

**Department of Health and Human Services  
DEPARTMENTAL APPEALS BOARD  
Appellate Division**

E Center

Docket No. A-15-59

Decision No. 2657

September 25, 2015

**DECISION**

E Center, a California non-profit corporation established in 1973, operates programs, including Head Start (HS), Early Head Start (EHS), Migrant and Seasonal Head Start (MSHS), and Migrant Early Head Start (MEHS), that serve children and their families in several states. These programs are financed with grants issued by the Administration for Children and Families (ACF) of the Department of Health and Human Services (HHS) under the federal Head Start Act, 42 U.S.C. § 9831, *et seq.* E Center filed this appeal challenging ACF's decision to disallow \$77,716 in expenditures that E Center charged to its HS and EHS grants during fiscal year 2013.

An independent auditor retained by ACF found that E Center improperly charged \$122,675 in capital expenditures for improvements as indirect costs to three grants (HS, EHS, and MHS) in violation of the cost principle in Appendix B, paragraph 15.b.(5) of Office of Management and Budget (OMB) Circular A-122 (codified in 2 C.F.R. Part 230). The cost principle at issue states that “[e]quipment and other capital expenditures are unallowable as indirect costs.” *Id.* E Center agreed with the audit report's finding that it had improperly charged capital expenditures as indirect costs but, after reviewing the charges, notified ACF that E Center had actually improperly charged a total of \$134,521 as indirect costs to four grants (HS, EHS, MSHS, and MEHS). Of this figure, E Center said, \$77,716 was improperly charged to the HS and EHS grants at issue here. In a letter to E Center dated March 24, 2015, ACF disallowed \$77,716 in expenditures for capital improvements that E Center improperly charged as indirect costs to the HS and EHS programs.

On appeal, E Center disputes only \$29,984 of the total \$77,716 disallowed; accordingly we affirm without discussion \$47,732 of the disallowed amount (the difference between \$29,984 and \$77,716). E Center contends that the disputed \$29,984 was not for costs of improvements to capital assets that materially increased the value of a building or its useful life and, therefore, was properly charged as indirect costs to the grants. However, as explained below, E Center did not provide any documentation or other evidence on appeal to support its contention, and the record before us, which consists of exhibits

submitted by ACF, does not support it. Accordingly, we conclude that E Center materially failed to comply with the terms of its Head Start grant award with respect to the disputed portion of the disallowance (\$29,984) and affirm the disallowance.

### **Applicable Law**

Non-profit organizations that receive federal Head Start funds are subject to OMB Circular A-122, titled “Cost Principles for Non-Profit Organizations.”<sup>1</sup> 45 C.F.R. § 74.27(a) (2013).<sup>2</sup> The cost principles in OMB Circular A-122 govern whether or to what extent a non-profit organization’s “costs” are “allowable” under (that is, may be charged to) a grant or other federal “award.” 2 C.F.R. § 230.20(a).

In order to be “allowable,” a grantee’s costs must meet various general criteria set forth in Appendix A to OMB Circular A-122. 2 C.F.R. Part 230, App. A, ¶ A.2. Costs must also “[c]onform to any limitations or exclusions set forth in [the cost] principles or in the award as to the types or amount of cost items,” and be “adequately documented.” *Id.*, App. A, ¶¶ A.2.b., A.2.g.

In addition, a grantee’s costs must be “allocable to” – that is assignable or chargeable to – its award or another “cost objective.” *Id.*, ¶¶ A.2.a and A.4; *Teaching & Mentoring Cmty., Inc.*, DAB No. 2636, at 2 (2015). The term “cost objective” is defined to include “a grant, contract, project, service, or other activity” of the grantee. 2 C.F.R. Part 230, App. A, ¶ A.4.a. Costs must be allocated to a particular cost objective “in accordance with the relative benefits received” – that is, in some proportion that reflects the benefit conferred on the objective as a result of the costs having been incurred. *Id.*; *Norwalk Econ. Opportunity Now, Inc.*, DAB No. 2543, at 2 (2013).

