federal Government for federally sponsored research activities during the last decade has been the subject of continuing interest and debate by various congressional committees, OMB, research hospitals, universities and their associations, and the public

at large. This heightened interest has resulted in numerous OIG audits of general and administrative costs at hospitals and colleges and universities which have disclosed widespread abuses related to unallowable and unallocable costs.

As stated above, OMB issued revisions to Circular A-21 in response to reported abuses in reimbursement at colleges and universities in October 1991. In announcing its changes to OMB Circular A-21, OMB stated that:

> "The Administration remains committed to funding a fair share of the costs of the research enterprise. But this share must not include excessive administrative costs. Abuses in cost recovery must be stopped. At the same time, since many of these abuses would not occur if there were agreed accounting standards, we must proceed immediately to define those standards...."

We believe that the potential exists for hospitals to include similar excessive administrative costs for federally sponsored research in their indirect cost proposals. During our reviews of general and administrative costs under Medicare at 20 hospitals, we identified unallowable, unreasonable and unallocable costs such as expenditures for alcoholic beverages, lobbying related efforts, flowers, memberships in country clubs and social organizations and lease payments for luxury automobiles. In some cases, OASC-3 does not contain specific guidance to exclude unreasonable costs, such as memberships in country and social clubs and lease payments for luxury automobiles. While these reviews focused on unallowable costs under Medicare, 2 of the 20 hospitals reviewed account for 18 percent of total NIH direct research funding to hospitals. We believe that the identified questionable costs would also be claimed under Federal research activities since the Medicare cost report is the starting point for the preparation of the indirect cost rate proposal. Further, we found that these questionable costs were included in Medicare cost reports in prior FYs. We did not identify any hospital adjustments removing similar unallowable and unallocable costs from prior years' indirect cost rate proposals.

We believe that OASC-3 should be revised to make the principles for hospitals clearer, more specific and more compatible with cost principles issued by OMB for colleges and universities (OMB Circular A-21). This report summarizes in two categories the changes needed to the OASC-3 to address: (1) specific potentially extravagant and excessive administrative costs; and (2) the changing business environment and accounting practices.

Necessary Changes to Address Potentially Excessive and Extravagant Administrative Costs

Our nationwide review of general and administrative costs claimed under Medicare by 20 hospitals disclosed numerous instances of reimbursement for unallowable and/or unallocable costs. Examples of unallowable and/or unallocable costs found at hospitals during review of general and administrative expenses under Medicare include:

- entertainment (room rental at a Chinese restaurant, an appreciation luncheon for a certified public accounting firm, a "humorist" luncheon, baseball tickets, season tickets for professional basketball games, golfing fees and a boat cruise and associated meals);
- alcoholic beverages (wine at a volunteer dinner and Trustees' dinner, beer and wine for an Executive Christmas party, farewell dinners and miscellaneous liquor expenses for hospital officials during travel);
- plant care and flowers (flowers for employee gifts, funerals and birthdays);
- donations and contributions (donations to support a local newspaper-sponsored educational program, and to a public school system);
- promotional items (promotional maps, pens and calendar magnets and hats and sweatshirts with the hospital logo);
- consulting fees for consulting services which benefited an affiliate, rather than the hospital;
- payment of a penalty levied by the Occupational Safety and Health Administration for a safety violation, payment of fines for various violations and payment of penalties and interest for late payments of taxes and vendor payments;
- lobbying related costs;
- memberships (membership fees to a country club for a senior executive, fees for private clubs and dues to a social/fraternal organization);
- miscellaneous expenses (expenditures for antique pillows, custom-designed curtains for the

President's office, group caricatures, jewelry and gifts); and

- lease payments for luxury automobiles and automobile allowances for executives.

The hospitals' Medicare cost reports, which included the questionable costs discussed above, are the basis for preparation of the indirect cost rate proposals. Cursory reviews of indirect cost rate proposals show that hospitals made no adjustments to eliminate these types of expenses before allocations were made to research activities. The OASC-3 states that an allowable cost must be: (1) reasonable; (2) allocable; (3) consistently treated; and (4) in conformance with any limitations or exclusions established by OASC-3 or by individual-sponsored agreements as to types or amounts of costs. To determine whether a cost is allocable, it is necessary to use the tests of whether: (1) costs are generally recognized as necessary for the overall operation of the hospital; or (2) research activities receive benefit. The OASC-3 does not provide any further guidance or clarification relative to the definitions of allowable, reasonable and allocable costs.

