DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date: SEP 13 1993

From: Bryan B. Mitchell Bryan Mitchell
Principal Deputy Inspector General

Subject: Report on Follow-up Audit of the Accumulated Surplus at Oregon's Internal Service Funds (A-10-93-00011)

To: Kenneth S. Apfel
Assistant Secretary for Management and Budget

The purpose of this memorandum is to alert you to the issuance on September 14, 1993 of our final report to the State of Oregon Executive Department. This report provides you with the results of our follow-up audit of the accumulated surplus at Oregon's Internal Service Funds (ISF). We found that the State of Oregon had not implemented the recommendations of two previous ISFs audits by the Office of Inspector General. Consequently, the State of Oregon's ISFs had an accumulated surplus at June 30, 1991 of $64.4 million, an increase of $14.5 million (29 percent) since the first audit. We have estimated the Federal share of the total accumulated surplus at June 30, 1991 to be approximately $12.1 million. The surplus represented the excess of revenues generated from services and products provided over expenses incurred by ISFs.

The ISFs are used to account for the financing of goods and services provided on a cost reimbursable basis by service centers to other agencies within the governmental entity. Federal cost principles require that such centers operate on a break-even basis by charging users for the allowable cost of goods and services provided. The Federal Government shares in ISF billings when the clients claim reimbursement for these billings as costs under Federal programs.

The Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments, establishes principles for determining the cost of grants and contracts with State and local governments. The Circular states that no provision for profit or other increment above cost is intended (Attachment A, section A.1). Additional requirements for reimbursement of the costs of Federal programs are included in the Oregon Statewide Cost Allocation Plan (SWCAP). The SWCAP is an agreement between Oregon and the Division of Cost Allocation, Department of Health and Human Services, which establishes methods for reimbursement of the State's direct and indirect costs. Section III of the SWCAP for Fiscal Year 1991 required that adjustments be made for variances between ISF billings and the allowable costs of providing goods and services.

We are recommending that the State of Oregon refund the $12.1 million Federal share of the accumulated surplus and adjust billing rates at least annually to eliminate any surplus or deficit.

The State of Oregon did not agree with our recommendations for a number of reasons. We have categorized and summarized the points discussed by the State and presented our response after the findings and recommendations.

If you have any questions, please call me or have your staff contact John A. Ferris, Assistant Inspector General for Administrations of Children, Family, and Aging Audits at (202) 619-1175.

Attachments

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

FOLLOW-UP AUDIT OF THE ACCUMULATED SURPLUS AT OREGON'S INTERNAL SERVICE FUNDS

A-10-93-00011

Dan Simmons, Director
Executive Department
State of Oregon
155 Cottage Street, NE
Salem, Oregon 97310

Dear Mr. Simmons:

This report provides you with the results of our follow-up audit of the accumulated surplus at Oregon's Internal Service Funds (ISF). The objective of our audit was to determine if the recommendations made in our prior two audits of Oregon's ISFs were implemented. We also determined the amount of surplus accumulated by ISFs and calculated the Federal Government's share of the surplus.

We found that Oregon had not implemented our previous recommendations. Our first audit disclosed an accumulated surplus at June 30, 1984 of $49.9 million adjusted for the same ISFs included in our current audit. We found that the surplus at June 30, 1991 was $64.4 million, an increase of $14.5 million since the prior audit, or 29 percent. The surplus represented the excess of revenues generated from services and products provided over expenses incurred by ISFs. The Federal share of the total accumulated surplus at June 30, 1991 was about $12.1 million.

The State of Oregon did not agree with our recommendations for a number of reasons. We have categorized and summarized the points discussed by the State and presented our response after the findings and recommendations. We continue to recommend that Oregon implement our three reported recommendations to comply with Federal cost principles and refund the Federal share of ISF accumulated surplus.

INTRODUCTION

We audited the accumulated surplus at the Oregon's ISFs to determine if the State implemented recommendations made in our two prior audits. We also determined the amount of surplus accumulated by ISFs and calculated the Federal Government's share of the surplus. Our audit covered the accumulation of surplus through the Fiscal Year (FY) ended June 30, 1991.