Appendix A further provides that the “total cost of [a federal] award is the sum of the *allowable direct and allocable indirect costs* less any applicable credits.” *Id.*, ¶ A.1 (italics added). “Direct costs are those that can be identified specifically with a particular final cost objective[.]” *Id.*, ¶ B.1. “Indirect costs are those that have been incurred for

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<sup>1</sup> The disallowance here involves costs that E Center charged to two grants, HS and EHS, for fiscal year 2013, which covers the period from July 31, 2012 to June 30, 2013. During that period, OMB Circular A-122 was codified – in its entirety and format – in Appendices A and B to 2 C.F.R. Part 230. *See* 70 Fed. Reg. 51,927 (Aug. 31, 2005). This decision cites to, and quotes from, that codification. After the grant period here ended, OMB consolidated the content of OMB Circular A-122 and eight other OMB circulars into one streamlined set of uniform administrative requirements, cost principles, and audit requirements for federal awards, which are currently published in 2 C.F.R. Part 200. 78 Fed. Reg. 78,590 (Dec. 26, 2013).

<sup>2</sup> The uniform administrative regulations in 45 C.F.R. Part 74, which apply to nonprofit organizations that receive grants or other awards administered by HHS, state that a grantee’s allowable costs will be “determined in accordance with the cost principles applicable to the organization incurring the costs.” *Id.* § 74.27(a). These regulations were in effect during the relevant grant period but were recently superseded by new regulations codified in 45 C.F.R. Part 75. *See* 79 Fed. Reg. 75,871, 75,899-75,900 (Dec. 19, 2014 interim final rule).

common or joint objectives and cannot be readily identified with a particular final cost objective” and thus must be assigned to final cost objectives on some equitable basis. *Id.* at ¶¶ C.1 and D.

Appendix B of OMB Circular A-122 addresses the allowability of specific types of costs, including capital expenditures. Appendix B, as relevant here, provides that “Equipment and other capital expenditures are unallowable as indirect costs.” App. B, ¶ 15.b.(5). “Capital expenditures” are defined as “expenditures for the acquisition cost of capital assets (equipment, buildings, land), or expenditures to make improvements to capital assets that materially increase their value or useful life.” *Id.* at App. B, ¶ 15.a.(1); *see also id.* at ¶ 27 (“Costs incurred for improvements which add to the permanent value of the buildings and equipment or appreciably prolong their intended life shall be treated as capital expenditures (*see* paragraph 15 of this appendix).”). However, costs incurred for “necessary maintenance, repair, or upkeep of buildings and equipment (including Federal property, unless otherwise provided for) which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable.” *Id.* at App. B, ¶ 27.

If a Head Start grantee “materially fails to comply with the terms and conditions” of its award, ACF may impose one or more enforcement remedies, including “[d]isallow[ing] (that is, deny[ing] both use of funds and any applicable matching credit for) all or part of the activity or action not in compliance.” 45 C.F.R. § 74.62(a)(2); *William Smith, Sr. Tri-Cnty. Child Dev. Council, Inc.*, DAB No. 2647, at 2 (2015). Compliance with the requirements specified in or incorporated by 45 C.F.R. Part 74 is a term and condition of a Head Start grant. DAB No. 2647, at 2, citing *Bright Beginnings for Kittitas Cnty.*, DAB No. 2623, at 2 (2015). A grantee has the “burden of documenting the existence and allowability of its expenditures of federal funds.” *Id.*, citing *Touch of Love Ministries, Inc.*, DAB No. 2393, at 3 (2011).

### **Case Background**

The following material facts are undisputed. E Center receives federal grant awards to operate various Head Start-related programs: HS, EHS, MSHS and MEHS. ACF Ex. 2, at 6. ACF conducted an on-site monitoring review of E Center’s HS-related grants through its contractor, an independent auditor, Randolph Scott & Company (Randolph).

In 2013, Randolph audited E Center’s financial statements for the grant fiscal years ending June 30, 2012 and June 30, 2013. ACF Ex. 2, at 3, 5-7. As part of its review, Randolph compared the costs from E Center’s general ledger to the costs included in E Center’s indirect cost proposals. In an audit report dated February 24, 2014, Randolph determined that in fiscal year 2013 (i.e., July 1, 2012 through June 30, 2013), E Center charged \$122,675 in expenditures for capital improvements as indirect costs to its HS,

EHS, and MSHS grants. *Id.* at 27. Randolph’s audit report further stated, “E Center agrees with the auditors’ comments: ‘*Capital expenditures for improvements were charged to the programs under Indirect Costs[.]*’” *Id.* at 28 (italics in original); *see also* ACF Ex. 1, at 2.

The HHS Office of Inspector General (OIG) subsequently reviewed Randolph’s audit report, and in a letter dated June 20, 2014 concluded that the “audit . . . met Federal audit requirements.” ACF Ex. 3, at 1. ACF then reviewed the audit findings and solicited additional information from E Center. ACF Ex. 4, at 1-3.

