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August 30, 2018

Paul Alivisatos
Executive Vice Chancellor and Provost

Randy Katz
Vice Chancellor – Research

Executive Vice Chancellor and Provost Alivisatos and Vice Chancellor Katz:

We have completed our audit of indirect cost recovery as per our annual service plan in accordance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* and the University of California Internal Audit Charter.

Our observations with management action plans are expounded upon in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to the staff of the Sponsored Projects Office and Contracts and Grants Accounting for their cooperative efforts throughout the audit process. Please do not hesitate to call on Audit and Advisory Services if we can be of further assistance in this or other matters.

Respectfully reported,

Jaime Jue
Interim Director

cc: Vice Chancellor and Chief Financial Officer Rosemarie Rae
Vice Provost Benjamin Hermalin
Assistant Vice Provost Heather Archer
Assistant Vice Chancellor and Controller Delphine Regalia
Assistant Vice Chancellor Patrick Schlesinger
Senior Vice President and Chief Compliance and Audit Officer Alex Bustamante
Associate Chancellor Khira Griscavage

AUDIT AND ADVISORY SERVICES

Sponsored Projects — Indirect Cost Recovery Audit
Project No. 17-687

August 30, 2018

Prepared by:	Reviewed and Approved by:
Robert Asato	Jaime Jue
Auditor-in-Charge	Interim Director

University of California, Berkeley
Audit and Advisory Services
Sponsored Projects — Indirect Cost Recovery

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OVERVIEW

Executive Summary

The purpose of the audit was to assess the adequacy of controls governing the administration of campuswide indirect cost recovery and associated waivers, assuring that such exceptions meet established criteria and the financial impact of unreimbursed expenses are understood and accounted for effectively.

Currently, decisions to approve waivers to full indirect cost recovery rates (i.e., federally negotiated rates) are approved on a case-by-case basis by the assistant vice chancellor-research administration and compliance. A decision to waive full indirect cost recovery rates necessarily implies that the campus does not fully recover the share of estimated indirect costs associated with the research project. These costs must therefore be satisfied by other campus funds.

From the principal investigator's perspective, there is no disincentive to pursuing research with indirect cost recovery waivers because their research budget is based only upon direct costs approved by the sponsor. Other peer institutions, such as MIT and Stanford, adjust for this misalignment of incentives by assessing the department or school to recover some or all of the difference between the federal rate and the project rate.

Indirect cost recovery waivers represent a loss of incoming funds to the campus that must be made up somewhere else, even if there are multitudinous intangible benefits to proceeding with the research. The question for the Vice Chancellor for Research organization and the Campus Budget Office is, therefore, how much the campus is willing to continue to invest, via re-allocation of funds from other sources around the campus, to cover for research that does not bring in full cost recovery.

If federal research funding continues to decline and there is increased pressure to pursue non-federally funded research, the campus would also be well served to develop a strategy to monitor and balance indirect cost waivers across different sponsor categories and approved rates such that additional campus investment to support non-federally funded research benefits and balances the overall research mission of the campus across various disciplines. The increasing margin between actual costs expended to support research and the costs recovered via the negotiated indirect cost rate (which is negotiated assuming a certain base level of federal research) will likely grow as a source of unfunded or underfunded expenses, contributing to the campus structural deficit in the near term. The campus may wish to establish criteria for evaluating the budget impact for individual requests for indirect costs waivers or metrics for evaluating and managing the impact of waivers on the overall campus research portfolio.

Source and Purpose of the Audit

The purpose of the audit was to assess the adequacy of controls governing the administration of campuswide indirect cost recovery and associated waivers, assuring that such exceptions meet established criteria and the financial impact of unreimbursed expenses are understood and accounted for effectively. Indirect cost exceptions was identified as an area of heightened risk as well it tracks to the Improve Research Support Services campus strategic initiative's objective of enhancing research support services through improvements to structure, process, and ways of collaborating.

Scope of the Audit

The audit scope included examining current processes and internal controls in the areas of

- administration of indirect cost exceptions and recovery and
- application of negotiated rates in conformance with agreement terms and conditions.

Audit techniques included interviews with departmental personnel in the Sponsored Projects Office and Contracts and Grants Accounting regarding the current processes and control activities and analyzing the campus' indirect cost exception data for fiscal years 2014-15 and 2015-16 to determine trends in the sponsor categories for which indirect cost exceptions have been approved and the campus divisions receiving these exceptions. Our fieldwork was completed in October 2016 and a draft report was issued in March 2017. Management's response and action plan was accepted in August 2018.

