Department of Health and Human Services

DEPARTMENTAL APPEALS BOARD

Appellate Division

SUBJECT: Arkansas Department of Information Systems
Docket No. A-05-17
Decision No. 2047

DATE: October 6, 2006

DECISION

The State of Arkansas appealed a determination made by the Division of Cost Allocation (DCA) of the Department of Health and Human Services (HHS). Arkansas was represented by its Department of Information Systems (DIS). The determination related to data processing and telecommunication services DIS provided to other Arkansas agencies and charged to those agencies through billing rates. Some of the charges were passed on to HHS programs or to other federal programs. DCA determined that DIS had not been following the requirements for using billing rates to allocate central service costs to federal programs. DCA determined that Arkansas owes the federal government $7,833,376 for overpayments for DIS services charged to federal funds during state fiscal year 2001 (and for associated interest) and that Arkansas should make a cash refund to the federal government. Arkansas appealed, arguing primarily that the total overcharges to federal funds should be offset by total undercharges for other DIS services.

In a related case, Arkansas appealed a similar DCA determination regarding overpayments for DIS services charged to federal funds during state fiscal years 1997-2000. That determination was separately appealed and was assigned Board Docket No. A-02-42. Arkansas opposed consolidation of the two cases, arguing that they were factually distinct. Thus, the Board permitted the briefing in the two cases to proceed separately. In Arkansas Department of Information Systems, DAB No. 2010 (2006), the Board upheld the DCA determination of the overpayment amount for the earlier period, as revised during Board proceedings, subject to several adjustments to which DCA had agreed during an informal conference in the case. In this decision, we uphold the DCA determination for fiscal year 2001, subject to the adjustments described below. We conclude that there is no factual distinction between the two cases that requires a different result on the issues raised.

Analysis

DCA was not required to permit Arkansas to offset total overcharges for DIS services against total undercharges for other DIS services in calculating the amount due.

The key issue before us is whether DCA acted in an arbitrary and capricious manner by refusing to permit Arkansas to offset total overcharges for DIS services against total undercharges for other DIS services in calculating the amount due.

In DAB No. 2010, we set out the requirements of Office of Management and Budget (OMB) Circular A-87 that apply to any state that seeks to allocate central service costs to federal funds through use of billing rates accounted for through an internal service fund. DAB No. 2010, at 4-8. In that case, the Board found that DIS was not reconciling DIS billing rates for data processing and telecommunications services to the actual, allowable costs of providing the services annually, as required by the Circular. Id. at 12-16. Here, while Arkansas suggests in its arguments that it was adjusting its rates to actual costs, it provided no evidence to show that it was in fact meeting the OMB Circular A-87 requirements for DIS charges to federal programs for fiscal year (FY) 2001. DCA, on the other hand, presented an affidavit by Terry Hill, a DCA Branch Chief, analyzing information submitted by Arkansas that shows that charges for many DIS services were substantially in excess of the costs of those services and that DIS did not adjust, through rebates or otherwise, for the difference between the actual costs and the amounts charged for services in FY 2001. DCA Ex. 1 (Hill Affidavit), and Attachments (Atts.). Yet, Arkansas does not seek here to show that it changed its rate-setting practices to comply with the Circular with respect to FY 2001 billing rates.

In DAB No. 2010, the Board concluded, generally, that DCA's method for calculating the amount due from Arkansas was reasonable because:

- Since Arkansas was not reconciling DIS billing rates to actual costs annually, Arkansas was not submitting claims for federal funding for DIS services in accordance with an approved cost allocation methodology, as required. Rather than disallowing the entire amount charged to federal funds for DIS services, however, DCA in effect permitted some amounts to be allocated to federal funds, after estimating the federal share of

overcharges resulting from billing rates that exceeded the actual costs of providing the services.

- The requirements applicable to the kind of central support services DIS provided permit some offset of overpayments against underpayments when adjusting federal funding, but those methods generally apply only when the adjustments are being made by a state on an ongoing basis and when approved by DCA. Moreover, DCA may require a state to account for each category of service separately, even if the services are funded through the same internal service fund.

