

Department of Health and Human Services

DEPARTMENTAL APPEALS BOARD

Appellate Division

SUBJECT: Greater Opportunities of the Permian Basin, Inc.
DATE: December 2, 1992
Docket No. A-92-208
Audit Control Nos. A-06-91-06754,
A-06-91-06755 and A-06-91-06756
Decision No. 1373

DECISION

Greater Opportunities of the Permian Basin, Inc. (GOPB) appealed three determinations by the Administration for Children and Families (ACF) disallowing costs charged to federal Head Start grants for program years ending (PYE) August 31, 1986, August 31, 1987 and August 31, 1988. The disallowed costs were fees in the amounts of \$2,197, \$2,255, and \$5,647 respectively, for independent audits of GOPB's Head Start program for each of the preceding years, i.e., PYE August 31, 1985, August 31, 1986 and August 31, 1987. The Office of Inspector General, Office of Audit Services (OIG/OAS) had determined that the independent audits were unreliable.

ACF argued that the audit fees could not properly be allocated to the Head Start program, because the program did not benefit from the audits, which were not accepted by OIG/OAS. ACF Brief (Br.) at 9-10. However, ACF admitted that the audit costs were incurred to meet a requirement of the Head Start grant award and were reasonable in nature and amount, and that GOPB acted prudently when incurring them. Telephone Conference, October 21, 1992 (Tel. conf.) (comments of ACF counsel).¹ GOPB argued that, by the time it was made aware that the auditor's work on the first audit was unacceptable, it was too late to avoid incurring the later audit costs.

¹The participants in the telephone conference were counsel for ACF, the Executive Director of GOPB -- Project Head Start (Betty J. Carter), and the current auditor (James L. Butler, CPA). A tape recording of the conference made with the consent of the parties has been retained for the record.

We find that the audit services were allocable to the Head Start program. We further find that the costs (with the possible exception of an amount to be determined) were necessary and reasonable at the time they were incurred. GOPB was not alerted by deficiencies on the face of the audit reports or communications from OIG/OAS that any of the audits were incurably flawed, until after GOPB had incurred substantially all of the audit costs. While we find that GOPB received sufficient notice during the course of the third audit to have caused it to at least inquire further about what action it should take to preserve federal funds, ACF made no finding about what amount of costs, if any, could have reasonably been avoided if GOPB had acted promptly upon receiving such notice. Accordingly, for the reasons discussed more fully below, we (1) reverse the disallowances of fees for the first two audits, and (2) reverse the disallowance of the fees for the third audit, subject to ACF making further findings as described below.

Background

GOPB obtained the three program-year audits at issue from the same auditor, Miguel Sanchez, certified public accountant (CPA). He had audited the program for a number of years previously, and his audits had been accepted. Tel. conf. (Comments of Betty J. Carter). It is undisputed that nothing in the conduct of the audits or on the face of the resulting audit reports alerted GOPB that the audits were unsatisfactory. Tel. conf. Each of the audit reports states that the audit was performed in accordance with the required standards and appears to address the major required areas. See, e.g., GOPB Audit Report, Grant No. H5616, for PYE August 31, 1985, at 2.

On February 28, 1986 and September 2, 1986, letters were sent from OIG/OAS to Mr. Sanchez, with copies to GOPB, in regard to the audit report for PYE August 31, 1985. ACF Exhibit (Ex.) A. The letters identified certain standards which the report failed to meet in whole or in part, returned the report to the auditor, and asked that the auditor revise it. The second letter also proposed that, as an alternative to revision, the auditor could cover both years in his imminent work on the PYE August 31, 1986 audit. Neither letter, thus, advised GOPB that the PYE August 31, 1985 audit would not be acceptable, once revised, or that Mr. Sanchez should not be permitted to perform the subsequent audit work, even though ACF was aware that he was about to begin work on the PYE August 31, 1986 audit.

However, GOPB was sent (and did not deny having received) a copy of a memorandum from OIG/OAS to federal program officials dated September 25, 1987. ACF Ex. A (as supplemented). This memorandum stated that, based on the quality control review of the working papers for the PYE August 31, 1985 audit, that audit report "should not be relied upon" and "the charges for audit costs" should be returned to the federal program. After review of the working papers for the PYE August 31, 1986 audit was also completed, OIG/OAS notified GOPB by letter dated ~~January 5, 1989~~ that Mr. Sanchez was "referred to the Texas State Board of Public Accountancy for appropriate disciplinary action," resulting in a reprimand and an agreement that he would not perform future auditing services. ACF Ex. B. The letter stated that his PYE August 31, 1985 and any later audit reports could not be relied upon and "it would not be permissible for him to perform additional audit work to correct these deficiencies." Id.²

GOPB contracted with James L. Butler, CPA, to redo the audits for PYEs August 31, 1985 through August 31, 1987. By letters dated July 1, 1992 and July 10, 1992, ACF disallowed the costs of the initial audits by Mr. Sanchez for each of those program years.³

²ACF also submitted a letter, dated March 20, 1989, from the Texas State Board of Public Accountancy to OIG/OAS, regarding Mr. Sanchez. ACF Ex. C. The letter described the results of an informal conference with Mr. Sanchez held on July 8, 1988, in which he agreed to do no further audit work, with the exception that he was expressly permitted to complete the PYE August 31, 1987 audit report on GOPB. Id.

