Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

THE COUNCIL ON RURAL SERVICE PROGRAMS, INC., CLAIMED UNALLOWABLE HEAD START COSTS

Inquiries about this report may be addressed to the Office of Public Affairs at Public.Affairs@oig.hhs.gov.

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Office of Inspector General

https://oig.hhs.gov

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OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

The designation of financial or management practices as questionable, a recommendation for the disallowance of costs incurred or claimed, and any other conclusions and recommendations in this report represent the findings and opinions of OAS. Authorized officials of the HHS operating divisions will make final determination on these matters.

EXECUTIVE SUMMARY

The Council on Rural Service Programs, Inc., claimed unallowable Head Start costs of $1.1 million and an additional $4.3 million of executive and administrative salary and fringe benefit costs that were inadequately supported under applicable Federal regulations and the terms of the grants.

WHY WE DID THIS REVIEW

Oversight and management of grant programs is crucial to the U.S. Department of Health and Human Services' (HHS) mission and to the health and well-being of the public. Audits of Head Start and other HHS grantees have found internal control deficiencies, problems with financial stability, inadequate organizational structures, inadequate procurement and property management policies, and inadequate personnel policies and procedures.

Our objective was to determine whether the Council on Rural Service Programs, Inc. (the grantee), claimed Head Start costs that were allowable under applicable Federal regulations and the terms of the grants.

BACKGROUND

Title VI of the Omnibus Budget Reconciliation Act of 1981 established Head Start as a Federal discretionary grant program. The Head Start program provides grants to local public and private for-profit and not-for-profit agencies to provide comprehensive child development services to economically disadvantaged children and families. The focus is on helping preschoolers develop the early reading and math skills they need to be successful in school. In 1994, the Head Start program was expanded to establish Early Head Start, which serves children from birth to 3 years of age, to promote prenatal care, enhance the development of infants and toddlers, and promote healthy functioning of families.

Within HHS, the Administration for Children and Families, Office of Head Start (OHS), administers the Head Start program. In fiscal years (FYs) 2009 and 2010, Congress appropriated approximately $7 billion per year to fund Head Start's regular operations.

The American Recovery and Reinvestment Act of 2009 (Recovery Act), P.L. No. 111-5, enacted on February 17, 2009, provided an additional $2.1 billion to expand the Head Start and Early Head Start programs during FYs 2009 and 2010. These funds were intended for activities such as expanding enrollment, funding cost-of-living wage increases for grantees, upgrading centers and classrooms, and bolstering training and technical assistance.

The grantee is a nonprofit organization, in operation for 39 years, that was established to plan and coordinate programs designed to combat poverty and to provide comprehensive education and support services to individuals and families. The grantee provides services in nine counties in west-central Ohio. The grantee's Head Start program is funded primarily through Federal grants. During our review period, OHS provided the grantee with $37.2 million in Head Start funding, which consisted of $31 million in Head Start and Early Head Start funding and an additional $6.2 million of Recovery Act funding. The grantee also received funding from other Federal, State, and local sources for non-Head Start youth programs, as well as adult education and volunteer programs.

HOW WE CONDUCTED THIS REVIEW

We reviewed $6,722,789 of Head Start costs that the grantee claimed during the audit period of January 1, 2009, through December 31, 2011. The costs that we reviewed were expended by the grantee solely for executive and administrative staff payroll, lease and rental payments, and miscellaneous costs incurred at the administrative offices. We did not review program costs that the grantee incurred at the Head Start centers. We reviewed the grantee's organizational structure, financial systems, facilities management, methodology for allocating payroll to grant awards, and lease agreements. We reviewed $4,287,883 in executive and administrative staff payroll and $1,624,384 in costs associated with lease and rental payments. We also reviewed 82 judgmentally selected expenditures totaling $810,522.

WHAT WE FOUND

Of the $6,722,789 in Head Start costs that we reviewed, the grantee claimed $1,360,554 that was allowable under applicable Federal regulations and the terms of the grants. However, of the remaining $5,362,235, the grantee claimed unallowable costs of $1,074,352, consisting of:

- $944,654 in less-than-arms-length lease payments;
- $59,489 in classroom rental payments that were improperly allocated to the Head Start program or did not benefit the Head Start program; and
- $70,209 in other costs that were improperly allocated to the Head Start program, did not benefit the Head Start program, or were not otherwise allowable under Federal regulations and the terms of the grants.