- DCA reasonably determined that permitting retrospective offsets of total overcharges for some DIS services against total undercharges for other DIS services could result in impermissibly shifting costs from State to federal funds or from one federal program to another or in avoiding conditions on federal funding such as caps on program administrative costs or requirements for timely claims for program funds.

- Contrary to what Arkansas alleges, DCA never affirmatively established a policy permitting the type of offset sought by Arkansas and has not treated Arkansas unfairly.

DAB No. 2010, at 2, 12-43. These conclusions were based on the evidence (and admissions) regarding DIS billing rates and charges, and a detailed analysis of the arguments Arkansas made about why it should be permitted to offset undercharges against overcharges. We see no reason to repeat that analysis here, but incorporate it by reference.

In its reply brief, Arkansas argues that DCA is incorrect that DCA's methodology is the only way to avoid cost-shifting. Arkansas asserts that DCA could have chosen to examine over and undercharges at the State agency level. DCA was not required, however, to show that its methodology is the <u>only</u> way to avoid cost-shifting, in order to reject the offsetting methodology proposed by Arkansas (which would result in cost-shifting). Here, as with respect to the earlier period, Arkansas fails to provide information to show that an alternative exists that would reasonably assure that no cost-shifting would occur.

This is clear in analyzing the example Arkansas gives to support its assertion that offsetting at the State-agency level would not result in cost-shifting. Arkansas cites its Exhibit 2 for the

proposition that both over and undercharges to the Arkansas Office of Child Support Enforcement (OCSE) were claimed under only one federal program and that, because the same federal grant benefitted from the overcharges and undercharges, there was no shifting of costs. AR Reply Br. at 7. The exhibit on which Arkansas relies does not support its position, however. First, the affidavit in that exhibit does not rule out the possibility that OCSE engaged in some State-only, non-grant activities that also benefitted from DIS services. Offsetting undercharges for any services benefitting OCSE's non-federal grants against overcharges to the OCSE federal grant could result in improperly shifting costs from non-federal programs to a federal program, even if it would not result in shifting costs from one federal program to another. Moreover, if by "State agency level" Arkansas means DFA, the State Department of which OCSE is a part, the affidavit does not establish that offsetting at the State agency level would not result in cost-shifting among federal programs. The affidavit in that exhibit concedes that, even though OCSE administers only one federal grant, DFA did have other grants that were charged for DIS "telephone services" in FY 2001. DIS Ex. 2 (McDonald Affidavit) at ¶ 5. Some types of telecommunications services provided by DIS were among the types of services for which DIS undercharged in FY 2001. DCA Ex. 2, at 6 (Att. B), and 8 (Att. C). Offsetting undercharges to DFA's other grants for telephone services against overcharges to OCSE's federal grant for other types of services could thus result in shifting costs among federal grant programs.

Moreover, Arkansas does not deny that State agencies other than OCSE had multiple federal programs, or provide any evidence that addresses the other concerns that DCA raises about permitting wholesale offsetting of DIS overcharges and undercharges – specifically, concerns that such offsetting could result in Arkansas avoiding conditions on federal funding such as caps on program administrative costs or requirements for timely claims for program funds.

DIS did not apply its policies, regulations, and procedures uniformly and consistently to federal and non-federal funds.

In its determination leading to this appeal, DCA stated that it had determined, based on a review of data, that DIS–

> operated its internal service funds in a manner that resulted in the shifting of costs between federally-funded programs and the inconsistent treatment of costs between federally-funded and state-funded programs.

DCA letter of September 27, 2004. DCA concluded that these actions violate the requirement in OMB Circular A-87, Attachment A, paragraph C.1.e. that costs charged to federal awards "be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit."

On appeal, Arkansas argues:

> During the time period in question, DIS' policies, regulations and procedures applied uniformly to federally funded and state funded activities. DIS provided centralized telecommunications and data processing services to customers based on usage of services. Individual service rates were developed considering cost, projected usage by all customer agencies, and historical treatment of cost figures. DIS' rate structure was premised on its longstanding use of 'netting' in its billing practices, a practice accepted by the Dallas DCA Regional Office. However, the rate structure did not deliberately target or favor customer agencies funded by federal funds over those with non-federal funds.