³The redone audits showed expenditures in excess of Head Start budgets for each program year. ACF Ex. E. The disallowance determination letters indicated that ~~these~~ excess allowable costs were covered by non-federal funds, which the current auditor indicated were derived from grantee income on a donated rental property, and not charged to the federal grants. Disallowance determinations, dated July 1, 1992 and July 10, 1992; Tel. conf. (comments of James L. Butler, CPA). GOPB thus had additional allowable costs which would be available to offset any reduction for unallowable audit fees in the relevant program years.

Applicable Law

Throughout the relevant period, federal regulations required every Head Start program to have an annual audit by an independent auditor to determine whether its financial statements are accurate, whether it is in compliance with the terms and conditions of its grant, and whether it has proper financial and administrative procedures in place. 45 C.F.R. § 1301.12(a). The audit must be submitted to ACF within four months of the prior budget period. See 45 C.F.R. § 1301.12(c).

The cost principles which govern the use of Head Start funds are those in 45 C.F.R. Part 74, which permit only "allowable costs of the activities for which the grant was awarded" as determined under the principles of Office of Management and Budget (OMB) Circular A-122. 45 C.F.R. § 1301.10; 45 C.F.R. § 74.170; 45 C.F.R. § 74.174(a). OMB Circular A-122 provides that, to be allowable, all costs must meet certain basic considerations, such as reasonableness and allocability to the award. A reasonable cost is defined as one that "in nature or amount . . . does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost." OMB Circular A-122, Attachment (Att.) A, Section A.3 (emphasis added). A cost is allocable to a grant if it is treated consistently with other similar costs and is "incurred specifically for the award." Id. at Section A.4.a. (A cost may also be allocable to an award if it can be distributed in a way that reflects the proportion to which it benefits the grant work, even if it also benefits other work, or if it is necessary to the overall organization, even if direct benefits cannot be shown. Id.)

The allowability of auditors' fees is also governed by specific principles applicable to professional services "rendered by persons who are members of a particular profession." Id. at Att. B, Section 34.a. Such costs are generally allowable "when reasonable in relation to the services rendered" Id. A number of factors are to be considered in determining whether such costs are allowable "in a particular case," but "no single factor or any special combination of factors" necessarily determines allowability.⁴

⁴The factors listed as relevant are:

(1) The nature and scope of the service rendered in relation to the service required.

Analysis

Counsel for ACF argued that the basis for disallowing the audit fees in this case was that they could not be allocated to the Head Start program, since the program did not receive the "relative benefits" of the audit costs. ACF Br. at 7; Tel. conf. ACF further argued that, even if ACF did not provide timely notice of the audit deficiencies, GOPB could not receive federal funds when it did not receive the benefit of the auditing services for which it was paying. ACF Br. at 11.

The Board provided the parties with a list of questions before the telephone conference, including a proposed analysis suggesting that allocability was not properly at issue where, as here, the costs were "incurred to meet the specific requirements of the Head Start program." Notice of and Questions for Telephone Conference, October 16, 1992, at 2. Instead, the analysis suggested that the relevant issue was the reasonableness of payments for audits with significant deficiencies. In the conference, ACF rejected this proposed analysis, conceding that the costs were reasonable in amount and nature and were incurred prudently, but insisting that the costs were not allocable to Head Start because no benefit accrued to the program from the audits. ACF cited two Board decisions in support of this position: Sandoval County Economic

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- (2) The necessity of contracting for the service
 - (3) The past pattern of such costs
 - (4) The impact of Government awards on the organization's business
 - (5) Whether the proportion of Government work to the organization's total business is such as to influence the organization in favor of incurring the cost
 - (6) Whether the services can be performed more economically by direct employment
 - (7) The qualifications of the individual . . . and the customary fees charged
 - (8) Adequacy of the contractual agreement for the service

Opportunity Corporation, DAB No. 1362 (1992), and Council for Economic Opportunities in Greater Cleveland, DAB No. 594 (1985).⁵

ACF's argument misconstrues the meaning of the term "benefit," in the context of determining the allocability of costs. A cost is explicitly made allocable to a grant under OMB Circular A-122 whenever it is "incurred specifically" for that grant project. There is no question here that the audit costs were incurred solely to meet the regulatory requirements of the Head Start program, and were therefore allocable to it. The issue of relative benefits arises only where a cost inures to the benefit of more than one of a grantee's activities and must therefore be shared in some equitable fashion among them. Here, no other activities are alleged to have derived any benefit from the audits. Therefore, as we noted in our proposed analysis, these costs could be disallowed only on some other basis, such as that they were unreasonable in relation to the value received.

