

September 23, 2010

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***Subject: Service Agreements
Audit & Management Advisory Services Project 2010-05***

Audit & Management Advisory Services (AMAS) has completed a review of Service Agreements as part of the approved fiscal year 2009/10 audit plan. This report summarizes the results of our review.

Background

A service agreement is a written legal agreement between the University and an external source containing terms and conditions under which goods or services are to be furnished by the University. Service agreements are generally differentiated from contracts or grants for effort related to research, instruction, or public service if the scope of work from the procuring agency relates to a clearly defined known quantity versus a project which involves definition and development of a protocol within the scholarly expertise of the University. Service agreements are reviewed and approved by Purchasing-Business Contracts for the general campus, the School of Medicine (SOM) Dean's Office for Health Sciences, the Scripps Institution of Oceanography (SIO) Director's Office for SIO.

Since 2004, several campus work groups and task forces have been formed to analyze and recommend solutions to continuing issues surrounding the proper classification of service agreement activity versus research activity and the application of appropriate overhead rates to recover campus administrative costs associated with the activity. These efforts are described below.

In January 2004 the UCSD Controller charged a Service Agreement Work Group (SAWG) to develop a procedure for the effective and complete review, negotiation, and approval of campus service agreements. AMAS participated in this work group, in an advisory capacity, along with representatives from across general campus, health sciences, and the Scripps Institute of Oceanography.

The SAWG report issued in January 2006 noted that, although a significant portion of service agreement activity occurred through campus recharge activity which utilized campus-approved

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billing rates, there were not well-defined processes, delegations of authority, or training to ensure that these activities conformed to University policy. The SAWG estimated that approximately \$5.73M in service agreement activity was via recharge. The remainder of service agreement activity was essentially one-time occurrences, or non-recharge activity, which was estimated at \$8.88M. The complexity of these activities often contributed to the misclassification of activities which should be considered research agreements, not service agreements. The SAWG also noted that misclassification of service agreements may be influenced by the perception that service agreements involved a less complicated process and because a significant portion of the required overhead was returned directly to the department. Further, the SAWG noted that the distribution of the indirect cost recovered by service agreement activity was not uniformly applied campus-wide in accordance with policy. The SAWG report included recommendations to improve campus management of service agreements, which are summarized below:

Standardization of Tools and Processes – The SAWG recommended the campus adopt a new, clear definition of the term “Service Agreement” and utilize standardized tools such as a Service Agreement Checklist and Service Agreement Template. In addition, better classification of service agreements versus other sponsored activity, in accordance with the new definition, would reduce campus risk in this area. The development of campus-wide training and Blink guidance was also recommended, as was a review of University Extension processes which were not included in the SAWG review.

Oversight – The SAWG recommended the formation of an Oversight Committee to ensure appropriate classification of service agreements and policy compliance. In addition, increased Vice Chancellor oversight in the review and approval of recharge activity, which may include activity requiring a service agreement, was recommended.

Costing – The SAWG recommended that processes for costing service agreements be improved to ensure that all departments assess administrative overhead on the direct cost of providing good and services to non-UC clients, as provided for in policy, and that the current service agreement differential income model be reviewed. In addition, SAWG recommended a team should be created to review the use of ISIS for billing and make any recommendations in this area.

Policy – The SAWG recommended that UCSD PPM 500-4 be updated to reflect changes in the service agreement process, and that University Regulation No. 4 be revisited and updated to reflect the current environment of University-industry relations. It was also recommended that delegation of authority be created, updated, or re-confirmed where appropriate.

As a result of the SAWG report, the Chancellor charged the Service Agreement Implementation Committee in April 2007, chaired by the Vice Chancellor Research, to determine how the recommendations contained in the SAWG report should be implemented, and what policy changes, if any, should be adopted. The Charge Letter for this committee is included as *Attachment A*.

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In November 2006, AMAS completed a review of SOM Service Agreements. The objective of this review was to evaluate SOM contracting processes for service agreements including the proper classification of contracts, and resulting assessment of charges for facilities and administration (overhead) costs. This review also concluded that campus policies and procedures for the negotiation and execution of service agreements were outdated and did not adequately prescribe processes, responsibilities, and authorities for the effective management of service agreement activity. SOM contracting processes for service agreements did not consistently result in the proper classification of contracts and the correct assessment of indirect charges for campus overhead. This was attributable to an outdated system-wide Regulation 4, outdated and incomplete campus policies and procedures, and some non-compliant contracting practices.

In December 2008, the Auxiliary & Self-Supporting Activities (ASSA) Tiger Team was appointed to review current cost recovery on sales and services by campus auxiliary and self-supporting operations to ensure that campus overhead costs are fully recovered. As service agreements represent a self-supporting activity, they fall under the purview of the ASSA Tiger Team, although this team did not separately analyze service agreements separate from other ASSA's.