Notice of appeal at 1-2. Based on these assertions, Arkansas asks us to conclude that the legal rationale supporting DCA's calculation methodology is erroneous. For the proposition that the prohibition on inconsistent treatment of costs in OMB Circular A-87 does not apply since the DIS rate structure did not "deliberately target or favor customer agencies funded by federal funds over those with non-federal funds," Arkansas cites several Board decisions, including New York State Dept. of Social Services, DAB No. 1336 (1992), aff'd, New York v. Shalala, 979 F.Supp. 177 (S.D. N.Y. 1997), aff'd, 143 F.3d 1119 (2nd Cir. 1998). AR Br. at 10-11. Arkansas quotes part of the statement, in that decision, that "a rational program . . . is [not] prohibited, so long as it is not designed to have a differential impact on Federally assisted activities." DAB No. 1336, at 28.

To support DCA's finding that DIS practices in FY 2001 resulted in inconsistent treatment of costs, DCA submitted worksheets analyzing information provided by Arkansas and also submitted the Hill Affidavit, explaining the results of that analysis. Among other things, this analysis shows the following:

- Arkansas consistently overcharged some service categories and undercharged others during the period from FY 1997 through FY 2001. For example, the CPU

Processing service category was charged 216% in excess of cost during 2001, while the service category for Programmers was undercharged 48% of cost.

- Prior to rebates, federally-funded State agencies in total were consistently overcharged (and when undercharged, were always undercharged less than State agencies that had no federal funding) for the period from FY 1997 through FY 2001.

- Even after the rebates DIS gave during the period FY 1997 to FY 2000, federally funded state agencies still had total overcharges equal to 18% of the total costs of the services received, whereas State agencies with no federal funding had been overcharged by only 1% of the total costs of the services received.

- In 2001, no rebates were given and federally funded agencies were overcharged $5.1 million on costs of $21.4 million, an overcharge of 24% of the total costs. At the same time, the State agencies that had no federal funding were undercharged $1.3 million on costs of $50 million, an undercharge of 3% of the total costs.

DCA Ex. 1, ¶¶ 6-12; DCA Ex. 2, Atts. C, D, E, F-1, and F-2. This evidence, which Arkansas did not rebut, suggests that, in fact, the disparities in treatment that resulted from the DIS rate-setting and rebate system may have been deliberate. Even though Arkansas had adopted a cost allocation methodology – use of an internal service fund, billing rates, and rebates – that should have resulted in uniform treatment (no activities being overcharged for services), the way that DIS applied that methodology clearly did not result in uniform treatment. DIS obviously had a pattern of setting rates for services more apt to be charged to federal funds much higher than the costs of those services, but setting rates for other services closer to or lower than the actual costs of the services. This practice, combined with the offsetting method DIS used to determine rebates, predictably resulted in disparate treatment.

Even if Arkansas did not deliberately overcharge state agencies with federal funds more than those with no federal funds, that would not be a basis for overturning the DCA determination, however. First, contrary to what Arkansas argued, the Board's decision in DAB No. 1336 does not suggest that only deliberate inconsistent treatment is prohibited by OMB Circular A-87. While the Board stated that a program may not be designed to have a differential impact on federally-assisted activities, the Board's

decision does not rule out a finding of inconsistent treatment of costs where that is the unintended result of what a state does.[1] The Circular on its face requires that costs be consistent with policies, regulations, and procedures that apply uniformly to all activities of a governmental unit. OMB Cir. A-87, Att. A, ¶ C.1.e.; see also, Att. C, ¶¶ E.4 and E.1. Thus, the issue is whether the costs have been consistently treated, not whether a state's failure to treat costs consistently was intentional. To interpret the Circular as prohibiting inconsistent treatment only when it is deliberate would contravene the purpose of ensuring that federal programs do not pay more than their fair share of costs.