In this regard, the Sandoval decision supports the position of GOPB rather than ACF. In Sandoval, an audit was contracted for and begun, but was canceled before completion because unforeseen circumstances necessitated an organization-wide audit. At the time the first audit was sought, the grantee acted reasonably by using an auditor familiar with the program, whose services had been acceptable in past years, to commence an audit which had to be done promptly and independently to comply with the four-month regulatory deadline. See Sandoval at 5-7. The Board found that the audit work was performed as a

⁵ACF also relied on Community Action Agency of Chambers-Tallapoosa-Coosa, Inc., DAB No. 1066 (1989). However, that case is inapposite. The funds disallowed in Chambers-Tallapoosa-Coosa were garnished by court order to satisfy an award for racial discrimination against the grantee. We found that the use of federal funds for this purpose was unallowable because it was not reasonable for any program-related purpose, because the grantee was explicitly put on notice that satisfaction of the judgment against it would not be an allowable cost, and because the cost principles specifically prohibit payment of penalties for violations of federal laws. The present case involves a category of costs which a grantee was required to incur (i.e., independent audits), a grantee that was not put on notice that further audits would be unallowable, and expenditures that met the specific requirements of the cost principles for professional services. See discussion below.

professional service, even though no audit report was ultimately produced. Id. There was no dispute that the hourly rate was reasonable. Once ACF notified the grantee that an organization-wide audit was required instead, the grantee discontinued the program-year audit. Id. at 2. We specifically rejected ACF's argument in Sandoval that the costs of the first audit were not allocable to Head Start, holding that "at the time the services were rendered and up until the contract was canceled, [the auditor's services were performed to further the grantee's] . . . compliance with the Head Start program regulations." Id. at 7 (emphasis added). We therefore reversed the disallowance, finding the costs reasonable and allocable. We distinguished Sandoval from Greater Cleveland, in which the grantee did not show that the costs of unsatisfactory audits were reasonable, and the grantee had to pay to have them performed again.

A number of factors in the present case are analogous to Sandoval. GOPB had used this auditor in the past and the services had been allowable. GOPB was required to contract with an outside professional to meet the requirement of an independent audit and to act promptly to meet the four-month deadline. At the time of performing the audits, the auditor was acting within the scope of his professional license in performing work on program-year audits which were specifically required by program regulations. The parties agreed that nothing in GOPB's agreement to contract with the original auditor was inadequate or improper. Tel. conf. ACF conceded that nothing in the reports or the services provided by the auditor would have alerted a prudent grantee that the professional services were not adequate. Tel. conf. (comments of ACF counsel). We thus find that GOPB has met the majority of the factors listed in OMB Circular A-122 to be considered in weighing the reasonableness of professional services costs, as did the grantee in Sandoval. See note 4 supra; OMB Circular A-122, Att. B, Section 34.b.⁶

⁶GOPB clearly satisfied factors 2 (necessity of contracting), 3 (past pattern of cost treatment), 6 (no direct employment alternative), 7 (qualified professional charging customary fees -- since Mr. Sanchez was operating within the scope of his license until completing the last GOPB audit and ACF did not claim excessive fees), and 8 (adequate contract -- since ACF did not object to the adequacy of the contractual arrangements). See Tel. conf. We have no information relating to factors 4 (impact of government awards on GOPB's business) or 5 (influence of proportion of

We recognize that some facts here are similar to Greater Cleveland, in that the audits were unsatisfactory, rather than incomplete, and in that subsequent auditors had to redo the audits. However, unlike in Greater Cleveland, ACF conceded here that the costs were reasonable when incurred. OMB Circular A-122 requires that reasonableness be evaluated not from omniscient hindsight, but from the standpoint of prospective prudence, i.e., "under the circumstances prevailing at the time the decision was made to incur the cost." OMB Circular A-122, Att. A, Section A.3. From that standpoint, we find GOPB acted prudently and the costs incurred were reasonable (with the possible exception of an amount to be determined).⁷

Although GOPB became aware before contracting for at least the last audit that the prior audits were not entirely satisfactory, GOPB was led to believe that the deficiencies could be resolved by additional explanations or documentation from the auditor. ACF Ex. A; Tel. conf. (Comments of James L. Butler, CPA, and Betty J. Carter). Mr. Sanchez, in fact, informed GOPB that he would send in the necessary corrections. Tel. conf. (Comments of Betty J. Carter). Not until the memorandum of September 25, 1987 was GOPB unambiguously informed that the audit for PYE August 31, 1985 was rejected as unreliable.

