

DEPARTMENTAL GRANT APPEALS BOARD

Department of Health and Human Services

SUBJECT: University of California--
General Purpose Equipment
Docket No. 78-156
Decision No. 118

DATE: September 29, 1980

DECISION

The University of California (grantee) appealed a decision by the National Institutes of Health (NIH) Grant Appeals Board, sustaining a disallowance of \$47,370 in costs claimed under Federal research projects. The Public Health Service (PHS), constituent agency for purposes of review of the NIH decision, was requested to respond to the appeal, and, in particular, to respond to a number of specific questions concerning the disallowance. Based in part on failure by PHS to be responsive to these questions, the Board Chairman issued an Order directing PHS to show cause why the disallowance should not be reversed on the grounds set forth in the Order.

The two major substantive issues addressed in the Order were 1) whether two portable freezers, included by auditors in a sample of equipment items purchased by grantee with Federal funds, should have been classified as "general purpose" equipment, and 2) whether PHS properly determined the total costs of general purpose equipment purchased without required approval by using a statistical projection. In addition, the Order questioned Board jurisdiction over part of the disallowance, since PHS had stated that the projected disallowance included costs associated with contracts.

The PHS response to the Order has clarified the way in which the sample findings were used to calculate the projected disallowance but has failed to persuade us that the statistical method used in this instance was reliable. In reaching this conclusion, we reject grantee's position that a disallowance may not be projected from a sample. As discussed below, sampling is a generally accepted audit technique, and that technique may be applied, in certain circumstances, to establish the amount of unallowable costs incurred by a grantee. On the other hand, we have a duty to inquire into the validity of the particular technique used and how it was used in each specific instance and may determine, as here, that the technique as used does not provide a reliable factual basis for a decision.

For reasons stated below, we also reverse the disallowance of the costs of the portable freezers. We do not reach the jurisdictional question raised in the Order since that question is rendered moot by our decision on the substantive issues.

Background

The NIH Grant Appeals Board decision resulted from an appeal of a determination by the Financial Advisory Services Branch (FASB), Division of Contracts and Grants, NIH, based on an HEW (now HHS) Audit Agency Report dated August 9, 1976. The auditors had selected a sample from a listing of equipment purchased by grantee from July 1, 1973 to June 30, 1975 (FY'74 and FY'75) with funds from Federal research grants and contracts. The listing consisted of 2,363 items in classifications with significant proportions of items considered to be "general purpose" equipment. In the sample of 172 items, the auditors identified 123 general purpose items and determined that grantee did not obtain required approval for the purchase of 16 of these items. The auditors estimated with a claimed probability of 90 percent that grantee had purchased general purpose equipment costing at least \$57,801 without proper approval during FY'74 and FY'75, with the single most likely estimate being \$84,999, and recommended that grantee refund at least \$57,801.

Of the 16 sample items questioned by the auditors, 10 were acquired with HEW funds. The FASB, NIH, first determined that 9 of these 10 were unallowable and disallowed \$53,676 based on an Audit Agency projection that this was the single most likely estimate of unallowable costs for all HEW projects for the audit period. The assurance factor for this projection was stated to be 95 percent.

FASB later agreed that one of the 9 items was incorrectly identified by the auditors as unallowable. The Audit Agency revised the figures, concluding, with a stated assurance factor of 90 percent, that the single most likely estimate of unallowable costs was \$47,370. The NIH Board upheld the disallowance in this amount. Since grantee has accepted disallowance of the costs of six of the HEW items in the sample, totalling \$2,764, the actual amount in dispute is \$44,606 (\$47,370 - \$2,764).

The NIH Board decision was based on two policy statements: a 1972 NIH Policy Statement, Grants for Research Projects, DHEW Publication No. (NIH) 72-8, July 2, 1972, applicable only to NIH grants for research projects, and a 1974 PHS Grants Policy Statement, DHEW Publication No. (OS) 76-50,000, July 1, 1974. The 1974 Policy Statement was intended to apply to "all transactions occurring after the date of publication" with respect to "grants made by ... the Public Health Service." (p. 2.) Grantee refers to Federal Management Circular (FMC) 73-8, Attachment A (Principles for Determining Costs Applicable to Research and Development Under Grants and Contracts with Educational Institutions), implemented by HEW at 45 CFR Part 74, Appendix D, Part I, 38 FR 26275, September 19, 1973.

The 1972 Policy Statement discusses research and general purpose equipment as follows:

Research equipment - Allowable. Individual items costing \$1,000 or more must have been in the grant budget approved by the NIH or will require prior approval ...

General purpose equipment - Allowable with prior approval by the NIN awarding unit for items costing \$200 or more. General purpose equipment is defined as items which are usable for activities of the institution other than research, i.e. office equipment and furnishings, air conditioning, reproduction equipment, automatic data processing equipment, etc. (p. 13.)