In an email dated August 5, 2014, E Center notified ACF it “discovered that the auditor’s entry for the capitalized items [listed in the audit report] did not agree with [E Center’s] records, and [E Center] needed to find out why.” ACF Ex. 4, at 1. E Center’s email further stated that “[t]here “was an error in their computation for the adjustment from Repairs and Maintenance to Capital Expenditures, and our revised amounts, although higher than what they reflected, are correct.” *Id.* E Center also stated, “The overall total expenditures for last year are correct though.” *Id.* We understand the email references to “their” and “they” to be references to the auditors and that the gist of the email was that based on its own review, E Center thought the auditors’ calculation that E Center improperly charged capital expenditures in the amount of \$122,675 actually understated the amount.

In a subsequent email to ACF dated September 12, 2014, E Center submitted a “Summary of Expenses charged to GAA – Repairs & Maintenance reclassified to Capital Expenditures” (Summary) that listed recalculated amounts for various costs. ACF Ex. 4, at 6. E Center’s recalculation shows that it reclassified as capital expenditures a total of \$134,521 that it had charged as indirect costs to the four HS-related grants (two of which are at issue in this disallowance). *Id.* E Center’s Summary further indicated (in handwritten notations) that, of this \$134,521 figure, it had charged \$15,694 in capital expenses as indirect costs to its EHS program and \$62,022 in capital expenses as indirect costs to its HS program or a total of \$77,716 for those two programs. *Id.*; *see also* ACF Ex. 1, at 2. E Center also submitted general ledger entries (“Breakdown of Total Amount of Indirect [Costs] for Fiscal Year 2012/13 by Program”) that list by month indirect costs charged to each of E Center’s four HS-related grants. ACF Ex. 4, at 7-9. (The lists for the HS and EHS grants are under “Program” numbers “700” and “800,” respectively.)

In a letter dated March 24, 2015, ACF notified E Center that it disallowed the \$77,716 as costs that were improperly charged to its HS and EHS grants for fiscal year 2013. ACF Ex. 1, at 1-2. E Center then filed this appeal.

## Analysis

“In an appeal of a federal agency’s disallowance determination, the federal agency has the initial burden to provide sufficient detail about the basis for its determination to enable the grantee to respond.” *Me. Dep’t of Health & Human Servs.*, DAB No. 2292, at 9 (2009), *aff’d*, *Me. Dept. of Human Servs. v. U.S. Dept. of Health & Human Servs.*, 766 F. Supp. 2d 288 (D. Me. 2011). If the agency carries this burden, which the Board has called “minimal,” then the nonfederal party (the grantee, in this case) must demonstrate that the costs are, in fact, allowable. *Mass. Exec. Office of Health & Human Servs.*, DAB No. 2218, at 11 (2008), *aff’d*, *Mass. v. Sebelius*, 701 F. Supp. 2d 182 (D. Mass. 2010). “When a disallowance is supported by audit findings, the grantee typically has the burden of showing that those findings are legally or factually unjustified.” *Id.*

There is no dispute here that ACF met its initial burden in disallowing the costs. In its disallowance letter, ACF stated that it was disallowing \$77,716 based on the audit report finding that E Center improperly charged capital improvement expenditures to the Head Start grants as indirect costs (Finding 2013-1-Indirect Costs). ACF Ex. 1, at 1-2. The disallowance letter referred to E Center’s statement in its response to the audit report that E Center “agreed with the auditor’s comments and disallowed costs.” *Id.* at 2; *see also* ACF Ex. 2, at 28. In addition, ACF relied on E Center’s representation in its September 12, 2014 email, with the attached Summary, that it improperly charged indirect costs totaling \$77,716. ACF Ex. 4, at 6. According to the record before us, E Center did not identify in any of its pre-disallowance communications with the auditors or ACF any costs that it believed were not expenditures for capital improvements.

However, in its brief to us on appeal, E Center now states it “[d]isagree[s]” that \$29,984 in expenditures should be included in the amount of the \$77,716 disallowance. Appeal Brief (App. Br.) at 2, 4-5. E Center identified the following expenditures, totaling \$29,984, that it claims were repair or maintenance costs, not capital improvements, and, therefore, should not have been disallowed:

- Fix lights and submeter panel: \$2379
- Fire up HVAC units and balance syste[m]s: \$1697
- Repair insulation T-bar ceiling area that is damaged: \$1832
- Painting interior: \$16,778
- Replace broken ceiling tiles and new all areas: \$1938
- Materials for finish work: \$3174
- Clean up premises: \$2186