We could not determine the allowability of the remaining $4,287,883 in executive and administrative salary and fringe benefit costs that the grantee claimed under its Head Start grants because the grantee did not adequately support, with personnel activity reports, the distribution of salaries and wages.

WHAT WE RECOMMEND

We recommend that the grantee:

- refund unallowable less-than-arms-length lease payments totaling $944,654;
- refund unallowable classroom rental payments totaling $59,489;

- refund costs totaling $70,209 for gift cards and other costs that did not benefit the Head Start program;

- either refund $4,287,883 to the Federal Government for inadequately supported executive and administrative salary and fringe benefit costs, of which as much as $1 million could have been for non-Head Start costs, or work with OHS to determine what portion of the costs was allowable; and

- take corrective actions to ensure that it:

    - makes lease payments for less-than-arms-length lease agreements in accordance with Federal requirements,

    - maintains personnel activity reports for employees working on Federal awards, and

    - institutes proper policies and procedures for allocating costs that benefit multiple programs.

GRANTEE COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

In written comments on our draft report, the grantee generally disagreed with our recommendations related to less-than-arms-length lease payments, classroom rental payments, gift cards and other costs, and executive and administrative salary and fringe benefit costs. The grantee's comments did not cause us to change our recommendations. However, we have updated the final report to address comments where appropriate.

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INTRODUCTION

WHY WE DID THIS REVIEW

Oversight and management of grant programs is crucial to the U.S. Department of Health and Human Services' (HHS) mission and to the health and well-being of the public. Audits of Head Start and other HHS grantees have found internal control deficiencies, problems with financial stability, inadequate organizational structures, inadequate procurement and property management policies, and inadequate personnel policies and procedures.

OBJECTIVE

Our objective was to determine whether the Council on Rural Service Programs, Inc. (the grantee), claimed Head Start costs that were allowable under applicable Federal regulations and the terms of the grants.

BACKGROUND

Federal Head Start Program: What the Program Provides

Title VI of the Omnibus Budget Reconciliation Act of 1981 established Head Start as a Federal discretionary grant program. The Head Start program provides grants to local public and private for-profit and not-for-profit agencies to provide comprehensive child development services to economically disadvantaged children and families. The focus is on helping preschoolers develop the early reading and math skills they need to be successful in school. In 1994, the Head Start program was expanded to establish Early Head Start, which serves children from birth to 3 years of age, to promote prenatal care, enhance the development of infants and toddlers, and promote the healthy functioning of families.

Within HHS, the Administration for Children and Families (ACF), Office of Head Start (OHS), administers the Head Start program. In fiscal years (FYs) 2009 and 2010, Congress appropriated approximately $7 billion per year to fund Head Start's regular operations.

The American Recovery and Reinvestment Act of 2009 (Recovery Act), P.L. No. 111-5, enacted on February 17, 2009, provided an additional $2.1 billion to expand the Head Start and Early Head Start programs during FYs 2009 and 2010. These funds were intended for activities such as expanding enrollment, funding cost-of-living wage increases for grantees, upgrading centers and classrooms, and bolstering training and technical assistance.

Council on Rural Service Programs, Inc.: How It Is Funded

The grantee is a nonprofit organization, in operation for 39 years, that was established to plan and coordinate programs designed to combat poverty and to provide comprehensive education and support services to individuals and families. The grantee provides services in nine counties in west-central Ohio. The grantee's Head Start program is funded primarily through Federal grants. During our review period, OHS provided the grantee with $37.2 million in Head Start funding, which consisted of $31 million in Head Start and Early Head Start funding and an additional $6.2 million of Recovery Act funding.[1] The grantee also received funding from other Federal, State, and local sources for non-Head Start youth programs, as well as adult education and volunteer programs.

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We reviewed $6,722,789 of Head Start costs that the grantee claimed during the audit period of January 1, 2009, through December 31, 2011. The costs that we reviewed were expended by the grantee solely for executive and administrative staff payroll, lease and rental payments, and miscellaneous costs incurred at the administrative offices. We did not review program costs that the grantee incurred at the Head Start centers. We reviewed the grantee's organizational structure, financial systems, facilities management, methodology for allocating payroll to grant awards, and lease agreements. We reviewed $4,287,883 in executive and administrative staff payroll and $1,624,384 in costs associated with lease and rental payments. We also reviewed 82 judgmentally selected expenditures totaling $810,522.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix A contains the details of our scope and methodology. Appendix B contains Federal requirements for Head Start grantees.