Paragraph J.13. of Part I of Appendix D to Part 74 (parallel to FMC 73-3) defines "permanent equipment" as "an item of property which has an acquisition cost of \$200 or more and has an expected service life of one year or more" and provides that--

- a. General purpose equipment. Approval must be obtained to acquire with Government funds any general purpose permanent equipment, i.e. any items which are usable for activities of the institution other than research, such as office equipment and furnishings, air conditioning, reproduction, or printing equipment, motor vehicles, etc., or any automatic data processing equipment.
- b. Research equipment. Approval must be obtained to acquire with Government funds any item of permanent research equipment costing \$1,000 or more.

The 1974 Policy Statement refers to "project-specific" rather than "research" equipment and (under the heading of "Costs") states, "Prior approval is required for project specific equipment purchases in excess of \$1,000 ... and for general purpose equipment in excess of \$300" (p. 14). Under "Property Management Standards" the following appears:

- (1) Project-specific equipment refers to equipment which directly facilitates the purposes of and is an integral part of the grant-supported programs, such as laboratory research equipment.
- (2) General purpose equipment refers to items of equipment that are generally usable for activities in the institution other than the technical, specialized activities supported by the grant, e.g. office equipment, air conditioning, office furniture, reproduction equipment, etc. (p. 51.)

It is unclear from the record which approval requirements were applied by the auditors. The Audit Report cites FMC 73-3 as providing that general purpose equipment is "any item usable for activities other than research" and refers to the "Federal policy generally" that such equipment costing \$200 or more must receive approval prior to purchase. The Report does not specify how that policy was binding on grantee with respect to all of its projects. The Report also cites the 1974 PMS Policy Statement for the proposition that "HEU agencies increased the minimum cost requiring approval to \$300...." The NIN Board decision relied on the 1972 NIN Policy Statement and the 1974 PMS Policy Statement. In response to a question in the Board's Order relating to whether PMS had approval for a deviation from FMC 73-3, arguably required because PMS required

advance written approval and FMC-73-8 does not (see, FMC 73-7), PHS stated that this was irrelevant since the basis for the disallowance was failure to obtain approval to acquire the equipment. This appears to be contradicted, however, by Audit Agency statements submitted with the PHS response, explaining that the "guidance in FMC Circular 73-8 was used for all agencies, but was supplemented by more specific criteria when appropriate." Lack of consistency on this point does not affect our decision on classification of the two freezers, as we find that none of the statements requires that these freezers be classified as "general purpose equipment." However, this lack does contribute to our doubt about the fairness of projecting the auditor's sample findings to all of grantee's HEW projects.

General Purpose Equipment

Grantee argues that the two portable freezers in the audit sample should not have been classified as general purpose equipment requiring approval because actual use of the freezers for research rendered them unfit for general use. Grantee's documentation shows that one of the freezers was used to store "specimens" and the other was used to store "scientific specimens (antiserums, antigens)" and that each would require expensive decontamination before being diverted to non-research use. PHS does not dispute this, but argues that, since prior approval must be obtained "to acquire" general purpose equipment, it is clear that the question controlling classification of equipment is whether it can be used for general purposes at the time acquired. We do not think that this necessarily follows, however. The classification of the equipment is separate from the timing of the approval process. None of the policy statements cited by PHS, except statements not in effect during the relevant time period, gives any specific guidance as to how to treat equipment which is usable for general purposes at the time acquired but which would not be usable for general purposes once committed to a project.

Furthermore, as grantee has pointed out, one reason that the policy statements are ambiguous is that some items of equipment, such as these freezers, potentially fall into either the general purpose category or the research/project-specific category. The policy statements do not provide guidance as to which prior approval requirements apply to these items.

The Board has, in several previous decisions, construed prior approval requirements in favor of a grantee, on grounds that advance approval requirements not plainly warranted by the nature of the case should not be read into ambiguous provisions. St. Landry Parish School Board, DGAB Docket No. 75-4, Decision No. 17, May 23, 1976; See, also, Point Park College, DGAB Docket No. 75-12, Decision No. 16, May 20, 1976. Whether construing the prior approval requirements to include these freezers is plainly warranted depends in part on the perceived purpose of the requirement. There is no guidance in the PHS policy statements or in the preamble to Part 74 as to what the authors of the approval requirement intended. Grantee's position is that "only equipment acquired with Federal funds which could later be used by an institution for non-Federal activities outside the research functions, is intended to be covered." (Application for Review, p. 3.) In light of this, grantee suggests that the test for

whether equipment is general purpose rests on the established pattern of usage within the institution. Grantee has stated, and PHS has not disputed, that grantee's primary use of portable freezers is for activities which are technical, specialized and research-related.