*Id.* at 2. E Center contends that these costs were not expenditures for capital improvements but instead were for repairs for a leased building that did not materially increase the value of the premises. *Id.* at 4-5. E Center's argument is without merit.<sup>3</sup>

As previously stated, the grantee has the burden to document the existence and allowability of its expenditures of federal funds. Before even reaching the issue of whether the listed alleged repair or maintenance costs actually qualify as such (as opposed to capital improvement expenditures), E Center must document that it actually incurred those costs and that they were allocable to its HS and EHS programs during the audit period in question. E Center did not submit *any* supporting documentation for the listed expenditures or other evidence capable of showing that it actually incurred these costs and that it incurred them for its HS and EHS programs during the audit period in question. E Center merely states before listing the alleged repair and maintenance costs: "A lease was entered between a Landlord and E-Center. Prior to moving in certain itemized work on the premises was completed." *Id.* at 1. E Center does not say the lease is for property associated with its HS or EHS programs or even directly tie the reputed "repair" costs it lists to the lease to which it refers. Even assuming E Center had shown that the itemized costs were incurred for its HS and EHS programs (which it did not), it has not shown them to be related to the costs reviewed by the auditors and disallowed by ACF or even to the time period in question. Merely alleging or describing as repair costs expenditures allegedly made in an unidentified program at some unidentified point in time, falls far short of meeting E Center's burden to show that the disallowance, or the disputed part thereof, should be overturned. E Center needed to document that some portion of the costs the auditors found to be capital improvement costs are actually repair costs incurred in its HS and EHS programs for the time period covered by the audit. The fact that its argument to us is at odds with the record evidence that E Center agreed with the audit findings makes E Center's burden even heavier. The audit report and E Center's own submissions to ACF are evidence that all of the disallowed costs were for capital improvements, and E Center, as the grantee, has the burden to show otherwise. E Center has not met that burden.

We note that E Center has not attempted to rely on the Summary and related general ledger entries prepared by E Center prior to the disallowance and submitted on appeal by ACF. *See* ACF Ex. 4, at 6-9. We have reviewed those documents nonetheless and conclude that they do not help E Center. In its Summary, E Center listed a series of

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<sup>3</sup> E Center cites to three cases in its brief to support its position that capital improvement costs affecting real property value are distinguishable from repair or maintenance costs. *See* App. Br. at 2-4, citing *Keller v. Chowchilla Water Dist.*, 80 Cal. App. 4<sup>th</sup> 1006, 1013 (2000); *In re Marriage of Fabian*, 41 Cal. 3d 440, 451 n.13 (1986); *In re Marriage of McNeill*, 160 Cal. App. 3d 548, 564 (1984). These cases involve the interpretation of California state law and do not address the definitions or cost principles in the OMB Circular A-122 at issue here. But even assuming the costs itemized in E Center's appeal brief would qualify as repair or maintenance costs under the cost principles, they would not affect our decision because, as discussed, E Center has not shown that any of these costs were incurred for its HS and EHS programs during the audit period in question or tied them in any way to the costs reviewed by the auditors and disallowed by ACF.

expenses under the heading “Actual Correct Breakdown.” *Id.* at 6. However, those descriptions do not identify which entries correspond to the HS and EHS grants or what portions of those entries, if any, are for repairs that E Center now argues are allowable. More importantly, according to the heading of the Summary – “Summary of Expenses charged to GAA – Repairs & Maintenance reclassified to Capital Expenditures” – all of the expenses listed in the summary are Capital Expenditures; that is, expenditures that E Center reclassified from repair and maintenance costs to capital expenditures. The general ledger entries that E Center submitted simply identify a “Breakdown of Total Amount of Indirect [Costs] for Fiscal Year 2012/13 by Program” by month. *Id.* at 7-9. None of the entries describe the specific costs that E Center now claims are allowable. Indeed, the entries do not identify the type of costs at all, but only say they are “[i]ndirect”.

Without any documentation or other evidence to support E Center’s contention, there is no legal or factual basis for us to overturn the disallowance.

Thus, we conclude ACF properly disallowed the entire \$77,716 in capital expenditures that E Center charged as indirect costs to the HS and EHS grants for its 2013 fiscal year in violation of the cost principle at 2 C.F.R. Part 230, App. B, ¶ 15.b.(5).

### **Conclusion**

For the foregoing reasons, we sustain ACF’s disallowance of \$77,716 in its entirety.

\_\_\_\_\_/s/  
Constance B. Tobias

\_\_\_\_\_/s/  
Susan S. Yim

\_\_\_\_\_/s/  
Sheila Ann Hegy  
Presiding Board Member