BACKGROUND

The ISFs are used to account for the financing of goods and services provided on a cost reimbursable basis by service centers to other agencies within the government. Federal cost principles require that such centers operate on a break-even basis by charging users for the allowable cost of goods and services provided. The ISFs provide various goods and services to about 136 State agencies (clients). The Federal Government shares in ISF billings when the clients claim reimbursement for these billings as costs under Federal programs.

The Office of Management and Budget (OMB) Circular A-87, Cost Principles for State and Local Governments, establishes principles for determining the cost of grants and contracts with State and local governments. The Circular states that no provision for profit or other increment above cost is intended (Attachment A, section A.1). Additional requirements for reimbursement of the costs of Federal programs are included in the Oregon Statewide Cost Allocation Plan (SWCAP). The SWCAP is an agreement between Oregon and the Division of Cost Allocation (DCA), Department of Health and Human Services (HHS), which establishes methods for reimbursement of the State's direct and indirect costs. Section III of the SWCAP for FY 1991 required that adjustments be made for variances between ISF billings and the allowable costs of providing goods and services.

On February 28, 1986, we issued an audit report which addressed the problem of accumulated surplus in Oregon ISFs as of June 30, 1984. The purpose of our audit was to determine if ISFs were charging federally-funded programs at rates which exceeded the cost of providing goods and services. In our report (Audit Control Number 60455-10), we recommended that Oregon: (i) eliminate the total accumulated surplus, (ii) review billing rates to ensure that charges to Federal programs are in accordance with OMB Circular A-87 and the SWCAP, and (iii) adjust billing rates at least annually to eliminate any surplus or deficit. The State of Oregon negotiated a corrective action plan with DCA to eliminate accumulated surplus through rate reductions over a 4-year period ended June 30, 1990, which was later extended to June 30, 1991.

On September 30, 1991, we issued a follow-up audit report (CIN: A-09-91-00090). We found that, as of June 30, 1990, the surplus had increased to $54.6 million, or $4.7 million over the June 30, 1984 balance of $49.9 million.

We again recommended that the State of Oregon eliminate accumulated surplus and establish written procedures to monitor and evaluate the ISF balances.

SCOPE

We performed our audit in accordance with generally accepted government auditing standards. The objectives of our audit were to determine if the State implemented the recommendations in our prior reports, the amount of surplus accumulated by ISFs as of June 30, 1991, and the share paid by the Federal Government.

We performed our audit field work during the period March through May 1993 at State offices in Salem, Oregon, and our office in Sacramento, California.

We relied on the work performed by Oregon's Division of Audits during the single audit for the State of Oregon for FY 1991 for the validity of the accumulated surplus and total billings.

Separate audits were performed on the surplus in the Self-Insurance Fund and the Oregon State System of Higher Education. The findings of those audits were negotiated and settled between DCA and the State of Oregon. We, therefore, excluded the surplus for those ISFs from our current audit.

We estimated the Federal Government's share of accumulated surplus at ISFs for 48 of the 136 clients. Except for three other agencies which received insignificant amounts of Federal funds, these 48 clients include all of the State agencies in Oregon which received Federal funds. We calculated the Federal participation rates for 29 of the 48 clients by dividing Federal operating expenditures by total operating expenditures. For 19 clients, we divided adjusted Federal operating expenditures by total operating expenditures. The actual expenditures and revenues for FYs 1990 and 1991 were reported in the biennium Governor's Budget for FYs 1994 and 1995.

To compute increases in the amounts reported for FYs 1990 and 1991, we adjusted the surplus reported in our previous audit for FY 1984. We adjusted the $73.8 million surplus reported in our initial audit to a balance comparable with surpluses at June 30, 1990 and 1991. This involved deleting the surplus in the Oregon State System of Higher Education which was separately settled with DCA and adding surpluses for two ISFs which were not included in the initial audit.

FINDINGS AND RECOMMENDATIONS

We found that the recommendations from our prior audits were not implemented. The ISFs continued to bill their clients for more than the cost of providing goods and services. The accumulated surplus at June 30, 1991 was about $64.4 million. We estimate that $12.1 million of the surplus related to Federal reimbursement of ISF billings claimed by clients. We are recommending that the State of Oregon refund the $12.1 million Federal share of the accumulated surplus and adjust billing rates at least annually to eliminate any surplus or deficit.

Under a prior negotiated agreement with DCA, the State should have eliminated the accumulated surplus over a 4-year period ended June 30, 1990. The DCA extended the time frame to June 30, 1991 to allow the State an additional year to implement the agreement.