Since the evidence shows that the system DIS used resulted in inconsistent treatment between federally funded state agencies and other state agencies, it does not matter whether, as Arkansas contends, the billing and rebate system was "designed to net profits and losses resulting in zero profit for the fund as a whole." AR Reply Br. at 6. The effect was to improperly shift DIS costs from state funds to federal funds.[2]

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[1] With respect to the other Board decisions, Arkansas asserts that the "critical element in all of these cases is the application of conflicting policies between federal and state costs." AR Br. at 11. The Circular provision, however, requires that procedures, as well as policies, apply uniformly. Moreover, a review of the decisions Arkansas cites does not support a view that the existence of "conflicting policies" was the critical element in the cases. Instead, in each of them, the inconsistent treatment resulted from state action that was not necessarily based on state policy, such as reducing insurance premiums for state agencies that received most of their funding from the state but not for agencies whose funding came mostly from federal sources (Louisiana Division of Administration, DAB No. 1893 (2003), aff'd, State of Louisiana Div. of Admin. v. HHS, No. 03-856-A (M.D. La. June 27, 2005)); making cash contributions only for the federal share of accrued leave (New York State Dept. of Family Assistance, DAB No. 1775 (2001)); and calculating federal and state contributions to a retirement fund differently (Indiana Public Employees' Retirement Fund, DAB NO. 314 (1982)).

[2] Arkansas suggests that DIS's rate structure "could not deliberately target or favor customer agencies funded by federal funds over those funded with state funds, because rates were determined by customer usage." AR Br. at 11. Arkansas admits, however, that costs were considered in setting rates, not only

(continued...)

Second, DCA also found that the prohibition against cost-shifting in OMB Circular A-87, Attachment A, paragraph C.3.c. was violated because, in FY 2001, DIS was undercharging the Arkansas Employment Security Division (ESD) for DIS services and overcharging other federally funded departments, in effect shifting costs from ESD to those other departments.

Arkansas acknowledges that DIS had a fixed-price agreement with ESD and does not deny that DIS was not charging ESD the full billing rates for all of the services provided. See DIS Ex. 7. Under OMB Circular A-87, an internal service fund must account for any difference between the established billing rate and the amount charged a customer agency, by treating the difference in what would have been charged at the billing rate and what was charged at a lower rate as "imputed revenue." Att. C, ¶ E.3.b(2). DCA provided evidence that DIS should have treated the difference between the billing rate and the fixed-price contract amount as imputed revenue and adjusted the costs charged to other users of the service accordingly, but did not do so. DCA Ex. 1, ¶ 13. The result of DIS's failure to do this was to shift costs to other federally funded programs from the federally funded programs ESD administers. Id. Arkansas neither claims that DIS met the requirement regarding imputed revenue, nor denies that the effect was to impermissibly shift costs among programs.

Instead, Arkansas tries to excuse its failure to recognize the imputed revenue from ESD by arguing that DIS simply gave ESD "credits" in the nature of rebates earlier than it gave rebates to other state agencies. This argument has no merit. First, the problem with failing to recognize imputed revenue is that it results in understating total revenues compared to total actual costs for a service (and therefore understates the total amount to be refunded or otherwise adjusted for that service). Second, credits given in order to reduce the billed amount to adjust for differences between a billing rate for a unit of service and a fixed price amount are not comparable to a refund intended to adjust for the difference between the billed amount for services and the actual costs of those services.

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[2](...continued)
usage. Knowing which type of services were most apt to be used by customer agencies with federal funds thus could have been a factor in why rates for those services more often exceeded costs (sometimes substantially) than rates for other types of services.

