DEPARTMENTAL GRANT APPEALS BOARD

Department of Health and Human Services

SUBJECT: California Department of Social Services
Docket No. 86-124
Audit Control No. 10273-09
Decision No. 855

DATE: March 31, 1987

DECISION

The California Department of Social Services (State or California) appealed a determination by the Administrator of the Family Support Administration of the U.S. Department of Health and Human Services (HHS or the Agency) disallowing $4,290,534 charged to the Aid to Families with Dependent Children (AFDC) program. Based on an audit, the Agency determined that the State had charged AFDC for the Federal share of costs which were allocable to the Food Stamp program of the U.S. Department of Agriculture (USDA).

Based on our review of the record, we uphold the disallowance.

Background

The dispute here concerns the division between USDA and the Agency of certification costs of county welfare departments for the period October 1, 1971 to June 30, 1972.

For the period in question, California had developed a "cost allocation plan" (CAP) which was approved by the Agency's predecessor. The CAP was a collection of detailed instructions to county agencies on how to distribute and claim costs for eight programs which received funding from various State, Federal, and county sources. 1/

1/ The CAP in this case is not a single easily identifiable document, but consists of two sets of directions to counties prepared by the State. See attachments to Agency's letter of January 15, 1987. The State's representative indicated that the precise documents in the record here were not the actual ones applicable during the time period in question, but also said that they were the same for all relevant purposes. Tape of Conference of February 4, 1987. While the documents do not provide easily accessible background, there basically is no dispute between the parties concerning what the CAP actually contained. The record does not contain a document evidencing Federal approval of the CAP, but the Agency acknowledged that HHS had, indeed, approved the State's CAP. Id.

The dispute focuses on two of the Federal programs to which costs were allocated: USDA's Food Stamp program, and the Agency's AFDC program. Under the CAP, a category of costs denominated "Food Stamp" costs actually included administrative costs of determining eligibility for both the Food Stamp program and AFDC. To divide (or "allocate") the costs between the two programs, California used a simple formula. The CAP provided for distribution of these costs based on a State study of the cases handled by eligibility workers. The allocation methodology used a ratio of "assistance" to "non-assistance" cases processed by the workers ("assistance" cases being ones in which individuals received AFDC).

The Agency routinely paid claims submitted based on the allocation methodology using the case ratio described above. USDA, however, refused. For reasons which are not fully developed in the record here (relating to USDA's interpretation of its own regulations and laws), USDA opposed the use of case-load data as an allocation basis. California negotiated with USDA and in January, 1973, USDA and California agreed on a retroactive allocation of costs based on a time study performed in August, 1972, which specifically identified the time spent by eligibility workers certifying "non-assistance" households. The State then submitted a revised claim to USDA. However, the State did not submit a revised claim to the Agency.

The reason we have a dispute to resolve is that USDA's insistence on a different and, arguably, more precise allocation methodology produced a substantially larger allocation to USDA's Food Stamp program. The total pool of costs to be distributed did not change, but the allocations changed as follows (using an example of direct costs for Fresno, California): under the original formula the Agency was allocated 79.49% of the costs (of which it could pay 50% under AFDC) and USDA was allocated 20.51% (of which USDA could pay 62.5%); but under the later formula, the Agency was allocated only 28.19% of costs, while USDA was allocated 71.81%. Agency's Brief, pp. 11-12.

In 1977, prompted by a newspaper investigation, Federal auditors performed a review which concluded that the State had claimed some of the same costs from both USDA and the Agency, and had charged the Agency for some costs no longer allocable to it. This disallowance eventually followed.

Timeliness and Related Issues.

California argued that the disallowance here should be overturned because of the effect of delays which occurred.

As a threshold matter, the State has not on appeal pointed to (nor are we aware of) any statute of limitations applicable here. Indeed, section 403(b)(2) of the Social Security Act (42 U.S.C. 603(b)(2)) authorizes the Agency to adjust current State grants to account for erroneous payments in "any prior quarter." Furthermore, the State does not dispute that the defense of laches is inapplicable here. Agency's Brief, pp. 5-6; State's Reply Brief, pp. 8-10; Maryland Department of Human Resources, Decision No. 519, February 29, 1984.