FINDINGS

Of the $6,722,789 in Head Start costs that we reviewed, the grantee claimed $1,360,554 that was allowable under applicable Federal regulations and the terms of the grants. However, of the remaining $5,362,235, the grantee claimed unallowable costs of $1,074,352, consisting of:

- $944,654 in less-than-arms-length lease payments;

- $59,489 in classroom rental payments that were improperly allocated to the Head Start program or did not benefit the Head Start program; and

- $70,209 in other costs that were improperly allocated to the Head Start program, did not benefit the Head Start program, or were not otherwise allowable under Federal regulations and the terms of the grants.

We could not determine the allowability of the remaining $4,287,883 in executive and administrative salary and fringe benefit costs that the grantee claimed under its Head Start grants

[1] For this report, we collectively refer to Head Start, Early Head Start, and Recovery Act funding as "Head Start funding."

because the grantee did not adequately support, with personnel activity reports, the distribution of salaries and wages.

UNALLOWABLE LEASE AND RENTAL PAYMENTS

Less-Than-Arms-Length Lease Agreements

Of the $1,398,957 in lease payments we reviewed, the grantee claimed $454,303 that was allowable under applicable Federal regulations and the terms of the grants. However, the grantee claimed unallowable lease payments totaling $944,654 that were associated with less-than-arms-length leases.[2] This lease amount included monthly rental payments, as well as a portion of unallowable overhead costs that were improperly allocated to the Head Start program.

The grantee leases a building in Piqua, Ohio, and a second building in Troy, Ohio, from A Learning Place, Inc. (ALP). ALP is a nonprofit organization that the grantee's executive director and former board member formed in December 1998 to provide educational opportunities to the public and combat poverty. ALP conducts its business in the Piqua building, which is shared with the grantee's executive and administrative staff. The monthly lease payments that the grantee made to ALP for the Piqua and Troy buildings were $22,523 and $12,820, respectively, plus overhead costs including utilities, property taxes, insurance, and maintenance. During our audit period of 2009 through 2011, the grantee claimed a total of $1,398,957 in Head Start funds for the two lease agreements.

We determined that the relationship between the grantee and ALP was less than arms-length on the basis of the following information:

- The grantee's executive director concurrently served as the executive director for the grantee and ALP from 2001 through 2003.

- ALP was highly dependent on the grantee to operate. The grantee's executive director and administrative staff performed many critical functions, such as management and financial statement preparation, on behalf of ALP. The grantee and ALP did not have a consultant agreement for this arrangement during our audit period.

- The grantee's executive director had check writing and credit card privileges for both the grantee and ALP during our audit period.

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[2] A less-than-arms-length lease is one under which one party to the lease agreement is able to control or substantially influence the actions of the other. Such leases include, but are not limited to, those between nonprofit organizations under common control through common officers, directors, or members. Rental costs under less-than-arms-length leases are allowable only up to the amount that would be allowed had title to the property been vested with the grantee. This amount would include expenses such as depreciation or use allowance, maintenance, taxes, and insurance (2 CFR pt. 230, Appendix B, § 43(c)).

- ALP had no economic viability without the income from the grantee. For the 3-year audit period, the grantee's lease payments provided an average of 93 percent of ALP's total gross income.

- In 1999, the grantee used $253,644 of Federal, State, and local funds to purchase 7.233 acres of land as part of the construction of a Head Start facility in Piqua, Ohio. In 2001, the grantee donated to ALP 4.74 acres of that land valued at $174,144. ALP constructed and owns three buildings on that land; one of the buildings is leased back to the grantee for its administrative offices.

- On the basis of the Office of Management and Budget (OMB) Circular A-133 audit[3] performed for the grantee in 2001, we learned that:

  - The grantee guaranteed a loan in the amount of $1.7 million for virtually all of ALP's debt;

  - The grantee made a cash donation to ALP in the amount of $43,720; and

  - ALP's purpose was principally to conduct adjunct staff training and undertake curriculum development in support of Head Start programs including, but not limited to, those conducted by the grantee.

We determined, on the basis of the relationship between the grantee and ALP, that the grantee controlled or substantially influenced the actions of ALP. As a result, the lease agreements between the grantee and ALP were made at less than arms-length. The grantee should have claimed only overhead costs (depreciation, utilities, taxes, maintenance, and insurance) up to the amount that would have been allowed had title to the property been vested with the grantee.