We also reject the suggestion by Arkansas that since any allocation method poses a risk of some cost-shifting (which is tolerated in order to reduce the burden of accounting for costs), we therefore should ignore the cost-shifting issue here. While we agree that no cost allocation method is perfect, cost-shifting is prohibited under the Circular (with a limited exception not applicable here). OMB Cir. A-87, Att. A, ¶ C.3.c. Moreover, the requirements for central services billing are intended to ensure that a grantee has a system in place that will minimize cost-shifting and, over time, result in equitable treatment. Here, Arkansas' failure to meet those requirements resulted in a level of cost-shifting that is clearly unacceptable.[3]

Finally, even if DIS practices during FY 2001 did not violate OMB Circular A-87 requirements regarding consistent treatment of costs and avoiding cost-shifting, that would not alone provide a basis for overturning the DCA methodology for calculating the refund Arkansas owes for overcharges to federal funds in that year. As we discussed above, the evidence shows that substituting the type of offsetting Arkansas wants here for the DCA methodology would itself result in impermissible cost-shifting and possibly in federal reimbursement of DIS costs that exceed applicable caps on funding or that were not timely claimed in accordance with federal program requirements.

DCA was not required under the circumstances here to calculate the amount of the refund required based on actual overcharges to each federal program.

In DAB No. 2010, the Board concluded that while Arkansas is correct that it would be more accurate to determine a disallowance amount by examining the actual charges to federal programs, rather than by applying an average federal financial participation (FFP) rate to the charges to State agencies, Arkansas had had numerous opportunities to come forward with

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[3] We also note that Arkansas relies on the Circular definition of an "indirect cost," but it is not clear from the record that any of the DIS costs were treated as indirect costs and allocated to federal programs through an indirect cost rate. Two of the affidavits Arkansas submitted from its State agencies state that some of the services DIS billed were treated as direct charges to federal programs and some were allocated to all benefitting programs using other allocation methods, such as time distribution. DIS Ex. 3, ¶ 3; DIS Ex. 4, ¶ 4. The other affidavit implies that the services were direct charged to a federal program. DIS Ex. 2.

documentation of the actual charges, but failed to do so. The Board concluded that, absent such documentation, DCA reasonably relied on evidence (either provided by or not rebutted by Arkansas) about charges to state agencies, and about the average FFP for each agency, to estimate the total excess charges to federal funds for DIS services.

Here, similarly, Arkansas did not come forward with documentation of the actual charges to federal programs for DIS services in FY 2001. Arkansas does assert, however, that, in calculating the amount owed by Arkansas, DCA used the wrong FFP rate for the Arkansas Department of Human Services (ADHS) for FY 2001. Arkansas argues that the rate DCA used in its calculations did not take into account a substantial decrease in state revenues for ADHS in FY 2001. In support of its position, Arkansas submitted evidence that the state revised its forecast of revenues for FY 2001, significantly decreasing the amount of funding available for ADHS programs, and that the official forecast of revenue "binds" the level of state funding.

In its response, DCA noted that Arkansas had first claimed that the proper FFP for ADHS for FY 2001 was 38%, that DCA had calculated the 57.16% it used by averaging four years historic usage of FFP by ADHS, and that Arkansas had submitted no documentation to support the 47.45% Arkansas now claims is the correct rate. DCA also presented evidence that the rate it used was from data submitted by Arkansas on July 8, 2004. DCA Ex. 1, at ¶ 19. DCA questioned whether a reduction in revenue would necessarily affect the FFP rate. DCA indicated, however, that it would be willing to review the data on which Arkansas is basing the 47.45% if Arkansas provided it.[4] DCA Br. at 10, n. 4.

In its reply brief, Arkansas indicated that it had provided additional information and that DCA's counsel had agreed that DCA would review it. DCA did not deny that it had agreed to try to resolve this issue informally.

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[4] We agree with DCA that, contrary to what Arkansas argues, a reduction in state revenue would not necessarily lead to a change in the proportion of costs covered by federal funds, compared to the proportion covered by non-federal funds, from one year to the next. Since the parties are seeking to resolve this issue on their own, however, we do not examine further the issue of what proportion the federal government in fact paid in FY 2001.

Thus, the amount determined to be the federal share of overcharges to ADHS for FY 2001 is subject to adjustment to the extent DCA accepts documentation of a lower FFP rate for ADHS than the 57.16% that DCA used. If the parties do not, in fact, resolve this issue on their own, DCA should issue a determination on the FFP amount for ADHS, stating why DCA does not accept Arkansas' documentation of a lower rate. Arkansas may then appeal to the Board on that limited issue, within 30 days after receiving DCA's determination. Such a later appeal would delay federal recovery only of the difference between the amount due for overcharges to ADHS for FY 2001 calculated using the rate DCA applied and the amount due for those overcharges calculated using the lower rate Arkansas says should be applied.