The essential thrust of the State's argument concerns requirements related to retention of records. HHS regulations provide that a grantee's financial and programmatic records generally must be retained for three years. 45 CFR Part 74, Subpart D (1985). This policy has been contained in HHS regulations since at least 1973. California argued that it was prejudiced by the passage of time and the lack of records properly destroyed under the records retention requirement.

We conclude that the record does not support California's argument.

It is well established in Board precedent that grantees have a fundamental obligation to account for federal funding which is not defeated per se by passage of the record retention period. See, e.g., Missouri Department of Social Services, Decision No. 395, February 28, 1983. It is also clear, however, that this Board will take into account the prejudice a grantee can prove which is attributable to the loss of records resulting from their innocent loss or destruction after expiration of the record retention period. See, e.g., California Department of Health Services, Decision No. 666, June 28, 1985. Thus, the question is whether the record here contains any substantial evidence that California was prejudiced by the delays involved.

We find no such prejudice. To begin with, the total claim amount (the backdrop against which this dispute arises) is not in dispute. Stated another way, the total sum to which the differing USDA and HHS allocation percentages apply is known and undisputed. Neither is there any dispute as to the amount of the portions claimed from USDA and HHS, nor the allocation percentages which produced these sums. All of these figures are fixed and undisputed in the record here. Furthermore, the Agency is not disputing any of the underlying costs claimed. Thus, the fact that underlying, or source, documentation was properly destroyed does not affect the State's case, since that documentation is not relevant here. It would be relevant if the Agency was challenging the claim amounts or allocation percentages, but it is not. The issues here concern only the

proportionate distributions and amounts fixed long ago. So, too, the fact that the passage of time may have eliminated from presence or memory testimony which might have explained what went on at the time (as the State speculated) appears similarly inconsequential. There simply is no dispute as to the essential facts of what the State claimed, and when and why it was claimed.

The State's only specific attempt to demonstrate prejudice related to the fact that Federal auditors initially could not find--at the State or local level--information about the amounts of the claims. State's Brief, pp. 3-4. It is not disputed, however, that the auditors eventually got the required information and the State never disputed the claim amounts. As the Agency stated:

> The auditors were able to compute the amount of the overpayments based on the State's regular fiscal record system and to verify these findings by referring to records provided by USDA . . . The State has never seriously questioned the sufficiency of the available records [citations to record omitted]. Agency's Brief, p. 8.

California also argued that the passage of time should preclude the disallowance because auditors had previously considered, and rejected, questioning the use of caseload methodology. A 1975 Federal audit of Los Angeles County had preliminarily raised the matter as an issue, but it was not included in the final audit report. State's Brief, p. 5; Reply Brief, pp. 10-11. The Agency argued that this deletion was based on the State's own position that the disputed methodology was consistent with the CAP, and that the State had not at that time disclosed that it had used the later-developed time study methodology to claim from USDA. Agency's Brief, p. 9. The State's sole response to this was essentially that the Agency probably knew of the "problem caused by USDA and its solution." Reply Brief, p. 11; see also, State's Brief, pp. 5-6. However, even if one assumes full knowledge of all these events on the part of Agency personnel, that still does not prove that those personnel ever did, or ever could have, approved charging the Agency for unallocable costs (and the State makes no such allegations). In any event, we know of no reason why Federal auditors cannot later expand a review or even change their minds about the scope of a review.

It is hard to disagree with California's assertion that there have been unusual delays in this case. However, the State simply has not shown any prejudice arising as a result of the delays. Perhaps recognizing that it had a difficult task in doing so, California resorted to arguing in its reply brief that ". . . the State need not prove 'prejudice' in order to stop the late

audit. In such situations, 'prejudice' arises as a matter of law." Reply Brief, p. 10. We reject such an approach as without foundation in law or fairness. Where prejudice can be shown from the delay in a post-retention period audit, it should be taken into account; but where, as here, no prejudice is shown, the delay is irrelevant to the substantive issues in the case.