We also determined that the grantee improperly claimed rental costs associated with less-than-arms-length leases and improperly allocated overhead costs for non-Head Start related space. Of $1,398,957 the grantee claimed for costs under the two lease agreements, we determined that $454,303 was allowable, and $944,654 was unallowable.

Unallowable Classroom Rental Payments

Of the $225,427 in classroom rental payments that we reviewed, the grantee claimed $165,938 that was allowable under applicable Federal regulations and the terms of the grants. The remaining $59,489, however, which the grantee claimed for rental payments, was unallowable. We reviewed the grantee's support for meetings and training events held in classrooms owned by

[3] OMB Circular A-133 establishes audit requirements for State and local governments, colleges and universities, and nonprofit organizations receiving Federal awards. Entities covered under this circular must conduct annual organizationwide "single audits" of all Federal funds they receive.

ALP.[4] We determined that the unallowable rental payments were improperly allocated or did not benefit the Head Start program.

In 2010 and 2011, the grantee allocated 100 percent of the classroom rental payments to Head Start grants. The allocation method that it used did not properly allocate the proportional share of these costs to non-Head Start activities.[5] The majority of the meetings and training events that we questioned benefited more than one program. In addition, we determined that some meetings and events benefited only the grantee's non-Head Start programs and should not have been allocated to Head Start grants. Furthermore, some Head Start funding was used for computer-related training classes provided to the general public and hosted by ALP and should not have been paid for with Head Start funds. The amount of $59,489 was improperly allocated or did not benefit the Head Start program for the classroom rental payments during our audit period.

OTHER UNALLOWABLE COSTS

We reviewed a judgmental sample of 82 expenditures totaling $810,522 that the grantee made during our audit period. Of that amount, the grantee claimed $740,313 that was allowable under applicable Federal regulations and the terms of the grants. However, the grantee claimed unallowable costs totaling $70,209.

The majority of the unallowable costs ($65,750) was for department store gift cards that the grantee gave to its employees as holiday gifts in 2009 and 2010. These cards were unallowable because they were for the personal use of employees, in violation of the cost principles.[6]

The remaining $4,459 in unallowable costs was improperly allocated or did not benefit the Head Start program. The allocation method that the grantee used did not properly allocate these costs to non-Head Start activities.[7] For example, we found that the grantee had allocated entirely to the Head Start grants catering costs for the grantee's board meetings that benefited more than one program. We also found travel expenses associated with a non-Head Start program that were allocated entirely to the Head Start grants.

INSUFFICIENT DOCUMENTATION OF EXECUTIVE AND ADMINISTRATIVE STAFF PAYROLL

Inadequate Payroll Distribution Records

We could not determine the allowability of $4,287,883 in salary and fringe benefit costs for the grantee's executive and administrative staff because the grantee did not adequately support, with

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[4] Meeting and training events were held in a separate building, which is adjacent to the grantee's administrative offices.

[5] 2 CFR pt. 230, Appendix A, § C.1-C.2.

[6] 2 CFR pt. 230, Appendix B, § 19.

[7] 2 CFR pt. 230, Appendix A, § C.1-C.2.

personnel activity reports, the distribution of salaries and wages. As a result, Federal funds were at risk of not being properly accounted for or used in accordance with Federal requirements.

Federal regulations require nonprofit organizations to maintain personnel activity reports that:

- reflect an after-the-fact determination of the actual activity of each employee,
- account for the total activity for which each employee is compensated,
- are signed by the employee or by a responsible supervisory official having firsthand knowledge of the activities performed, and
- are prepared at least monthly and coincide with one or more pay periods.[8]

Instead of requiring the use of personnel activity reports, the grantee's policy states that "…administrative and support personnel who work in the central office support all programs. These employees are assigned to multiple grants in the payroll system based on the estimated benefit received by each grant funding stream and allocated accordingly." Federal regulations state, however, that budget estimates (i.e., estimates determined before the services are performed) do not qualify as support for distribution of salaries and wages to awards.[9]

The distribution of salaries and wages must be supported by personnel activity reports, unless the cognizant agency (the Federal agency responsible for negotiating and approving indirect cost rates) has approved a substitute system in writing. HHS had not approved the payroll distribution methodology used by the grantee.