DCA did not improperly include "imputed interest" in the disallowance amount, but has indicated that it is willing to consider an alternative method for computing the amount of interest in fact earned.

Here, as in the related dispute, Arkansas argues that DCA improperly included "imputed interest" in calculating the disallowance amount. In DAB No. 2010, the Board rejected Arkansas' argument that the situation here is comparable to cases in which the Board held that a federal agency could not recover from a grantee interest that was "imputed" in the sense that the interest was not actually earned by the grantee, but could have been earned if the grantee had invested funds it held. The Board distinguished the situation here, by explaining the relevant provisions in OMB Circular A-87, as interpreted in *A Guide for State and Local Government Agencies: Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates with the Federal Government* (ASMB C-10). The Board stated:

> OMB Circular A-87, which did go through notice and comment rulemaking, treats the interest earned by an ISF as revenue to the ISF. Specifically, for each ISF with an operating budget of $5 million or more, the plan must include, among other things, "a revenue statement with revenues broken out by source, e.g., regular billings, interest earned, etc." OMB Cir. A-87, Att. C, ¶ E.3.b.(1). The Circular also provides that [e]ach billed central service activity must separately account for all revenues (including imputed revenues) generated by the service, expenses incurred to furnish the service, and profit/loss." Id., Att. C., ¶ G.1.

> As was pointed out in the comments on the proposal that led to the 1995 revisions, generally accepted accounting principles for states do not require states to account for and report internal service activities in proprietary accounts. 60 Fed. Reg. at 26,488. In other words, states may commingle ISF funds with their other funds, so long as the ISF is recognized in the government's comprehensive annual financial report. See ASMB C-10 at ¶ 4-10. Moreover, even if a state has a proprietary account, a state may have transferred money out of that account into its general treasury. Rev. Tr. at 58. Thus, a state may have difficulty in determining an exact amount of interest earned on ISF funds. Rev. Tr. at 56. ASMB C-10 merely recognizes this and provides an alternative method of calculating and reporting the actual interest earned. Specifically, ASMB C-10 interprets the Circular provision regarding accounting for all revenues to mean that earnings on ISF cash balances "are to be treated as applicable credits" and provides an alternative to reporting actual interest earned, by providing that "earnings may be imputed by applying the government's, e.g., State Treasurer, Average Rate of Return on the average monthly balance for a given fund." ASMB C-10, at ¶ 4-11. This is a reasonable interpretation of the Circular provisions on ISFs, is consistent with the Circular provision on applicable credits, and is consistent with past Board decisions. This interpretation also makes sense because otherwise states would have an incentive to deliberately overcharge federal programs for central service costs in order to earn interest on the overcharges between the time when federal funds are drawn down based on the billings and when the overcharges are paid back. Arkansas had timely notice of this interpretation and of the definition of applicable credit.

DAB No. 2010, at 43-45 (footnotes omitted).

Here, DCA presented evidence that, while Arkansas does not credit interest earned on funds in the data processing and telecommunications internal service fund to that fund, Arkansas pools cash in the State Treasury to invest and earn interest. DCA Ex. 1, at ¶ 23; DCA Ex. 2, Att. P, at Note 1.E. Arkansas presented nothing to rebut this evidence. Thus, as in the related cases, the interest at issue here is the interest Arkansas actually earned on overcharges to federal funds. That interest is "imputed interest" only in the sense that, because Arkansas did not account for the interest as part of its fund

accounting, the applicable rate is deemed to be the government's average rate of return on the monthly balances.

Arkansas also challenges DCA's method of calculating the amount of interest earned on excess federal funds. Since DCA indicated that it was willing to consider an alternative method for calculating the interest earned, we have provided below for a limited opportunity for Arkansas to provide to DCA the information required for the alternative method.