In response to our audit, the State issued a policy regarding the rates of four of the large ISFs within the Department of General Services. Beginning July 1, 1989, the policy required that the first 10 percent of the charges from these four ISFs must be paid from nonfederal funds. However, the Division of Audits reported in the single audit report for FY 1991 that some departments disregarded the policy and continued to charge Federal programs for the full amount of the invoices from these four ISFs. Also, the effects of this policy were not recorded in the accounting records of the four ISFs. In addition, DCA did not review or approve this method and was not able to obtain any documentation from the State to support the amount of reduction. The DCA also noted that the procedure would not be feasible because using agencies cannot consistently identify the Federal portion of ISF billings. We found that the State's accumulated surplus increased by $14.5 million from June 30, 1984 to June 30, 1991. We recommend that the State of Oregon refund the entire $12.1 million Federal share of the accumulated surplus. This adjustment could be reduced if the departments that implemented this policy could support the 10 percent that was charged to nonfederal funds.

We noted that Oregon issued an Administrative Rule, effective March 27, 1992, which established policies regarding the setting of rates and monitoring ISF operations. Some of the basic rules established under this policy regarding the setting of rates for ISFs are summarized as follows:

- The rates must be established using costs based on generally accepted accounting principles.

- The rates must consider fixed costs, variable costs, break-even point, projected unit and dollar business volumes, where applicable.

- Interim statements will be prepared and submitted to the Executive Department. The minimum statements required will be comparative balance sheet and operating statement by program. Forecast operating statements will be developed and a comparison of actual to planned results of operations will be prepared. Based on this comparison, the Executive Department may require rates to be adjusted.

- Unallowable costs as defined in OMB Circulars A-87 and A-21 will not be included in the rates.

- All rates for ISFs that will be charged to Federal programs must be approved by DCA.

This policy also allows the ISFs to retain 60 days of working capital. This Administrative Rule was issued in March 1992, but had not been put into effect as of the close of our field work in May 1993. We were informed that the State decided not to implement this Administrative Rule. Also, we did not allow a 60-day working capital in our computation of the excess surplus because the generation of working capital from surplus is not allowable under OMB Circular A-87. Other than the provisions for the 60-day working capital, we recommend that Oregon implement the provisions of this Administrative Rule for FY 1994.

RECOMMENDATIONS

We recommend that the State:

1. Refund $12.1 million to the Federal Government for its share of the accumulated surplus as of June 30, 1991.

2. Adjust ISF rates annually based on allowable costs to eliminate any surplus or deficit.

3. Except for the provision for the 60-day working capital, implement its Administrative Rule, dated March 27, 1992.

OREGON'S RESPONSE

In a letter dated July 8, 1993, the State of Oregon stated that it does not agree that a refund should be paid to the Federal Government from Oregon's ISFs. The letter states that we included ISFs which do not bill programs with Federal funds and did not consider a 60-day working capital allowance agreed to between DCA and the State. As a result, the State believes that the reported retained earnings balance should have been $33.3 million instead of $64.4 million as shown in our audit report. If the 60-day working capital is considered, the balance would be further lowered and several of the ISFs would no longer have a surplus.

In addition, the letter states that we did not accurately identify Federal funds in computing the Federal participation rates because we used the Governor's recommended budget and not necessarily the budget adopted by the legislature. Also, the budget does not consistently separate the program cost from administrative cost and would not reflect ISF billings that were not charged to Federal programs.

Also, the State's use of retained earnings is consistent with good business practices. The funds are maintained and invested by the ISFs that earned them, resulting in decreased billing charges for both State and Federal Governments.

The letter also states that the audit ignores about $6 million of State funds used to pay a portion of the ISF billings allocable to Federal programs under a procedure that charges 10 percent of the billings to nonfederal funds. Also, since this 10 percent was charged to nonfederal funds, DCA does not have the authority to review and approve that portion of the rates charged to State funds. Finally, the State expressed an intent to continue using ISF billings to generate funds for expansion and replacement of capital assets.