The Disallowance of "Direct" Costs.

We deal first with issues related to "direct" costs, as the parties addressed arguments separately to "indirect" costs (although, as explained below, we are not dealing with a typical direct/indirect cost distinction).

The heart of the State's argument goes to its obligation to refund to the Agency. Essentially, the State's arguments are that it had a valid agreement--its cost allocation plan, or CAP--with the Agency specifying an allocation scheme; that it lived up to that agreement; and that it allocated funds differently to USDA because of a dispute with USDA which was settled by using a methodology which did not affect the earlier allocation to the Agency.

It is not disputed that Office of Management and Budget (OMB) Circular A-87, "Principles for Determining Costs Applicable to Grants and Contracts with State and Local Governments," provides the basic Federal regulatory context here. 2/

A basic objective of the Circular is to provide that "federally assisted programs bear their fair share of costs." Para. A.1. Another objective states that there is "no provision for profit." Id.

The Circular defines a cost allocation plan as "documentation identifying, accumulating, and distributing allowable costs under grants and contracts together with the allocation methods used." Para. B.2. The objective of a CAP is to "support the distribution of any joint costs related to the grant program." Para. J.1. The CAP is the grantee's, although submitted to HHS for approval, and it is clear that the grantee bears the basic responsibility for developing and implementing the CAP, and

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2/ The Circular was originally promulgated in 1968, and was amended in June, 1970, to add further material on preparation of cost allocation plans. Although the Circular has gone through name changes and modifications since then, we are aware of no changes significant to this dispute; in any event, we cite to the 1970 version apparently in effect when the cost allocation plan involved here was developed.

seeing that program funds are properly expended. See, e.g., Paras. A.2., J.2., J.3., J.4.a. Where there are joint costs spanning agency lines, the Circular provides for a "cognizant," or lead, Federal agency (which in this case was HHS). Para. J.4.b. However, the Circular says little about the role of a "cognizant" agency and, concerning interagency disputes, says only that "to the extent that problems are encountered among the Federal agencies . . . the [OMB] will lend assistance as required." Para. J.6. The record does not indicate that OMB was ever involved here. 3/

Nothing in Circular A-87 establishes the CAP as the rigid, bilateral "contract" which California would have us believe. A CAP is the grantee's plan to support its distribution of joint costs among programs. It is undisputed that HHS had responsibility for approval of the CAP, but nothing in the Circular suggests that this gave rise to an intractable obligation to avoid seeking recovery of what would later turn out to be a windfall to the State. While HHS had approval authority, and the right to audit costs, it goes too far to say that approval of the plan locked HHS into a certain reimbursement structure notwithstanding later occurrences which clearly showed the State changed its CAP methodology to allocate less costs to HHS--particularly where the State never submitted any revised methodology to HHS for approval and, arguably, even violated the CAP by using an incompatible methodology to bill USDA. It would be a perversion of the cost planning concept, and clearly unsupported by Circular A-87, to hold that HHS had an immutable obligation to observe California's first allocation approach and ignore its second. A CAP is a plan and a means to an end, not an end in itself. Circular A-87 established a way to determine the allocability of costs; it in no way established any express or implied right to payment for unallocable costs. Circular A-87 may imply a general right to reimbursement at the rates specified in a Federally-approved CAP, but we conclude that it does not automatically lock HHS into a certain rate of reimbursement notwithstanding any later occurrences which clearly modify the substance and reasonableness of the calculation. And, as already indicated, if the CAP was viewed as definitively as the State would like, then it would follow that the State either violated it or effectively modified it substantially without HHS approval.

Even if we viewed the CAP as rigidly contractual in nature, we still could not justify, under A-87 or otherwise, the payment of

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3/ Indeed, it is not clear whether HHS or OMB could compel a Federal department to accept a cost treatment which the latter department determined was incompatible with its governing law.

costs not allocated to HHS. A fundamental principle specified in federal statutory law for well over a century is that appropriated funds may only be expended for the purposes for which the funds were appropriated, unless Congress provides otherwise. 31 U.S.C. 1301. Thus, HHS cannot use its appropriated funds to pay USDA's Food Stamp expenses, or vice versa.