PHS "believes that the reason for the [approval] requirement is that the Government does not want to supply items of general purpose equipment to grantee/contractors...[because] they should have this type of equipment on hand and ready for use prior to receipt of grant/contract awards." This is, perhaps, one possible purpose of the requirement. On the other hand, PHS has not shown that grantee did have or should have had portable freezers ready for use on these projects and, indeed, other portable freezers used for similar purposes might also be contaminated. Thus, given the ambiguity of the policy statements, and the circumstances of this case, we conclude that these portable freezers were not general purpose equipment. Accordingly, we reverse the disallowance of \$684 in costs for the two freezers.

The Validity of Projection

Grantee does not challenge the validity of statistical sampling as an audit technique in general but questions the propriety of basing a disallowance on a projection from a sample. The NIH Grant Appeals Board, with respect to use of extrapolation from a sample as a basis for a disallowance, noted the "HEW" practice which generally utilizes this statistical sampling technique." (p. 3.) The only authority cited on this point was Chapter 6-70 of the HEW Grants Administration Manual, Projection of Cost Disallowances Resulting from Systems Deficiencies Reported by Audit. Chapter 6-70, dated April 20, 1976, was, as PHS now admits, not applicable during the time period in question and is, furthermore, intended solely as internal instructions to Department staff. 6-70-40.

An Audit Agency letter, submitted with the PHS response to the Order, cited Audit Instruction A-18, dated February 28, 1973, for the proposition that the "HEW Audit Agency has long had a formal policy of recommending financial adjustments on the basis of statistical samples." (p. 1.) That instruction was not, however, directed to, or binding on, grantee and, moreover, was not a long-standing policy at the time the affected grants were awarded.

Lack of specific provision, in the terms of grantee's research agreements, for establishing cost disallowances through projection is not necessarily grounds for reversing this disallowance, however. As the Audit Agency points out, statistical sampling has been accepted, in certain circumstances, as a basis for determining adjudicative facts. Thus, the matter may be viewed as an evidentiary issue rather than as a question of applicability of agency policy. The PHS position on this has been somewhat inconsistent. While arguing that statistical sampling could be used to establish an amount of unallowable costs, PHS took the position in its response to the appeal that use of a sampling technique was within the Department's audit responsibility and that, therefore, the technique was not reviewed by the NIH Board. If an agency disallows an amount determined through use of this audit technique, however, that agency must accept responsibility for explaining the technique and defending its validity as used in a particular case.

Grantee's Arguments

Grantee not only questioned in general the use of a projection from a sample as a basis for disallowance but argued, in particular, that 1) the legal effect of a refund to the Federal Government of the funds disallowed would be that grantee was purchasing the equipment and the projection provides an inadequate basis for determining what specific equipment grantee would be acquiring title to; and 2) since the costs are not identified to specific research agreements, grantee is not afforded the opportunity to demonstrate that the costs are in fact allowable.

As pointed out in the Board's Order, grantee's first argument fails to consider that, generally, title to equipment purchased with grant funds vests in grantee and grantee's accountability for equipment purchased with Federal funds has for the most part been waived (see 45 CFR 74.134 (1974)). Furthermore, PHS agreed to pay grantee an equipment use allowance calculated on the amount of the projected disallowance. Thus, the effect of failure to identify what specific equipment grantee would be "purchasing" with any refund would be minimal.

Grantee's second argument fails to consider that an adjustment was made to the sample for costs which grantee demonstrated to be allowable subsequent to the audit and that an adjustment to the projection was also made. Assuming the sample to be representative of the universe and the adjustment to the projection to be statistically sound, grantee would not be harmed by the failure to identify the projected costs to specific research agreements. Thus, our decision here is not based on the lack of identification of costs to the specific agreements.

Grantee's arguments did, however, raise some question as to the fairness of the technique and emphasize the need for determining whether the sample was representative and the projection statistically sound.

The Sampling Technique

In response to the Order, PHS submitted an Audit Agency letter which described the sampling technique as follows:

We selected an unrestricted random sample of 172 items in equipment classifications which contained significant proportions of general purpose equipment. All items which were not general purpose equipment were not audited and treated as acceptable.... Eight of the 98 items charged to HEW projects were found to be both general purpose equipment and unapproved. In accordance with acceptable statistical procedures for projecting the amount of unallowable costs in such cases, the total unacceptable amount for the 8 cases was divided by 172 (the number of sample cases) to determine the average amount of unacceptable cost per item. This average amount was then multiplied by the 2,363 items in the equipment classifications selected to arrive at the most likely estimate of unacceptable costs. Standard statistical techniques were utilized to determine the upper and lower limits at given levels of confidence. (Audit Agency Letter, pp. 4-5.)