By that time, GOPB had already contracted for the final audit (for PYE August 31, 1987), and field work had already been performed on site. Tel. conf. (Comments of Betty J. Carter). ACF did not make a finding as to whether GOPB could have saved project funds by terminating the contract at that point in order to prevent the final audit report from being written. See Tel. conf.; GOPB Audit Report, Grant No. H5616, for PYE August 31, 1987, at 2. ACF did not instruct GOPB to

government to total business). As to factor 1, the nature and scope of services rendered were ultimately inadequate in relation to the service required, but, as discussed elsewhere, GOPB did not have notice of the extent of the deficiencies at the time of incurring and paying substantially all of the costs.

⁷In the present case, unlike Greater Cleveland, no unallowable costs were found when the audits were redone. By contrast, in Greater Cleveland, the original auditors had overlooked fraud and abuse and certified the adequacy of internal controls in an agency where federal reviewers found evidence of embezzlement and illegal loans. Greater Cleveland at 5, n.2.

terminate the contract for the final audit nor advise GOPB until January 5, 1989 that audits by the same auditor subsequent to PYE August 31, 1985 would also be considered unreliable and that he would not be permitted to make corrections. ACF Ex. B. We conclude, however, that GOPB should have been sufficiently alerted by the final rejection of the PYE August 31, 1985 audit to have taken some action, such as seeking guidance from ACF, to prevent further losses.⁸ The record before us does not demonstrate how much of the third year's audit costs, if any, could have been saved by such action. Thus, while we reverse the disallowances ACF took here, our decision does not preclude ACF from reinstating a part of the disallowance of the audit fees for the third audit, if ACF makes a finding concerning what specific amount of costs GOPB incurred after receiving ACF's September 25, 1987 memorandum could have been reasonably avoided by prudent action at that time. ACF would also have to determine to what extent any such unallowable costs would be offset by allowable costs GOPB originally covered with non-federal funds (see note 3 above). It is for the latter reason that we have placed the burden of going forward here on ACF, since it appears likely that any small amount of the disallowance remaining would be offset.

Finally, we reject ACF's argument (made for the first time in the telephone conference) that the disallowances here should be upheld because GOPB unreasonably failed to recoup the funds from the first auditor after learning that the audits were unacceptable and had to be repeated. Tel. conf. GOPB responded that efforts were made to

⁸ACF responded to GOPB's argument that it was not given timely notice of the unreliability of Mr. Sanchez' audits by arguing that GOPB was charged as a federal grantee with knowledge of applicable statutes and regulations and that GOPB had not demonstrated the necessary elements to estop the government from disallowing improper costs. ACF Br. at 10-11. However, ACF conceded that nothing on the face of the audit reports was sufficient to alert a prudent grantee to their inadequacies. OIG/OAS was able to unearth the extent of those inadequacies only after a substantial period of analysis and review. Therefore, ACF did not show that GOPB failed in its duty to be familiar with applicable law and regulations. Further, GOPB did not raise a defense based on estoppel in arguing that ACF did not provide it with timely notice. Rather, the absence of notice of irremediable deficiencies in the audits simply supports the finding that GOPB acted prudently in procuring the subsequent audits from the same source.


locate the auditor without success, so that recovery of the funds has not been possible. Id. While GOPB should certainly continue to pursue recovery of the funds, since the audits ultimately proved not to be in compliance with program requirements of which the auditor should have been aware, ACF did not explain what other reasonable steps GOPB should have taken to seek recoupment.

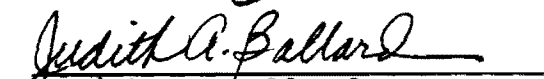
Conclusion

For the reasons explained above, we find that the costs of the audits were allowable, reasonable, and allocable to the Head Start program, except to the extent that some undetermined part of the third year's audit costs could have been reasonably avoided as discussed above. Accordingly, we (1) reverse the disallowances of the audit fees for the first two audits, and (2) reverse the disallowance of the audit fees for the third audit, subject to partial reinstatement by ACF upon a finding as to (a) the amount of costs reasonably avoidable if GOPB had acted promptly after receiving the September 25, 1987 notice, and (b) the extent to which such unallowable costs exceed the allowable costs GOPB originally covered with non-federal funds, but could have charged to federal funds (see note 3 above).

If ACF makes such a determination, ACF should communicate that determination to GOPB in writing. GOPB may appeal ACF's finding about the amount of unallowable costs, by filing a written notice of appeal with this Board within 30 days of receiving ACF's determination.


M. Terry Johnson


Norval D. (John) Settle


Judith A. Ballard
Presiding Board Member