Hospital officials have interpreted many expenses of a general nature consistent with the hospitals' established policies and procedures and business practices as allowable and allocable without regard to their necessity or benefit to research activities. We believe, however, that while the incurrence of expenditures for luxury automobiles, country clubs and alcoholic beverages may be consistent with a hospital's established policies and procedures, these expenditures do not benefit research and are not necessary for the overall operation of the hospital. As such, these costs are unallowable for allocation to Federal research activities.

In conclusion, in view of the possible extravagant and excessive expenditures potentially incurred for research cost reimbursement at hospitals, OASC-3 needs to be updated to curb excessive and extravagant administrative expenditures. Only by providing guidelines on the allowability of specific cost categories and prohibiting the expenditure of research funds for certain costs, can HHS be assured that research expenditures at hospitals are expended for allowable, reasonable and allocable costs.

Revisions Needed to Address the Changing Environment and Accounting Practices

Since the 1974 revision to the OASC-3, numerous changes have occurred in the research arena and in today's business and accounting practices which should now be formally addressed in

the hospital cost principles. Some of the more important areas, discussed in EXHIBIT C, relate to the use of the simplified method for establishing an indirect cost rate for small institutions, accrual of retiree health insurance costs, equipment and capital expenditures, collection of unallowable costs and adjustment of previously negotiated rates, the potential shifting of unrecovered costs of foreign sponsored and industry sponsored research, and the basis for distribution of indirect costs.

In summary, there have been numerous changes in the research arena, from increased funding to accounting changes to rising deficits. The changing environment in which research activities are performed requires that HHS keep pace with changes in the scientific research arena and today's business and accounting practices. We believe that by addressing the environmental and business changes discussed in EXHIBIT C, HHS will be better able to ensure that scarce Federal resources are utilized for the most efficient and effective purposes. As discussed in the BACKGROUND section, the majority of NIH research funding is provided directly to colleges and universities and indirectly to their affiliated (i.e., university administered) hospitals. These institutions are covered by OMB Circular A-21. Hospitals receiving direct NIH funding, however, are covered by OASC-3. As such, there are two different sets of cost principles which apply to Federal research funding received by hospitals. The OASC-3, however, has a major impact on only a relatively small group of hospitals. In this regard, while 205 hospitals received NIH research grants and contracts directly in FY 1991, only 32 accounted for 85 percent of total NIH research funding to hospitals. We believe that working with OMB to extend Circular A-21 coverage to all hospitals would assist in eliminating confusion and inconsistencies resulting from two different sets of principles.

RECOMMENDATIONS

We are recommending that ASMB act to modernize and strengthen the cost principles applicable to hospitals to exclude certain specified costs from reimbursement and address changes in the research environment and accounting practices by either: (1) revising OASC-3, where applicable, to be consistent with Circular A-21 (See EXHIBIT A for specific principles requiring revision); or (2) working with OMB to extend Circular A-21 coverage to all research hospitals.

ASMB's Comments

The ASMB is in agreement with the basic recommendation that the cost principles for hospitals should be updated and made more consistent with the cost principles for universities.

To facilitate identification, please refer to Common Identification Number A-01-92-01528 in any correspondence related to this report. If you have any questions or would like to discuss this matter, please call me or have your staff contact Daniel W. Blades, Assistant Inspector General for Public Health Service Audits, at (301) 443-3582.

EXHIBITS

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

RECOMMENDED HOSPITAL COST PRINCIPLES REVISIONS

The current version of OASC-3 does not provide the specific guidance contained in the current version of Circular A-21 in each of the areas mentioned below.

Cost/Principle	Proposed Revision
Advertising and Public Relations	The recent revisions to Circular A-21 highlight advertising and public relations as a separate cost category and provide specific examples of unallowable costs. Examples of unallowable advertising and public relations costs include costs of advertising designed to promote the institution; promotional items and memorabilia (models, gifts and souvenirs); and displays and exhibitions related to other institutional activities.
Adjustment of Negotiated Rates	The recent revisions to Circular A-21 provide that negotiated indirect cost rates based on a proposal later found to include unallowable costs shall be adjusted or refund shall be made regardless of the type of rate negotiated.
Alcoholic Beverages	Revisions highlight alcoholic beverages as a separate category which is unallowable.
Basis for the Distribution of Indirect Costs	While OASC-3 provides that indirect costs should be distributed on the basis of total salaries and wages, in practice many hospitals are allocating costs on the basis of modified total direct costs (which consists of salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants up to $25,000 each). The application of the modified total direct cost basis is consistent with Circular A-21 treatment.
Collection of Unallowable Costs	Circular A-21 revisions provide that identified unallowable costs charged to the Government will be refunded with appropriate interest.