Circular A-87 deals both with "allowability" and "allocability." To be "allowable," a cost must be necessary and reasonable for the particular program involved, allocable to the program, conform to law and other governing limitations, and:

> e. Be accorded consistent treatment through application of generally accepted accounting principles appropriate to the circumstances.
>
> f. Not be allocable to or included as a cost of any other Federally financed program in either the current or a prior period.
>
> g. Be net of all applicable credits.
>
> Para. C.1.

A cost is "allocable" to a cost objective (e.g., a particular grant program or a cost center within that program) to the extent that the cost objective is benefitted. Para. C.2.a. If there are joint costs-- i.e., those which benefit more than one program--they are dealt with in a CAP. Paras. C.2.c., J. An important rule of allocation is as follows:

> b. Any cost allocable to a particular grant or cost objective under the principles provided for in this circular may not be shifted to other Federal grant programs to overcome fund deficiencies, avoid restrictions imposed by law or grant agreements, or for other reasons.
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> Para. C.2.b.

The principles above are applicable to direct costs as well as indirect costs. 4/ See, e.g., Paras. D, E, F, and G.

4/ California alleged that (a) A-87 was concerned with allocability, not allowability; and (b) that A-87 dealt with indirect costs, not direct costs. Both allegations are incorrect on the face of the Circular.

These provisions are explicit about the following policies directly applicable here. A direct cost item (e.g., here, an eligibility worker's pay) cannot be paid for with Federal AFDC funds unless the item is an allowable cost under AFDC. Among other elements of allowability, the cost must be allocable to AFDC, treated consistently, and not allocable to any other program (such as USDA's Food Stamp program). There is no dispute here that, under California's revised methodology, some of the same costs previously allocated to (and paid by) HHS were specifically allocated to USDA. The important point under Circular A-87 is that once the costs were allocated to USDA, they were, ipso facto, no longer allocable to (and therefore no longer allowable under) the AFDC program. California cannot have its cake and eat it too. California effectively recategorized the costs as unallowable under AFDC. This meant the result was irrespective of percentages and amounts paid out previously; to the extent California allocated cost items to USDA, those items are unallowable under AFDC. It is the allocation of the costs by California which is the decisive factor. California attempted to diminish the impact of the reallocation by describing it essentially as tantamount to an arbitrary or compromise solution to a dispute with USDA; but we conclude that we are bound to observe the obvious fact that California itself revised the allocation of costs between the two programs based on its own time study, and that the clear and rather simple directions in Circular A-87 compel us to consider that allocation as the one which binds the State. 5/

5/ California also cited a USDA guideline (which said that USDA could supplement another Federal agency's payment of a portion of a certification worker's salary), interpreting the guideline to mean that "the only limitation" was that "the total reimbursement could not exceed 100 percent of the expenditure." State's Brief, p. 16. However, the document specifically addressed otherwise "eligible" costs, and on its face said nothing about allocability. The only reasonable reading of the document, given Circular A-87, is that "eligible" costs payable by USDA include only those costs allocable to a USDA program. In any event, an alternative interpretation would be a matter for USDA to consider, and would not affect what we conclude is the clear applicability of the Circular A-87 requirements to California as a grantee under the AFDC program. Furthermore, the State did not rebut the Agency's argument that AFDC and Food Stamp funding authorities are "mutually exclusive," since under applicable law and Agency rules "neither agency was permitted to bear Food Stamp certification costs allocable to the other." Agency's Brief, p. 17; New Mexico Department of Human Services, Board Decision No. 211, August 31, 1981.

The Disallowance of "Indirect" Costs.