Office of Inspector General's Response

The State's position is that only $33.3 million of the $64.4 million balance was subject to Federal participation, a reduction of about $31.1 million. About $4.6 million of this difference is due to mathematical errors in the State's computation. The major portion of the remaining difference of $26.5 million is as follows:

- $18.5 million relates to ISFs which the State believes did not receive Federal funding. The

State was unable to provide supporting documentation. However, we found that the clients billed by these ISFs received Federal funds. For example, the billing summary provided to us by the State Owned Buildings ISF shows that this ISF charged various other departments. Based on information we obtained from the Governor's budget which contained actual expenditures, we identified specific departments that received Federal reimbursements. We used this information to calculate the Federal share of accumulated surplus for the State Owned Buildings ISF allocated to each client. Thus, if the clients did not receive Federal funds we did not include these amounts in our calculation of the Federal share.

- $5.7 million is the amount the State identified in the retained earnings as the amount not claimed for Federal reimbursement. We did not deduct this amount for the reasons discussed in the last paragraph of our response.

- $2.2 million is the amount the Department of General Services claims to be additional contributed capital. This amount was not reviewed by the Division of Audits in its audit of the financial statements. The Department of General Services did not provide any additional documentation to support this claim, nor was the amount recorded in the accounting records.

We did not reduce retained earnings for a 60-day working capital in our calculation. The working capital agreement with DCA was based on a proposed revision to OMB Circular A-87 which has not been implemented. Thus, an allowance was not made for the working capital provision.

We based our calculation of the Federal participation rates for client agencies on Federal reimbursements reported as actual expenditures in the Governor's budget. Since we did not use budgeted amounts, any differences in the budget amounts in the Governor's budget and the budget adopted by the legislature did not affect our computation. Also, as described above, if the client did not receive Federal funds we did not calculate a Federal participation rate and, therefore, did not compute a Federal share.

The issue under review is not whether the State applied good business practices; rather, it is whether the

Federal Government should pay billings above the cost of services provided to generate reserves for future capital purchases by ISFs. Such a practice is inconsistent with current cost principles under OMB Circular A-87, which provides for the reimbursement of allowable costs incurred, using generally accepted accounting and Federal cost principles.

As described in our audit report, the State could not provide documentation to show that the $5.7 million was charged only to nonfederal funds by the departments which administer the Federal programs. This procedure required that, for billings of four ISFs, only 90 percent of the amount on the billings were subject to Federal reimbursement. However, the departments paid the ISF the entire amount billed, using State funds to pay the 10 percent not claimed for Federal reimbursement. According to Oregon officials, the $5.7 million shown as a memo in the retained earnings account was based on the assumption that all departments were claiming only 90 percent of the amount on the billings for Federal reimbursement. As previously stated, the Division of Audit in the single audit reported that some of the departments continued to charge Federal programs for the full amount of the ISF billings. We, therefore, did not adjust the retained earnings for the $5.7 million claimed by the State to have been charged to nonfederal funds.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this report. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

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In accordance with the principles of the Freedom of Information Act (Public Law 90-23), Office of Inspector General, Office of Audit Services reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5).

Sincerely yours,

Herbert Witt
Regional Inspector General
for Audit Services

Direct Reply to HHS Action Official:

David S. Low, Director
Division of Cost Allocation
50 United Nations Plaza, Room 304
San Francisco, California 94102

APPENDIX

Oregon
EXECUTIVE
DEPARTMENT
ACCOUNTING
DIVISION

July 8, 1993

HERBERT WITT
REGIONAL INSPECTOR GENERAL FOR AUDIT SERVICES
REGION IX, OFFICE OF AUDIT
50 UNITED NATIONS PLAZA
SAN FRANCISCO CA 94102

Dear Mr. Witt:

Re: Internal Service Fund Audit A-10-93-00011

Internal Service Funds that do not have federal participation are included in the total of the ISF balances that the Office of Inspector General is questioning. The ISFs with federal participation or that are not excluded from this audit, are as follows:

Executive Department		$ 7,956,000
Department of General Services	141,792,000	
Less:		
Insurance Fund	96,270,666	
State Surplus Property	233,338	
State Owned Buildings	21,843,042	
Capital Projects	-2,898,274	
Non-Federal Equity	5,744,403	
Adjustment - Cont. Cap.	2,221,000	
Adjustment - Owned Buildings	-4,817,000	
Total General Services		18,377,825
Justice Department		1,866,000
Corrections Industries		-1,091,000
Department of Human Resources		1,193,000
Department of Transportation		2,002,000
Health Division		65,000