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

RECOMMENDED HOSPITAL COST PRINCIPLES REVISIONS

Cost/Principle	Proposed Revision
Compensation	The revised A-21 specifies that the portion of the cost on institution-furnished automobiles that relates to personal use of employees (including transportation to and from work) is unallowable.
Donations and Contributions	The revised Circular A-21 specifically states that donations and contributions are unallowable regardless of the recipient. Further, the value of donated services and property, regardless of the recipient are not allowable either as a direct or indirect cost, except that depreciation or use allowances on donated assets are permitted.
Entertainment	The revised Circular A-21 specifies that tickets to shows and sporting events are unallowable.
Equipment and Capital Expenditures	The revised Circular A-21 defines general and special purpose equipment and capital expenditures. Further, it provides specific rules of allowability relative to equipment and other capital expenditures.
Goods and Services for Personal Use	The recent revisions to Circular A-21 highlight these costs as a separate cost category and specifically state that these types of costs, incurred for the institution's officers and employees, are unallowable.
Housing and Personal Living Expenses	The recent revisions to Circular A-21 highlight these costs as a separate cost category and specifically state that this type of cost incurred, for or by the institution's officers, are unallowable.

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

RECOMMENDED HOSPITAL COST PRINCIPLES REVISIONS

Cost/Principle	Proposed Revision
Interest Costs	The Circular A-21 (July 1982 revisions), provides that the costs of interest associated with certain specified assets which are used in support of sponsored agreements are allowable. While OASC-3 does not allow interest costs, discussions with Division of Cost Allocation (DCA) staff disclosed that the ASMB has been allowing hospitals to claim interest costs to be consistent with OMB A-21 principles. We believe that the ASMB should clarify its policy relative to the allowability of certain interest expenses.
Lobbying	The revised Circular A-21 makes specific reference to Federal restrictions on lobbying contained in 45 C.F.R. Part 93.
Memberships and Subscriptions	Recent revisions to Circular A-21 specifically state that any memberships in social, country or dining clubs are unallowable. Additionally, these evolving reimbursement rules make membership costs for civic and community organizations and subscriptions to civic periodicals unallowable.
Pension Plan Costs	The Circular A-21 (since its February 1976 issuance) specifies that pension plan costs are allowable provided the cost assigned to a given FY is paid or funded for all plan participants within 6 months after the end of the year.

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

RECOMMENDED HOSPITAL COST PRINCIPLES REVISIONS

Cost/Principle	Proposed Revision
Professional Services	Recent revisions to A-21 provide more specificity as to the types of legal related expenses which are unallowable. Defense and prosecution of criminal and civil proceedings, and claims, appeals and patent infringement related costs are specifically highlighted as unallowable.
Profits and Losses on Distribution	Circular A-21 (since its February 1976 issuance) requires that proceeds from assets acquired with Federal funds, in part or wholly, be distributed in accordance with OMB Circular A-110, Attachment N (Property Management Standards).
Retiree Health Insurance Benefits	While Circular A-21 does not specifically address the treatment of retiree health benefit costs, it does provide that pension costs (which is a type of postretirement benefit) will be reimbursed to the extent paid or funded. The OASC-3 should clarify HHS' existing policy relative to when accruals for retirees' health benefit costs qualify for reimbursement. In this respect, reimbursement for retirees' health care costs should be based on the amount actually paid or funded similar to the treatment of pension costs.
Severance Pay	Recent revisions to Circular A-21 specify that severance costs incurred in excess of the institution's normal severance pay policy applicable to all employees upon termination are unallowable (commonly known as a golden parachute payment).