Background Information

Facilities and Administration (F&A) Costs and the Indirect Cost Recovery Rate

Academic Personnel Manual, APM-020, Section II, 3. *Expenses Incurred by the University* states the university policy on efforts to recover all costs of extramurally-funded projects is

> "[f]or all tests and investigations made for agencies outside the University, a charge shall be made sufficient to cover all expenses, both direct and indirect."

Indirect costs, often referred to as "facilities and administration" costs, are those shared costs that cannot be easily associated with specific research projects but are integral to successful research, such as utilities, library expenses, office space, and other services that support research on the campus (such as the Sponsored Projects Office, Contracts and Grants Accounting, and Campus Shared Services – Research Administration). Since these shared costs are difficult to attribute directly to a specific project, an indirect cost rate is used to calculate how much the university can recover for the use of its facilities and administration as a percentage of direct costs incurred on any given sponsored project. Different indirect cost rates apply to on- or off-campus research, instruction, and other sponsored activities. The campus negotiates its federally approved indirect cost rate with the US Department of Health and Human Services (DHHS). Unless there is an exception, federally-funded sponsored projects use the DHHS approved rate.

While the campus makes every effort to recover all costs of extramurally-funded projects, there is a consensus among those we interviewed that funds recovered from sponsors to support the indirect costs of their projects do not fully reimburse the campus' expenses associated with supporting research.

This perception is echoed in the UC Office of the President's *Indirect Cost Waiver Policies and Practices Workgroup Recommendations Report* (July 2, 2012), the product of a systewmide work group of senior research administrators, which explains why sponsors' funds for supporting the indirect costs of projects do not fully reimburse the campus' expenses.

- "Federally-negotiated rates contain many 'restrictions' which limit indirect cost recovery for legitimate costs. For instance, the federal government has capped reimbursement for administrative costs at 26% since 1991, despite the increasing administrative, compliance and reporting requirements which have been added year after year."

- "A major factor in the under-recovery of indirect costs is the intentional waiver of full cost recovery for specific projects, sponsors or types of research. A significant number of research sponsors do not reimburse the University for indirect costs, or do so at a greatly reduced rate."

- "Many of these waived indirect costs are not necessarily recoverable. Some waivers are vital to campus interests, where the benefit of securing funding for a proposed project outweighs the financial burden of subsidizing these indirect costs. Others are based on written sponsor policies which limit the amounts sponsors are willing to pay for indirect costs."

Exceptions to the Negotiated Indirect Cost Rate

The university's general position is that all sponsored research should recover indirect costs at least at the federally negotiated rate for each campus. According to the UC Contract and Grant Manual, Section 8-632, a request for a waiver (or exception) to a federally negotiated indirect cost rate may be for an individual award or a class of awards. Individual exceptions are valid only for a named single award and a class exception applies to all awards under the particular sponsor's program.

Exception requests are considered under one of two criteria, either sponsor policy or campus vital interest. A class exception may be approved only on the basis of sponsor policy and individual exceptions are based on campus vital interest. The Contract and Grant Manual, Section 8-634, describes vital interest as "the development of campus research, training or public service programs or infrastructure may best be served by accepting a sponsored award at less than the indirect cost rate normally paid by the sponsor." Further, this section states that, "[s]uch interests must be viewed as vital to a campus to the extent that funding the proposed project at a loss is more important to the campus than recovering the full indirect costs."

According to the Delegation of Authority Letter DA 2592, dated March 2, 2018, the vice chancellor for research delegated authority to the assistant vice chancellor-research administration and compliance "to approve the application of an indirect cost rate other than the 'approved indirect cost rate' in the submission and acceptance of extramural contracts and grants. This authority is not applicable to federal funding that is received directly or indirectly. For State of California funding, this authority is granted only for indirect cost rates above a threshold established by the Office of the President, and only for funds that are not covered by 2 CFR 200."

Campus Waived Indirect Costs

Based upon an analysis of data in the campus financial system, which has a data category that tracks dollar amount associated with the difference between the federally-approved rate and the actual accepted rate contained in the sponsored agreement or contract, the dollar value associated with indirect cost recovery rates that were below negotiated rates was approximately $41 million for FY2014-15 and $38 million for FY2015-16. We did not undertake efforts to independently validate these calculations generated by the campus financial system.

Summary Conclusion

Currently, decisions to approve waivers to full indirect cost recovery rates (i.e., federally negotiated rates) are approved on a case-by-case basis by the assistant vice chancellor-research administration and compliance. A decision to waive full indirect cost recovery rates necessarily implies that the campus does not fully recover the share of estimated indirect costs associated with the research project.[1] These costs must therefore be satisfied by other campus funds.