155 Cottage Street NE
Salem, OR 97310-0310

Department of Energy		-259,000
Forestry		-3,295,000
State Treasury	4,142,000	
Less:		
Debt Management	156,539	
Investment Services	4,223,420	
Total State Treasury		-237,821
Secretary of State		-156,000
Agriculture		-18,000
Total	$	33,288,004

This balance is about one-half of the amount per the audit report. When the 60 day working capital amount agreed to between the Division of Cost Allocation (DCA) and the State is taken into account, several of the ISFs no longer have balances in excess as defined by the DCA. Additionally, we are not comfortable that the audit performed by the Office of Inspector General accurately identifies federal funds that are used for administrative purposes. The document used to develop the federal participatory percentages is the Governor's recommended budget. This budget is not the budget that is necessarily adopted by the legislature. Additionally, it does not consistently separate the program costs from the administrative costs. For example, the Department of Forestry has had a policy of not charging the ISF operations to federal funds.

Aside from the issue of percentage of participation, the retained earnings balances are within ISFs that require significant investment in capital assets. The remaining funds needed for day to day operations are retained within the funds and accrue interest to the favor of the ISF that holds the idle cash. The State invests at least $8.00 for every $2.00 that the federal government invests in the operations of the internal service funds. The State of Oregon is not going to make poor business decisions with the State's funds just to take advantage of the federal funding sources. In fact, the State operates the ISFs so that both the State and federal government benefit from decreased costs. For example, over the past five years the state motor pool has reduced costs per mile of operation from about 26.5 cents per mile to about 19 cents per mile. The State aggressively manages any idle cash that the ISF retains, and manages the assets to the best advantage of the service provided. To arbitrarily remove non-liquid assets from the ISFs damages the ability of the ISFs to operate, and discourages good business practices eventually resulting in increased costs to both governments. The federal government has not been, nor will be, harmed in that no assets have been, or will be, transferred from the ISF that charges the rate. The State of Oregon disagrees that a refund is due the federal government for any of the current retained earnings balances of the ISFs.

Reduction of Billings

The audit report appears to attempt to disallow as a reduction of federally participated in retained earnings the portion of the ISF billings that the State of Oregon has designated as non-allowable federal charges. The report bases the conclusion on:

1. "...The Division of Audits reported in the Single Audit Report for FY 1991 that some (emphasis added) departments continued to charge Federal programs for the full amount of the invoices from these four ISFs".

2. "...DCA did not review or approve..." and "...was not able to obtain any documentation from the State to support the amount of reduction. The DCA also noted that the procedure would not be feasible because using agencies cannot consistently identify the Federal portion of ISF billings".

The report does not note that each of the agencies identified as charging the non-federal portion to federal programs subsequently refinanced the charges. The net result being that the charges were financed with State only funding in accordance with State policy. To attempt to disregard almost $6,000,000 in non-federal equity due to anecdotal evidence is not reasonable.

Second, the DCA has the authority to review and approve the rates that will be charged or not charged to federal programs. The DCA does not have the authority to determine the types or amount of charges the State can and cannot charge to it's own funding sources. The Oregon State legislature has determined that the ISFs operations will be supported 100% through rates. To presume that the DCA has the authority to review and approve that portion of the rates charged to State only funding presumes that the DCA can overrule the Oregon State Legislature. Additionally, it is entirely feasible for the State agency to identify which portion of the billing cannot be charged to federal programs. The federal portion is consistently 90%, (80% of motor pool), of the ISF billing.

We will continue to use this method to accumulate state resources to finance the necessary expansion of services or replacement of equipment whose cost is in excess of the depreciation expense that the federal government has agreed to. These are legitimate needs of ISFs that the federal government will not equitably participate in.

60 Day Working Capital

The 60 day working capital allowance contained within the rule is a result of negotiations with DCA, and the recognition that the eventual issuance of the revised OMB Circular A-87 will allow this accumulation. We feel that this is a practical business decision that makes sense. We agree that this issue is between the State of Oregon and the DCA.

Our objective in managing government is the same as the federal government. We should change from a time consuming discussion of whether either government has gained an advantage to a percentage of cost basis that is being considered by the National Performance Review. We strongly support this effort.

Sincerely,

Dan Simmons, Director
Oregon Department of Administration Services

DS:vs

cc: John J. Radford
Donald R. Charlton

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