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

RECOMMENDED HOSPITAL COST PRINCIPLES REVISIONS

Cost/Principle	Proposed Revision
Shifting of Unrecovered Costs	The Circular A-21 revisions specifically prohibit the shifting of any under-recovery of research sponsored by foreign governments, industry or other sponsors to federally sponsored research.
Simplified Method	Circular A-21 stipulates a qualifying level of direct costs relative to the application of the simplified method for computing an indirect cost rate for small institutions.
Travel	Revisions to Circular A-21 provide additional guidance over travel costs. Circular A-21: (1) specifies that in the absence of an acceptable institutional policy regarding travel costs, the rates and amounts established under subchapter 1 of chapter 57 of title 5, United States Code, or by the Administrator of General Services, shall apply to sponsored agreements; (2) requires institutions which charge first class air fare to justify and document on a case-by-case basis the applicable conditions necessitating the use of first class air travel (such as when coach or discount fares would require circuitous routing or travel during unreasonable hours); and (3) provides specific guidance relating to costs incurred for air travel by other than commercial carrier (i.e., air travel by institution-owned, leased, or chartered aircraft).

NIH FUNDING OF $3 MILLION OR MORE TO INDEPENDENT RESEARCH HOSPITALS FY 1991

Rank	Hospital	Total Research Funds
1	Brigham and Women's Hospital Boston, Massachusetts	$74,356,410
2	Massachusetts General Hospital Boston, Massachusetts	$76,022,314
3	Dana-Farber Cancer Institute Boston, Massachusetts	$42,776,536
4	Children's Hospital Boston, Massachusetts	$28,118,655
5	Roswell Park Memorial Institute Buffalo, New York	$20,231,265
6	New England Medical Center Hospitals Boston, Massachusetts	$17,306,400
7	Beth Israel Hospital Boston, Massachusetts	$15,817,159
8	St. Jude Children's Research Hospital Memphis, Tennessee	$13,728,790
9	Children's Hospital of Philadelphia Philadelphia, Pennsylvania	$12,985,956
10	Jewish Hospital of St. Louis St. Louis, Missouri	$12,262,210
11	National Jewish Center for Immunology Denver, Colorado	$11,308,802
12	Henry Ford Hospital Detroit, Michigan	$11,858,544
13	Memorial Hospital for Cancer New York, New York	$11,274,233
	FUNDING TO TOP 13	**$348,047,274**
	PERCENT OF TOTAL FUNDING	**66%**

NIH FUNDING OF $3 MILLION OR MORE TO INDEPENDENT RESEARCH HOSPITALS FY 1991

Rank	Hospital	Total Research Funds
14	New England Deaconess Hospital Boston, Massachusetts	$ 8,692,391
15	Rush-Presbyterian-St. Lukes Med. Center Chicago, Illinois	$ 7,548,911
16	University Hospital Boston, Massachusetts	$ 7,663,906
17	Children's Hospital Medical Center Cincinnati, Ohio	$ 7,153,934
18	Children's Hospital of Los Angeles Los Angeles, California	$ 7,351,408
19	Los Angeles County Harbor-UCLA Med. Ctr. Torrance, California	$ 6,690,287
20	Massachusetts Eye and Ear Infirmary Boston, Massachusetts	$ 6,457,534
21	Montefiore Medical Center (Bronx) New York, New York	$ 5,801,366
22	Cedars-Sinai Medical Center Los Angeles, California	$ 5,000,043
23	Kennedy Inst. for Handicapped Children Baltimore, Maryland	$ 3,940,472
24	Boston City Hospital Boston, Massachusetts	$ 3,872,635
25	Good Samaritan Hospital & Medical Center Portland, Oregon	$ 3,852,331
26	City of Hope National Medical Center Duarte, California	$ 3,591,833
27	Children's Hospital of Pittsburgh Pittsburgh, Pennsylvania	$ 3,572,338

NIH FUNDING OF $3 MILLION OR MORE TO INDEPENDENT RESEARCH HOSPITALS FY 1991

Rank	Hospital	Total Research Funds
28	Rhode Island Hospital Providence, Rhode Island	$ 3,368,015
29	North Shore University Hospital Manhasset, New York	$ 3,363,154
30	Hospital for Special Surgery New York, New York	$ 3,169,114
31	Presbyterian Hospital in New York, New York	$ 3,272,845
32	New York State Psychiatric Institute New York, New York	$ 3,120,481
	FUNDING TO TOP 32	**$445,530,272**
	PERCENT OF TOTAL FUNDING	**85%**
	TOTAL FUNDING TO 205 HOSPITALS	**$524,106,773**

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

CHANGING ENVIRONMENT AND ACCOUNTING PRACTICES

SIMPLIFIED METHOD

The Federal Government's longstanding policy relative to the establishment of an indirect cost rate has been to provide small institutions an alternative simplified method for determining allowable indirect costs. In this regard, OASC-3 states that hospitals may use the simplified procedures when the "total direct cost of all Government-sponsored research and development work...is minimal." (emphasis added) The OASC-3, however, does not provide specific guidelines relative to what constitutes a small institution.