The ASSA Tiger Team made a number of immediate and short-term recommendations to address the under-recovery of administrative costs. These recommendations included review by the Campus Recharge Rate Review of current procedures to ensure units' compliance with existing policy, including proper classification of activities and confirmation that rate charges to outside users include the recovery of applicable overhead costs. The committee recommended the development of an auxiliary overhead rate based on the methodology used to negotiate campus recovery with the federal government, and standardization & automation of processes for the recovery of ASSA administrative overhead, similar to the automated process in place for campus research activity and overhead (facilities & administrative) cost recovery.

Because many of the recommendations made by the Tiger Team required further analysis before they could be implemented, the ASSA Task Group was charged in November 2009 to continue the work of the Tiger Team and identify how best to proceed with implementation. Among the Tiger Team recommendations that were identified as the primary focus of this Task Group were to:

- Develop an administrative overhead rate(s) by using the current cost-based overhead rate development approach and costing principles used by the University and the federal government to set overhead rates for sponsored projects;
- Evaluate the assessment of campus overhead on other self supporting activities and use of the actual calculated rate rather than the federally negotiated, and discounted, rate;
- Address auxiliary and other self supporting activities identified as not remitting or under-remitting overhead to the campus; and
- Standardize and automate the overhead recovery process, similar to the current process for sponsored projects.

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Objectives, Scope, and Procedures

The objective of our review was to evaluate campus practices for the oversight of service agreements, and determine the extent to which the campus has implemented the recommendations of the Service Agreement Work Group. We performed the following procedures to meet our objectives:

- Reviewed relevant University and campus policies pertaining to service agreements;
- Later viewed relevant campus-wide reports addressing or referencing service agreement issues, such as those from the Service Agreement Work Group (2006), the ASSA Tiger Team (June 2009), and the Senate-Administration Task Force on Budget (January 2010); and
- Evaluated the current status of campus efforts on service agreement issues, including the implementation of recommendations from the various reports.

Conclusions

Based on our review procedures, we concluded that the direction of the ASSA Tiger Team and Task Group to develop administrative overhead rates based on the methodology used to negotiate campus recovery with the federal government, and to standardize and automate processes for recovery of the administrative overhead will largely address the continuing concerns that service agreements be consistently priced and that overhead costs be recovered and distributed in accordance with policy.

In addition, we noted that Purchasing-Business Contracts has adopted and enhanced the standardized templates and checklists recommended by the SAWG, and posted these tools and additional guidance on Blink for all campus users to access. We also noted that Purchasing-Business Contracts requires, for each proposed service agreement, that the department develop and submit a formal budget identifying costs that will be incurred to provide the services and differential income. Further delegation of authority for contracting of approved campus recharge activities should be implemented from Purchasing-Business Contracts to campus departments.

However, we noted that the campus has not yet fully implemented many of the other recommendations of the 2006 Service Agreement Work Group report. In particular, processes have not been established to provide oversight to ensure appropriate classification of service agreements and policy compliance, and relevant policies have not been updated to reflect changes in the service agreement process or current environment of University-industry relations.

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Observations and Management Corrective Actions

Some recommendations adopted by the Service Agreement Work Group have not yet been fully addressed.

The ASSA Task Group is moving forward with development of an administrative overhead rate for auxiliary and some specific self-supporting academic activities. The ASSA Task Group report specifies that other self-supporting activities not subject to the administrative overhead rate are required to comply with existing campus policy for income-producing activities, and are subject to the differential income rate, currently 45%, which will be consistent with the cost principles used by the University and the federal government to set overhead rates for sponsored projects. In addition, an automated process is in development to assess and distribute differential income.

While the progress of the ASSA Tiger Team and Task Group addresses many concerns regarding service agreement processes raised by prior campus work groups, several important recommendations of the SAWG have not yet been completed. These include:

- Increased Vice Chancellor Role in the Review and Approval of Recharge Activity, including increased communication between the Recharge Rate Review Committee and the Vice Chancellors;
- Development of an Oversight Committee;
- Request UCOP Revisit Recommendation to Revise Regulation 4 *Special Services to Individuals and Organizations*;
- Update PPM 500-4 *Approval and Execution of Incoming Purchase Orders for University Goods and Services*; and
- Establish a Billing and Collection Review Team to review the use of ISIS for billing and, if appropriate, recommend improvements to establish a uniform effective billing system.

Management Corrective Actions:

The Office of VCR will continue the charge of the Service Agreement Implementation Committee under the delegation of authority from the Chancellor, and initiate efforts to review and implement the remaining recommendations of the SAWG not already addressed as part of the ASSA Tiger Team / Task Group efforts.