Improper Allocation of Salary and Wages

Although the grantee operated other programs and received funding from other Federal, State, and local sources, the grantee allocated salary and fringe benefit costs for its executive and administrative staff almost exclusively to Head Start grants. However, on the basis of the total revenue that the grantee received during each calendar year in our audit period, we determined that Head Start funding accounted for 65.1 percent of all revenue in 2009, 77.6 percent in 2010, and 76.5 percent in 2011. Because the grantee did not properly allocate the proportional share of these costs to non-Head Start activities, we used an alternative method for estimating the amount of improper executive and administrative staff payroll charges to the Head Start program. Using the revenue percentages, we estimate that the grantee could have improperly received $1 million of Head Start funds for executive and administrative staff payroll costs that did not benefit the Head Start program.[10]

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[8] 2 CFR pt. 230, Appendix B, § 8.m(2)(a)-(d).

[9] 2 CFR pt. 230, Appendix B, § 8.m(2)(a).

[10] We are not recommending that the grantee use this allocation method in future reporting periods.

RECOMMENDATIONS

We recommend that the grantee:

- refund unallowable less-than-arms-length lease payments totaling $944,654;
- refund unallowable classroom rental payments totaling $59,489;
- refund costs totaling $70,209 for gift cards and other costs that did not benefit the Head Start program;
- either refund $4,287,883 to the Federal Government for inadequately supported executive and administrative salary and fringe benefit costs, of which as much as $1 million could have been for non-Head Start costs, or work with OHS to determine what portion of the costs was allowable; and
- take corrective actions to ensure that it:
    - makes lease payments for less-than-arms-length lease agreements in accordance with Federal requirements,
    - maintains personnel activity reports for employees working on Federal awards, and
    - institutes proper policies and procedures for allocating costs that benefit multiple programs.

GRANTEE COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

In written comments on our draft report, the grantee generally disagreed with our recommendations related to less-than-arms-length lease payments, classroom rental payments, gift cards and other costs, and executive and administrative salary and fringe benefit costs. The grantee's comments did not cause us to change our recommendations. However, we have updated the final report to address comments where appropriate.

Less-Than-Arms-Length Lease Payments

Grantee Comments

The grantee did not concur with our recommendation to refund lease payments totaling $944,654. The grantee stated that we disregarded the fact that ACF concluded in 2006 that the relationship between the grantee and ALP was at arms-length and the lease payments were allowable. The grantee stated that we relied on facts and events that took place prior to 2006 and that the draft report is premised on two incorrect assumptions: (1) that ACF's approval had no legal significance and (2) that two private corporations can never restructure and separate their relationship. The grantee further stated that we applied an incorrect interpretation of the "substantial influence" prong of the cost principles in that substantial influence must be tantamount to legal control. The grantee stated that we failed to support our conclusion that the grantee explicitly or implicitly controls ALP or vice versa.

The grantee made references to our finding that it controlled or substantially influenced the actions of ALP. The grantee indicated that the percentage of payments to ALP under the leases for the Piqua and Troy facilities constituted approximately 60 percent of ALP's revenue and disagreed that ALP has no economic viability without income from the grantee.

Office of Inspector General Response

ACF conducted an onsite review of the grantee in 2005 and concluded that the lease payments between the grantee and ALP were not allowable because they were made at less than arms-length. The less-than-arms-length finding was largely based on the Executive Director having managerial influence over both organizations and both organizations having a shared board member. Subsequently, in 2006, ACF revised its finding and concluded that the relationship between the grantee and ALP was at arms-length and that the lease payments were allowable. We acknowledge that ACF's 2006 decision concluded that concerns over the shared board member and the Executive Director were resolved. However, our audit covered a different time period and was broader in scope. We considered the facts about the Executive Director's responsibilities and the shared board member in conjunction with other information and determined that the less-than-arms-length condition was still present at the time of our audit. Our finding that the relationship was less than arms-length is based on a number of factors, which we considered in the aggregate.

We determined that the grantee's calculation of the percentage of payments it made to ALP under the leases for the Piqua and Troy facilities failed to account for cost of goods sold for the restaurant and the income from classroom rental payments. We determined that the grantee provided 93 percent of ALP's total income on the basis of our gross income calculation, the same as under our prior revenue calculation. We maintain that the level of ALP's income provided by the grantee was substantial and that ALP would not be economically viable without the grantee's support.

Although ALP was an incorporated entity separate from the grantee, had no overlapping board members during the time of our audit, employed numerous employees, and maintained a restaurant and rental facilities, 93 percent of ALP's gross income came from the grantee. This fact alone suggests that the grantee could influence the actions of ALP.