A distinction was made concerning indirect costs because the element of so-called "double recovery" of costs was not present; in fact, California insisted that it would lose money because USDA will not pay indirect costs. Stated another way, the reallocation of higher costs to USDA apparently means that costs of which HHS paid 50% under the original allocation methodology, when later allocated to USDA, are not paid at all. 6/

The heart of the State's argument was as follows:

> Assume that the Administrator [of FSA] is correct regarding the direct costs and that the settlement with USDA required the State to submit a retroactive revised Cost Allocation Plan with respect to the allocation of direct costs. That revised plan might logically have also revised the method of computing indirect costs. The Administrator's decision (as well as the Audit Report) proceeds on the assumption that the "revised" Cost Allocation Plan would not "revise" the method of allocating indirect costs. That assumption is nothing more than what its name implies - an assumption, mere speculation.
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> State's Brief, p. 13 (emphasis in original).

We cannot agree with the State, for the following reasons.

First of all, as already discussed, we are dealing with the State's plan for allocating costs based on the State's own time study, and under Circular A-87, the cost allocation determination is directly dispositive of what can be treated as allowable under the respective programs. It is important to keep this in mind as a context for the discussion below.

Some understanding of typical direct/indirect cost allocation is useful as background here. Direct costs are those which "can be identified specifically with a particular cost objective," such as the salary of a person working solely and directly for

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6/ For purposes of our decision, we assume that USDA indeed will not or cannot pay the indirect costs in question. Whether or not that assumption is correct is beyond the scope of our review. California indicated that it might seek some relief from USDA depending on the nature of our decision.

a given program. Circular A-87, Para. E.1.; see also, Para. E.2.a. Indirect costs are those which are incurred for a joint purpose, and are "not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved." Para. F.1. Circular A-87 implies a preference for direct costing and, indeed, in theory, all costs might be handled on a direct cost basis if the accounting system was sophisticated enough. But this is frequently impractical, and the Circular allows indirect costs (for example, clerical pool costs) to be distributed based on some lesser but reasonably dependable surrogate basis, such as a percentage of time. Para. F.

There is a distinction between the typical direct/indirect rate structure, described above, and the situation involving California. In reality, California's direct costs were themselves treated just as if they were indirect costs: that is, California applied a surrogate measure--a percentage based on a time study--to pools of both direct costs and indirect costs. See, e.g., the CAP (attached to the Agency's letter of January 15, 1987), "program distribution" (3rd unnumbered page of Attachment 2); Tape of Conference of February 4, 1987. The indirect cost pools were ones in which California collected certain overhead-type expenses like "clerical support" and "EDP" (electronic data processing). Id., and Audit Report (Agency Exhibit B), p. 8. The State applied allocation percentages "derived by comparing a specific indirect cost pool to total direct charges." Id. Under the CAP, indirect costs were treated as a "fixed percentage of direct costs." Agency's Final Decision, p. 6. The Federal auditors did no more than arithmetically adjust the computation to reflect the State's use of its revised methodology. Tape of Conference of December 16, 1986. 7/ There is no difference in treatment and methodology for the indirect costs in relation to the direct costs, at least insofar as it would relate to the case-count versus time study allocation basis. As counsel for California stated, the indirect costs and direct costs "are lock step, in the sense that the way we did it, under the approved plan, you lumped them all together and allocated them by the same percentage." Tape of Conference of February 4, 1987.

7/ California never challenged the Federal calculation of the allocation and disallowance amounts per se; the State's dispute fundamentally was with the bases of the disallowance, based on which the State also rejected the amounts. See Tape of Conference of December 16, 1986; State's Brief, pp. 14-18; Agency's Brief, pp. 15-16.

The State's point--that there might have been other ways to measure indirect (or for that matter, direct) costs and that the State might have used a different measurement if it had thought it necessary to revise its CAP--is a truism. But California has not shown, or even alleged, that the direct/indirect cost relationship it used with its case count methodology became inaccurate or skewed when used with its time study methodology. In final analysis, the State is bound by the arithmetic allocations it selected.

Against the foregoing background, one can see the ineluctability of the same conclusion to which we were led for direct costs. The State has established the measure of what costs--including, with no distinction supported by the record, its indirect costs--are attributable to AFDC, and AFDC has no more authority for payment of more than its allocated share of indirect costs than for more of the direct costs. The only difference is that the indirect costs do not involve the additional issue of a "duplicate" payment as did the direct costs. However, whether or not USDA can reimburse California for USDA's allocated share of costs is beside the point.