From the principal investigator's perspective, there is no disincentive to pursuing research with indirect cost recovery waivers because their research budget is based only upon direct costs approved by the sponsor. Other peer institutions, such as MIT and Stanford, adjust for this misalignment of incentives by assessing the department or school to recover some or all of the difference between the federal rate and the project rate.

Indirect cost recovery waivers represent a loss of incoming funds to the campus that must be made up somewhere else, even if there are multitudinous intangible benefits to proceeding with the research. The question for the Vice Chancellor for Research organization and the Campus Budget Office is, therefore, how much the campus is willing to continue to invest via re-allocation of funds from other sources around the campus to cover for research that does not bring in full cost recovery.

If federal research funding continues to decline and there is increased pressure to pursue non-federally funded research, the campus would also be well served to develop a strategy to monitor and balance indirect cost waivers across different sponsor categories and approved rates such that additional campus investment to support non-federally funded research benefits and balances the overall research mission of the campus across various disciplines. The increasing margin between actual costs expended to support research and the costs recovered via the negotiated indirect cost rate (which is negotiated assuming a certain base level of federal research) will likely grow as a source of unfunded or underfunded expenses, contributing to the campus structural deficit in the near term. The campus may wish to establish criteria for evaluating the budget impact for individual requests for indirect costs waivers or metrics for evaluating and managing the impact of waivers on the overall campus research portfolio.

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[1] Even though university practice accepts the use of indirect cost rates negotiated with cognizant federal agencies as meeting requirements to obtain full cost recovery, some individuals we interviewed as part of this audit point out that even negotiated rates do not fully recover research support costs because of limitations and exclusions of certain indirect cost elements in federal rate negotiation.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Impact of Indirect Cost Waivers on Campus Finances

Observation

University policy allows for exceptions from use of the indirect cost rates negotiated with the campus's cognizant federal agency. However, exceptions are currently granted for one of two reasons: (1) sponsor policy or (2) campus vital interest. Guidance from the Office of the President states that a campus vital interest exists when

> "the development of campus research, training, or public service programs or infrastructure may best be served by accepting a sponsored award at less than the indirect cost rate normally paid by the sponsor."[2]

Currently, decisions to approve waivers to full indirect cost recovery rates (i.e., federally negotiated rates) are approved on a case-by-case basis by the assistant vice chancellor-research administration and compliance.

A decision to waive full indirect cost recovery rates necessarily implies that the campus does not fully recover the share of estimated indirect costs associated with the research project.[3] These costs must, therefore, be satisfied by other campus funds.

In instances where sponsor policy prohibits using the federally negotiated rates, the waiver decision is binary. We accept the sponsor terms or do not perform the research. If we accept the sponsor terms, we have implicitly assessed that the non-monetary benefits associated with the prospective research outweigh the campus investment to cover an uncovered share of indirect cost. Similarly in cases proposed by principal investigators, department chairs, or deans where accepting a lower or no indirect cost recovery rate is in the vital interest of the campus, the share of foregone indirect costs creates a resource demand.

From the principal investigator's perspective there is no disincentive to pursuing research with indirect cost recovery waivers because their research budget is based only upon direct costs approved by the sponsor. Indirect cost recovery is retained by the campus to pay for institutional research support (libraries, laboratory space, research administration, etc.) Other peer institutions,

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[2] Kusiak, Michael. Office of Research & Graduate Studies. Research Policy Analysis & Coordination. January 17, 2013 letter. "Subject: University of California Indirect Cost Recovery Policy and Guidance Summary"

[3] Even though university practice accepts the use of indirect cost rates negotiated with cognizant federal agencies as meeting requirements to obtain full cost recovery, some individuals we interviewed as part of this audit point out that even negotiated rates do not fully recover research support costs because of limitations and exclusions of certain indirect cost elements in federal rate negotiation.

such as MIT[4] and Stanford[5], adjust for this misalignment of incentives by assessing the department or school to recover some or all of the difference between the federal rate and the project rate.

Indirect cost recovery waivers represent a loss of incoming funds to the campus that must be made up somewhere else, even if there are multitudinous intangible benefits to proceeding with the research. The question for the Vice Chancellor of Research organization is, therefore, how much we are willing to continue to invest via re-allocation of funds from other sources around the campus to cover for research that does not bring in full cost recovery.

If federal research funding continues to decline and there is increased pressure to pursue non-federally funded research, the campus would also be well served to develop a strategy to monitor and balance indirect cost waivers across different sponsor categories and approved rates such that additional campus investment to support non-federally funded research benefits and balances the overall research mission of the campus across various disciplines.