In view of the growth in research funding to hospitals and the lack of definitive guidelines relative to the qualifying level for application of the simplified method, we believe that OASC-3 should define the qualifying ceiling for use of the simplified procedure for computing an indirect cost rate relative to the qualifying level of direct costs. For example, Circular A-21 stipulates that an institution may use the simplified method for small institutions when total direct cost of covered activities does not exceed $3 million (OMB is currently proposing to increase the threshold to $10 million). Using similar A-21 language for hospitals would clarify the rules of application of the simplified method and should make the simplified method available to more hospitals by stipulating the ceiling on the qualifying level of direct costs. If a qualifying level similar to that applied to educational institutions was adopted (e.g., applying a qualifying level of $3 million in direct research costs), about 84 percent of the hospitals receiving direct NIH research funding would qualify for use of the simplified method. In this respect, 173 of the 205 hospitals which received direct research funding from NIH in FY 1991 received total research funding (i.e., direct and indirect costs) of less than $3 million. The simplified method would then become available to these 173 research hospitals.

RETIREE HEALTH INSURANCE COSTS

The Financial Accounting Standards Board (FASB) issued FASB Statement Number 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," in December 1990. The FASB 106, effective for FYs beginning after December 15, 1992, results in an accounting change from the cash basis of accounting to the accrual basis of accounting

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for postretirement benefits such as retiree health care costs. The FASB 106 requires hospitals to accrue for retirees' health benefit costs during the years the employees render the necessary service, rather than paying for these costs when they are actually incurred. In this regard, hospitals are now required under generally accepted accounting principles to report in their financial statements the accrued liability for retiree health care costs for current and retired employees. The FASB 106 requires the reporting of net periodic service costs annually, as well as a transition obligation (i.e., a cumulative effect of an accounting change) which may be recognized either immediately or amortized over a period up to 20 years.

We have issued a management advisory report to the Health Care Financing Administration alerting them to this accounting change (from the pay-as-you-go basis to the accrual basis) and its potential impact under the Medicare program. Further, we have an assignment in our FY 1993 Work Plan to review the impact of FASB 106 on research activities at colleges and universities, hospitals and other nonprofit institutions. We believe that OASC-3 should be revised to stipulate that retiree health care costs will continue to be reimbursed to the extent funded or paid.

EQUIPMENT AND CAPITAL EXPENDITURES

Between FYs 1982 and 1989, Federal funding to research hospitals increased approximately 130 percent from $215 million to $494 million. We believe that this dramatic increase in funding brought about a corresponding significant increase in expenditures for equipment and capital expenditures to support the additional research effort. We were not, however, able to obtain readily available data on the amount of increased equipment and capital expenditure costs. In view of the increased level of research funding, we believe that OASC-3 needs to be strengthened relative to equipment and capital expenditures. For example, Circular A-21 defines equipment, capital expenditures and special and general purpose equipment. Further, it provides specific rules of allowability relative to equipment and other capital expenditures. We believe that OASC-3 should be modified to define equipment and other capital expenditures and provide the rules of allowability for equipment and capital expenditures consistent with OMB Circular A-21.

REVIEW OF COST PRINCIPLES FOR FEDERALLY SPONSORED RESEARCH AT HOSPITALS

CHANGING ENVIRONMENT AND ACCOUNTING PRACTICES

COLLECTION OF UNALLOWABLE COSTS AND ADJUSTMENT TO PREVIOUSLY NEGOTIATED RATES

In response to the excessive and extravagant indirect costs charged to research by colleges and universities, OMB revised Circular A-21 to provide that: (1) identified unallowable costs charged to the Government will be refunded with appropriate interest; and (2) negotiated indirect cost rates based on a proposal later found to include unallowable costs shall be adjusted regardless of the type of rate negotiated.