Finally, we note that Circular A-87 contains a provision specific to indirect costs which states as follows:

> When the amount allowable under a statutory limitation is less than the amount otherwise allocable as indirect costs under this circular, the amount not recoverable as indirect costs under a grant may not be shifted to another federally sponsored grant program or contract.
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> Para. F.3.b.

For the forgoing reasons, we conclude that the Agency correctly disallowed indirect costs as well as the direct costs.

"Forgiveness" under Public Law 95-291.

The Agency's Final Decision in this case, unusually detailed and lengthy at 12 pages, included a statement that the amount of the disallowance should be reduced by the amount of any social services costs, if the State could document any, under the provisions of P.L. 95-291. p. 10. This law precluded recovery of Federal funds paid to a State for social services costs under several obsolete titles of the Social Security Act prior to April 1, 1977. See California Department of Benefit Payments, Decision No. 160, March 31, 1981; Agency's Brief, pp. 18-19. Board Decision No. 160 basically dealt with the issue of whether certain costs could be pooled or had to be allocated directly. Following the latter decision, California apparently received a

partial reduction, or "forgiveness," of the disallowance amount involved in that case pursuant to P.L. 95-291. State's Brief, pp. 19-20. In this case, California argued that the Agency, not California, should compute the amount of the "forgiveness." Id.

On appeal, the Agency changed its approach. Now, it argued that California was precluded from any benefit of P.L. 95-291 because "the claims that are the subject of this disallowance . . . were never considered social service costs and were claimed by the State as administrative costs . . . ." Agency's Brief, p. 19. In its Reply Brief, California argued essentially only that it found the Agency's positions in the final decision and in the brief on appeal "confusing" and that some costs had been forgiven following Board Decision No. 160. Reply Brief, pp. 14-16.

During its oral presentation, California's representative said, "quite frankly, we are confused" by the changed Agency stance on the P.L. 95-291 issue. Tape of Conference of December 16, 1986. The Agency representative explained that in reviewing the record in detail for purposes of developing his brief, it became clear that the cost claims here had never been and could not be considered as social services costs under P.L. 95-291. Id., and see affidavits attached to the Agency's Brief (Exhibits W and X). The Agency representative distinguished costs involved in Decision 160 (which he acknowledged had included some social services costs) from the purely administrative certification costs involved in the case before us. The Agency argued that the costs by definition (because of the way all were claimed as certification costs) could not be treated as social services costs.

California offered no substantive rebuttal of the foregoing. At the December conference, California's representative acknowledged that certification costs are not social services costs and do not fall within the ambit of P.L. 95-291, and that if it was true that the costs here were not claimed as social services costs, forgiveness would not be available. California argued essentially that no one really understood what had occurred after Decision No. 160, although some costs clearly had been forgiven--perhaps like the costs here. We note that Decision No. 160 was dealing with a different issue than that involved here (i.e., as stated, whether certain costs should have been pooled or allocated directly), and different kinds of costs (including substantial costs of issuing and handling food coupons and acquiring, storing and distributing food). Some of those kinds of costs may have been within the ambit of P.L. 95-291; but in any event, California cannot make a case merely by speculating on possibilities. This leaves California only with an argument, not articulated with any clarity, that there might be some social services costs lurking among all of the costs underlying the

claims here, now hidden forever due to the proper destruction of records. We think the Agency fairly put California to its proof of this proposition, for, it is not disputed, the costs clearly have been cumulated and claimed entirely as certification costs. The issues before us relate only to that. The Agency muddied the water with its final decision, but that minor confusion, now corrected, is no basis for finding that California is entitled to relief.

Conclusion.

For the reasons discussed above, we uphold the disallowance.

/s/
Cecilia Sparks Ford

/s/
Alexander G. Teitz

/s/
Norval D. (John) Settle
Presiding Board Member