Furthermore, if under the current presidential administration, federal funding for research decreases for certain areas, the margin between actual costs expended to support research and the costs recovered via the negotiated indirect cost rate (which is negotiated assuming a certain base level of federal research) will likely grow, contributing to the campus structural deficit in the near term. As a result, the disassociation of the process for evaluating and approving indirect cost recovery waivers and the campus budget planning process represents a potentially increasing source of unfunded or underfunded expenses for the campus. The campus may wish to establish criteria for evaluating the budget impact for individual requests for indirect costs waivers or metrics for evaluating and managing the impact of waivers on the overall campus research portfolio.

Management Response and Action Plan

The assistant vice chancellor-research administration and compliance agrees that the campus must take steps to maximize, to the extent feasible, the collection of indirect cost rates associated with sponsored projects. We include a number of measures to be implemented and evaluated for future implementation.

As the report notes, there are limits on the collection of indirect costs imposed by the sponsor that the campus must accept if it wants to accept the funding. The federal sponsors not only limit administrative overhead to 26% (and have since 1991) but only permit overhead to be applied to a subset of direct costs. This subset is defined as Modified Total Direct Costs (MTDC). MTDC includes items such as salaries and wages, fringe benefits, materials, supplies, services, and subawards up to the first $25,000 of each subaward. MTDC limits items such as equipment, capital

4 From the MIT Office of Sponsored Programs: "F&A Underrecovery (UR) is the difference between the current negotiated F&A rate that MIT charges to a sponsored research project and the rate that the sponsor is willing to pay….MIT Policy on Research Underrecovery: At the time of research proposal development, the total anticipated underrecovery of F&A for each year of the award must be noted in Kuali Coeus along with the specific source(s) of funds (Department, Center, School, or VPR) that will cover the underrecovery." http://osp.mit.edu/grant-and-contract-administration/underrecovery

5 Stanford assesses an infrastructure charge on sponsored project awards assessed an F&A rate of 0%. https://doresearch.stanford.edu/research-administration/financial-Concepts/infrastructure-charges

expenditures, student tuition remission, scholarships, fellowships, and the portion of each subaward above $25,000.

Similarly, in awards from the State of California, UC's Office of the President has directed the campuses to collect certain rates on a defined schedule (currently 25% increasing to 40% starting July 1, 2021). The audit report also notes that certain sponsors, such as some charitable foundations, publish overhead cost policies of general applicability that place the campus in the position of either agreeing to perform the research at the sponsor's reduced indirect cost rate or declining to accept the award.

These limitations are important to note in devising a realistic strategy to increase recovery of indirect costs and properly defining what should be considered "under recovery" of indirect costs. Other schools noted in the report such as MIT require the department or originating unit to make up the difference between the estimated realized amount collected on a federal award and the amount to be collected under a sponsor policy with a lower indirect cost rate. However, such schools may have access to sources of funding (such as a larger endowment on a researcher per capita basis.)

To support increased recovery of indirect costs, we believe that certain measures should be implemented or evaluated for implementation. These include the following:

- The campus should prepare a set of educational materials aimed at faculty members that explain in straight-forward terms the importance of full recovery of indirect costs. These materials would explain how these costs are calculated and charged and how they are used by the campus to support research. Some faculty members believe that indirect costs do not benefit the research enterprise and there have been instances in which they encouraged sponsors not to provide them.
- Create a workgroup of faculty, costing policy, sponsored project office, and contract and grant accounting representatives to develop strategies to increase indirect cost recovery. This group would be charged with defining and monitoring under recovery of IDC and would evaluate proposed methods of increasing recovery.
- Evaluate the need for better definitions and/or guidance on on-campus vs. off-campus research. Because the rate for off-campus research (26%) is so much lower than on- campus research (57%), there is a financial incentive for researchers to argue for an off-campus rate.
- Evaluate the need for better definitions and/or guidance on vendor agreements vs. subawards. Because IDC on subawards is limited to the first $25,000, there is a financial incentive for researchers to argue for vendor agreements to be treated as subawards.
- Evaluate the establishment of a policy for collection of a minimum rate on all projects, regardless of sponsor. While the policy might not go as far as MIT and require that all awards collect IDC as though they were federal awards, an intermediate step (such as Stanford University's minimum 8% rate) could be considered.
- Evaluate whether the campus should re-consider its current practice of using vital interest waivers for certain non-research projects. For example, IDC is often waived on under-represented minority outreach programs and projects that support collections of libraries and museums. The campus might determine that some minimum rate, such as 10%, is appropriate to reduce the subsidy of these programs.

- Work with national associations to maintain current federal indirect costing policy on sponsored projects.
- Work with national associations to increase research-related costs on foundation projects.

For the above measures, management plans to have implemented or evaluated progress and milestones by July 31, 2019.