Specifically, the Service Agreement Implementation Committee will form a standing oversight committee (or similar work group) which may include representatives from Purchasing, General Accounting, Technology Transfer, Health Sciences, SIO, and others as appropriate. Representation on this work group should also include Financial Analysis Office, to provide consistency with the Recharge Rate Review Committee on costing issues, as appropriate. The purpose of this oversight work group would be to:

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- Address the revision of PPM 500-4 and delegations of authority related to service agreement contracting;
- Provide policy interpretation and guidance for individuals responsible for processing service agreements, including exceptions granted for charging of differential income in accordance with the ASSA Task Group recommendations;
- Serve as a resource to resolve issues related to service agreement classification and/or processing responsibility; and
- Refer issues outside the purview of this workgroup to the appropriate campus authority.

We appreciate the cooperation and assistance provided during the review. Audit observations will be added to our follow-up system. While management corrective actions have been included in the audit report, we may determine that additional audit procedures to validate the actions agreed to or implemented are warranted. We will contact you to schedule a review of the corrective actions, and will advise you when the findings are closed.

UC policy requires that all draft audit reports (copied on tan paper for ease of identification) be destroyed after the final report is issued. Because draft reports can contain sensitive information, please either return these documents to AMAS personnel or destroy them at this time.

If you have any questions regarding this report, please call me at 534-3617.

Stephanie Burke
Assistant Vice Chancellor
Audit & Management Advisory Services

cc: D. Bennett
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S. Carter
L. Collins
T. Johnson
D. Larson
S. Lepe
D. McGraw
T. Perez
S. Vacca
N. Wilson

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Attachment A – Service Agreement Implementation Committee Charge Letter

April 9, 2007

Art Ellis, Vice Chancellor – Research, Chair
David Brenner, Vice Chancellor – Health Sciences
Tony Haymet, Vice Chancellor – Marine Sciences (or designated senior representative Ken Melville)
Don Larson, Controller
Yu-Hwa Lo, Professor, Electrical & Computer Engineering
Jane Milner-Mares, Business Officer, Family & Preventive Medicine
Gary Firestein, School of Medicine
Dallas Thornton, San Diego Supercomputer Center

SUBJECT: Charge of Service Agreement Implementation Committee

Dear Colleagues:

As you know, the ability of our faculty to establish and nurture effective scientific and business relationships with industry is a significant strategy in assuring UC San Diego's future growth and success as a world leader in research that benefits society at large. After extensive study of the service agreement policy and process, the initial Service Agreement Workgroup issued its report. I am appreciative of the Workgroups diligent efforts and many excellent recommendations to enhance the service agreement process and manage the risk associated with this type of activity. The Health Sciences representatives on the original workgroup, and subsequently representatives of the Health Sciences faculty, have expressed concerns regarding certain aspects of the report's recommendations. Those concerns are appreciated as well.

The charge of the Service Agreement Implementation Committee is to determine how the recommendations contained in the original workgroup report should be implemented, and what policy changes, if any, should be adopted. During the course of your work, I ask that you very carefully consider the following guiding principles:

- 1) The ability to use service agreements to stimulate and grow the research activity at UC San Diego is a useful and necessary strategy, and the growth of this type of activity needs to be encouraged and supported.
- 2) The definition and treatment of service agreement activity at UC San Diego needs to be consistent and uniform, so unambiguous and understandable guidance can be given to all service agreement practitioners.

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Attachment A – Service Agreement Implementation Committee Charge Letter

- 3) The process to develop, review, approve, and execute service agreements must be thorough enough to adequately mitigate the potential risk associated with this type of activity, while being efficient enough to ensure that this activity is not hindered.
- 4) While the funding provided directly by this activity is useful, a much larger benefit is provided through the potential for replacement of declining federal research dollars with funds generated as a result of relationships with private entities that are developed through service agreement activity.
- 5) Appropriate allocation of cost and administrative overhead to service agreement activity is essential to sustain the effectiveness of this business practice, and to satisfy the requirements for consistent cost allocation prescribed by federal regulations.
- 6) The template recommendation of the initial service agreement workgroup is an excellent idea, and an essential component of a successful implementation of an effective service agreement process.
- 7) You are encouraged to seek best practices in effective service agreement activity and management by contacting colleagues at other major research universities.

I am requesting that this committee issue its final report to me within three months of the date of this charge. The following individuals have agreed to act as staff to this committee to facilitate a comprehensive awareness of the issues vetted by the original workgroup, and to provide a coordination point for any detailed information gathering that may be necessary for this committee to accomplish its charge:

Ron Espiritu, Assistant Vice Chancellor, School of Medicine
Diane Wynshaw-Boris, Business Contracts Manager, Business & Financial Services

I appreciate your taking the time from your full set of responsibilities to serve UC San Diego in this capacity. Further, I appreciate the willingness of Art Ellis to serve as chair of this committee.

With kind regards,

Marye Anne Fox
Chancellor

cc: M. Chandler
R. Espiritu
S. Relyea
D. Wynshaw-Boris