As discussed on page 6, our nationwide review found potential reimbursement of excessive and extravagant research costs at hospitals similar to those excessive costs identified at colleges and universities. In light of these potential extravagant and excessive costs, we believe that OASC-3 should contain collection and rate adjustment provisions similar to Circular A-21 to ensure that hospital indirect cost rate proposals do not contain unallowable costs and that the Government funds only its fair share of the cost of the research enterprise.

POTENTIAL SHIFTING OF UNRECOVERED COSTS OF FOREIGN AND INDUSTRY SPONSORS

During recent congressional hearings on research indirect cost, the issue of the potential subsidy of foreign or industry sponsored research was raised. An OIG review found that colleges and universities were entering into research agreements with foreign and industry sponsors which allowed indirect cost rates below the rates negotiated with the Federal Government. The methods used to calculate and negotiate Federal rates, however, ensured that the Federal Government did not pick up the tab for non-recovered overhead associated with the lower nonfederal rates.

As with colleges and universities, foreign and industry sponsored research agreements are being actively sought by hospitals. Our review of general and administrative costs at one hospital revealed that the hospital received nonfederal research funding during FY 1991 in excess of $41 million, including several significant agreements with foreign companies. The increase in foreign and industry sponsorship

REVIEW OF COST PRINCIPLES
FOR FEDERALLY SPONSORED RESEARCH
AT HOSPITALS

CHANGING ENVIRONMENT AND ACCOUNTING PRACTICES

of research brings about the potential that hospitals could allocate the unrecovered portion of indirect costs related to foreign and industry sponsors to Federal research. Therefore, we believe OASC-3, similar to Circular A-21, should specifically prohibit the shifting of any under-recovery of costs applicable to research sponsored by foreign governments, industry or other sponsors to federally sponsored research. In this regard, Circular A-21, section C.4.c. states that "Any costs allocable to activities sponsored by industry, foreign governments or other sponsors may not be shifted to federally sponsored agreements."

BASIS FOR THE DISTRIBUTION
OF INDIRECT COSTS

The OASC-3 provides that indirect costs shall be distributed to applicable sponsored agreements based on salaries and wages. Conversely, Circular A-21 states that indirect costs shall be distributed to applicable sponsored agreements on the basis of modified total direct costs (MTDC), consisting of salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants up to $25,000 each.

Our reviews at hospitals and discussions with Regional DCA staff indicate that many hospitals have in fact been using the MTDC for many years to distribute indirect costs. This approach is generally adopted to be consistent with colleges and universities and their administered hospitals. We believe that OASC-3 should be revised to reflect the change in practice relative to the distribution basis for indirect costs.

APPENDIX

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of the Secretary

Washington, D.C. 20201

APR -5 1993

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TO: Bryan B. Mitchell
Acting Inspector General

FROM: Elizabeth M. James
Acting Assistant Secretary for
Management and Budget

SUBJECT: Draft OIG Report -- HHS Research Cost Principles for Hospitals

We have reviewed the draft OIG report on the Department's cost principles for research grants and contracts awarded to hospitals.

We agree with the basic recommendation in the report that the research cost principles for hospitals should be updated and made more consistent with the cost principles for universities in Circular A-21. We intend to begin work on revising these principles when the revisions of the Government-wide cost principles for universities and State and local governments (Circulars A-21 and A-87 respectively) are finalized by OMB. As you know, we have focused our efforts in this area primarily on A-21 and A-87 since universities and State and local governments receive the vast preponderance of Federal grant and contract funds. In comparison to these organizations, the research funds awarded to hospitals are relatively small, less than 5% of the amount awarded to universities and less than ½ of 1% of the grants awarded to State and local governments.

In our view, the most significant cost issues discussed in the draft OIG report involve the allowability of interest costs associated with the construction and acquisition of facilities, and the treatment of health benefits provided to retired former employees. The treatment of these costs in the Department's principles for hospitals should be consistent with Government-wide policies in these areas for other types of organizations. Since Government-wide policies on these issues have not as yet been established by OMB, we think it would be preferable to defer modifying the hospital principles until the Government-wide rules are established. We are hopeful that these issues will be addressed in the near future as part of the revisions of A-21 and A-87. The handling of these and other matters in A-21 and A-87 will guide our efforts in revising the Department's principles for hospitals.

We appreciate the opportunity to review the draft OIG report.