While this description clarified to a certain extent the manner in which the sample was used, the letter failed to provide the detail, specifically requested in the Order, regarding the method used to calculate the disallowance and to make adjustments to the projection.

On the issue of whether the sample was truly representative of the universe, PHS responded with a conclusory statement that the sample was representative, unsupported by any analysis discussing sufficiency of the sample size or the adequacy of an unrestricted random sample for measuring these costs.

There are other considerations which support reversal here. This is not a disallowance of costs associated with one particular project but an extrapolation to all of grantee's HEW grant and contract projects over a two-year period. There is nothing to clarify whether comparable requirements applied to all of the projects in a binding way. The PHS policy statements which applied to at least some of the projects contained, as discussed above, ambiguous provisions. We note, in this connection, that all of the disallowed sample items related to PHS projects.

Further, as the projection was adjusted for questioned items subsequently determined to be allowable, the given assurance factor changed from 90 percent to 95 percent, then back to 90 percent. Certainly, the assurance factor is critical in applying any statistical evaluation. The fact that the assurance factor here varied casts suspicion on the validity of the statistical technique used. A further inconsistency arises from the fact that the Audit Agency recommended disallowance of the minimum projected amount but PHS disallowed the "most likely single estimate." PHS was specifically asked whether this was an acceptable accounting practice but responded only with vague statements that it thought the choice of this figure was "reasonable and fair."

Court Cases Distinguished

As discussed above, in certain circumstances, statistical sampling may be used to establish an adjudicative fact. The cases cited by PHS on this point are, however, distinguishable from this case.

In Georgia v. Califano, 446 F. Supp. 404 (D.Ca. 1977), a case in which a Medicaid disallowance of excess physician fees was upheld, the District Court concluded that the agency's use of statistical samples there was not arbitrary and capricious, stating that "statistical methods are well recognized as reliable and acceptable evidence in determining adjudicative facts." 446 F. Supp. at 409. The Court further stated, however, that --

...to find that statistics may be admitted as evidence of a proposition is not to say that the statistical model will always be conclusive. The weight which must be given to such statistical evidence is necessarily one which must be considered by the fact finders in light of the practical difficulties of obtaining a claim by claim review. In the instant case, statistical sampling was the only feasible method of audit [of] many thousands of claims submitted each month by each state. ... the State could present evidence to challenge the statistical samples of HEW. The State maintains a copy of each physician's actual claim. 466 F. Supp. at 410.

It appears that it would have been difficult for HEW to audit with respect to each item of equipment purchased by grantee. Use of the sampling method here may nonetheless be distinguished from its use in the circumstances presented in Georgia. First, the sample items in Georgia all related to the same program. Here, a number of types of projects are involved and different policies applied to different types and to the two grant years involved. In addition, the nature of the factor audited is distinguishable. The burden of disproving an average amount of physician overcharges is much less than the burden of disproving, by actual documentation, an allegation of failure to obtain approval for purchases of general purpose equipment, particularly where the definition of "general purpose" is less than clear.

It should also be noted that in Georgia the Court's function was not the same as that of this Board, which must make findings of fact. Also, the State had failed to challenge the HEW sample during administrative reconsideration of the disallowance. Grantee here contested the use of the sample during the informal appeals process.

In the case of Rosado v. Wyman, 322 F. Supp. 1173 (D.E.D.N.Y. 1970), the Court also qualified its reliance on statistical sampling, stating:

Statisticians can tell us with some assurance what the reliability factors and probabilities are. Only the law can decide, as a matter of procedural and substantive policy, what probabilities will be required before the courts will change the status quo by granting a remedy. 322 F. Supp. at 118.

In Rosado, the Court accepted the statistical sample as valid but did so partly on the basis that all parties had agreed that the results from the sample would be treated as a uniform result for the entire universe. PHS has not disputed grantee's statement here that it agreed to the use of a sample only as a basis for recognizing management deficiencies, not as a basis for projecting the amount of a cost disallowance.

The Board decision in California State Department of Health, DGAB Docket No. 78-69-CA-HC, Decision No. 55, May 14, 1979, is also inapposite. That decision, like Georgia, involved Medicaid overpayments and was based in part on the reasonableness in that situation of placing a burden on the grantee of presenting evidence of actual claims. In the California case, both sides agreed that it would be proper to utilize projections from a sample (taken by the State). Therefore, that decision is not controlling in this case where grantee challenges the Audit Agency projection.

Conclusion

For the reasons stated above, grantee's appeal is sustained. The holding does not, of course, preclude PHS from reauditing the costs involved. In view of the length of time which has passed since these costs were incurred, however, any further audit should be performed promptly.

/s/ Clarence M. Coster

/s/ Donald G. Przybylinski

/s/ Norval D. (John) Settle, Panel Chair