The determination for FY 2001 is not distinguishable merely because of a difference in some of the federal programs Arkansas was operating in this period.

Arkansas asserts that the determination for FY 2001 differs from the determination for the earlier period because Arkansas had some different federal programs it was operating in the two periods. The significance of this, according to Arkansas, is with respect to its argument that DCA is required to make a showing of actual harm to the federal interest before the federal share of the overcharges may be recovered. In a ruling issued in the related case and attached to DAB No. 2010, the Board rejected the Arkansas argument about harm to the federal interest. Nothing in this case leads us to a different result.

As DCA states in its brief, the mere fact that federal programs benefitted from DIS services is not enough. The issue here is what is a reasonable remedy given that Arkansas did not properly and timely determine the relative benefits to individual programs in accordance with the approved cost allocation methodology and the requirements of OMB Circular A-87. Arkansas does not deny that its rates resulted in substantial overcharges to federal programs for some DIS services, nor does Arkansas deny that it never claimed federal funding for the undercharges it now seeks to offset against the amount overcharged. The evidence DCA presented does show, contrary to what Arkansas asserts, that the overcharges were unreasonable in amount because they exceeded the actual, allowable costs of the services. The mere fact that some of the overcharged programs were audited and the auditors did not identify the charges as unreasonable in amount does not establish that the amounts were in fact reasonable. The auditors would have relied on the billing rates for central services costs being set and adjusted in accordance with OMB Circular A-87, rather than looking behind the billing rates. Moreover, even assuming that Arkansas rated highly in its performance of federal grant programs, that does not excuse Arkansas from failing to meet the applicable requirements for charging central services costs to

those programs through use of billing rates adjusted annually to actual costs of the services provided.

Our ruling rejecting Arkansas' argument that DCA was required to demonstrate harm to the federal interest (beyond the harm from paying more than actual costs for some billed central services) as part of this proceeding is incorporated by reference here.[5]

Arkansas did not establish, as a general matter, that a request for refund must be preceded by a finding of substantial noncompliance.

We also reject the new argument Arkansas makes here that federal programs impacted by the DIS charges "require a finding of substantial noncompliance of the programmatic requirements, if funds administered by these programs are requested to be returned to the federal government." AR Br. at 12. In support of this argument, Arkansas cites to a Child Support Enforcement Program regulation, the Board's decision in Hillman Rehabilitation Center, DAB No. 1611, and a provision in the Workforce Investment Act of 1998 (WIA). None of these citations supports the argument Arkansas made (although, as we discuss below, the statutory provision may have some effect on the recovery of funds under WIA).

First, the cited Child Support Enforcement Program regulation, 45 C.F.R. § 305.61, does not address recovery of unallowable costs charged to federal funds. Instead, this regulation addresses the circumstances under which a state may be subject to a "financial penalty." The financial penalty results in a reduction of "amounts otherwise payable" to a state (under a different program) if, among other things, a state "failed to comply substantially" with requirements of the Child Support Enforcement Program in one fiscal year and failed to take sufficient corrective action in the succeeding fiscal year. The reduction is taken "for quarters following the end of the corrective action year" and continues until the state is in substantial compliance. No such financial penalty is at issue here.

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[5] As with respect to the earlier disallowance period, however, our decision for FY 2001 does not preclude Arkansas from seeking, through an applicable process in a federal agency other than HHS, to have applied any grant-specific provision that requires a showing of harm to the performance of the program as a prerequisite for recovery of federal funds for costs that do not meet federal requirements.

Second, the "substantial compliance" standard at issue in DAB No. 1611 applies to long-term care facilities that participate in Medicare or Medicaid, not to states. Failure to meet the standard may result in termination of participation or in other remedies, such as civil money penalties. This decision has no relevance for recovery of misspent funds from states.

Third, the WIA provision on which Arkansas relies, 29 U.S.C. § 2934(d), does appear to require a determination by the Secretary of Labor, prior to using an offset to recover funds not expended in accordance with WIA, that "the misexpenditure of funds was due to willful disregard of the requirements of this chapter, gross negligence, failure to observe accepted standards of administration, or a pattern of misexpenditure as described in paragraphs (2) and (3) of subsection (c) of this section." Such a determination may not be made until notice and opportunity for a fair hearing has been given to the recipient. This section does not, however, apply a substantial compliance test (much less a "substantial noncompliance" test) as a prerequisite for recovery of misspent funds. Thus, while our decision does not preclude Arkansas from seeking to have this provision applied by the Department of Labor, prior to recovery of WIA funds spent on DIS overcharges, we conclude that this provision does not support a general conclusion that a finding of substantial noncompliance is a prerequisite for recovery of misspent federal funds.

DCA did not overstep its role as a cognizant agency.

Arkansas argues here that DCA has no authority to recover unallowable costs on behalf of the federal government. Arkansas says that it recognizes DCA's status as cognizant agency and DCA's authority to review, negotiate, and approve cost allocation plans, as well as DCA's discretion to determine whether an adjustment or refund should be made when it later determines that a negotiated cost allocation plan included unallowable costs. AR Reply Br. at 4-5. Arkansas argues, however, that DCA's authority under OMB Circular A-87 does not allow DCA to collect funds on behalf of the federal government. In support of this argument, Arkansas relies on a statement made in the Board's decision in Indiana Dept. of Public Welfare, DAB No. 793 (1986). In that decision, the Board stated that "DCA is responsible for determining whether costs charged to more than one program . . . are claimed in accordance with a cost allocation plan, although the actual disallowance of costs determined not to be properly claimed rests with the affected program office."

Arkansas' reliance on DAB No. 793 is misplaced. That decision was issued before the 1995 revision to the Circular. The

relevant DCA authority is now addressed in Attachment C, ¶ F.3 of OMB Circular A-87, which provides:

> Negotiated cost allocation plans based on a proposal later found to have included costs that: (a) are unallowable (i) as specified by law or regulation, (ii) as identified in Attachment B of this Circular, or (iii) by the terms and conditions of Federal awards, or (b) are unallowable because they are clearly not allocable to Federal awards, shall be adjusted, or a refund shall be made at the option of the Federal cognizant agency. These adjustments or refunds are designed to correct the plans and do not constitute a reopening of the negotiation.

(Emphasis added.) Thus, as Arkansas seems to concede, DCA was clearly within its authority in determining that Arkansas needs to make a refund to the federal government because Arkansas included costs in its cost allocation plan that were unallowable. That is all that DCA has determined here.

Conclusion

For the reasons stated above or incorporated by reference, we uphold the DCA determination that Arkansas owes a cash refund for overcharges for DIS services in FY 2001 and associated interest, with the amount to be adjusted consistent with our decision above. Arkansas has 60 days from the date it receives this decision to provide to DCA the information needed for an alternative method for calculating the interest earned. If the parties do not resolve this dispute, and/or do not resolve the dispute concerning the FFP rate for ADHS, DCA should issue a new determination regarding the matter or matters. Arkansas will then have 30 days after receiving the DCA determination to appeal to the Board on any remaining matter.

Our decision does not preclude Arkansas from asserting, in an appeals process of a federal agency other than HHS, its position regarding the WIA provision discussed above or its position that a prerequisite for recovery of federal funds claimed under another agency's awards is a showing of specific harm to the federal interest (beyond the fact that federal programs overpaid Arkansas for DIS services). Regarding HHS funds, we have already ruled that neither a showing of specific harm nor a showing of substantial noncompliance is a prerequisite to recovery of HHS funds, and our decision is the final agency action on the matter. Since Arkansas has not yet obtained a favorable ruling on these issues from any other federal agency (and has not established

what the overcharges and undercharges were to any specific federal program), nothing in our decision should be read as preventing the Federal Government from collecting the full amount DCA determined was due (as adjusted pursuant to our decision) and later repaying Arkansas if another federal agency rules that an amount associated with its programs was inappropriately recovered from Arkansas.

/s/
Donald F. Garrett

/s/
Leslie A. Sussan

/s/
Judith A. Ballard
Presiding Board Member