Classroom Rental Payments

Grantee Comments

The grantee generally did not concur with our recommendation to refund classroom rental payments totaling $59,489. Although the grantee acknowledged that it overallocated a portion of the short-term classroom rental costs to the Head Start program, it disagreed with our method for determining the portion of the costs allocable to Head Start. The grantee stated that our allocation methodology resulted in an underallocation of expenses to Head Start. The grantee further stated that some of the line-by-line disallowances were premised on incorrect assumptions. Specifically, the grantee stated that we incorrectly concluded that $17,425 in expenses associated with computer-related training sessions was unallowable because these were public events. The grantee stated that members of the public are permitted to enroll in the trainings for a fee, but its records reflect that no nonemployees attended the trainings during the audit period. The grantee stated that this finding should, at a minimum, be modified to remove the funds associated with the public events.

Office of Inspector General Response

We used an alternative allocation method to determine the portion of unallowable classroom rental payments because the grantee did not provide supporting documentation for meeting and training events. Without that support, we could not calculate the percentage of costs associated with Head Start activities based on use. Therefore, we used the grantee's Head Start funding as a percentage of the total revenue received during our audit period as the basis for our allocation.

We disagree with the grantee's comments that $17,425 in expenses associated with computer-related training sessions that were open to the public should be removed from the findings. These training sessions hosted by ALP were open to the public and did not benefit the Head Start program. We requested records during our onsite work and, after receiving the grantee's comments, requested documentation for the people who attended the training sessions. However, the grantee did not provide the records that we requested.

Gift Cards and Other Costs

Grantee Comments

The grantee did not concur with our recommendation to refund $65,750 for gift cards that did not benefit the Head Start program, stating that the finding was erroneous and should be removed. The grantee stated that the draft report's conclusion that gift cards are goods or services for personal use is contrary to the language of OMB Circular A-122, *Cost Principles for Non-Profit Organizations*, Appendix B, § 19 (2 CFR pt. 230, Appendix B, § 19). The grantee stated that gift cards should be allowable as an employee morale cost per 2 CFR pt. 230, Appendix B, § 13. Additionally, the grantee stated that Northwest Tennessee Economic Development Council, DAB No. 2200 (2008), implicitly recognized that gift cards may be an appropriate employee morale expenditure.

Office of Inspector General Response

We disagree with the grantee's comments that the gift cards should be allowable as an employee morale expenditure. We also disagree with the grantee's interpretation of Northwest Tennessee Economic Development Council, DAB No. 2200 (2008), stating that the DAB implicitly recognized that gift cards may be an appropriate employee morale expenditure. The primary issue in that case was whether costs had been adequately documented. We also note that in Ohio

Head Start Association, Inc., et al., v. United States Department of Health and Human Services, et al., the Circuit Court for the District of Columbia, as part of a larger opinion addressing Head Start's Designation Renewal System, stated that it could not conclude that HHS was unwarranted in issuing a deficiency finding after a grantee spent in excess of $41,000 on gift cards for employee Christmas gifts. The court further explained that the plaintiff's internal guidelines purportedly authorizing the expenditure did not make this use of Head Start funds any less egregious (902 F.Supp.2d. 61, Nov. 5, 2012).

Lastly, we note that ACF made a deficiency determination regarding the gift card expenditures in its Overview of Findings of a followup review of the above referenced grantee's triennial review. The report, dated April 11, 2011, stated that the gift cards were unallowable expenditures that were for the personal use of employees. The purchases were unallowable both as employee morale expenditures and as incentive compensation (2 CFR 230, App. B, § 13.a and 2 CFR 230, App. B, § 8.j., respectively).

We maintain our finding that the holiday gift cards purchased for the grantee's employees were unallowable.

Executive and Administrative Salary and Fringe Benefit Costs

Grantee Comments

The grantee did not concur with our recommendation to either refund $4,287,883 of inadequately supported salary and fringe benefit costs or work with OHS to determine what portion of the costs was allowable. The grantee stated that our draft report failed to acknowledge that the grantee had a system of allocations for administrative costs and asked that we revise our report to recognize the internal allocation method that was used. The grantee stated that we were incorrect to imply that employees did not document their time, but it acknowledged that improvements in this area were needed. The grantee further stated that we were incorrect to conclude that salaries for executive and administrative staff were charged almost exclusively to Head Start and asked that we remove this assertion from our report. The grantee stated that a significant portion of the executive and administrative salaries were offset on a monthly basis by using a percentage based on the number of Head Start children in mixed classrooms, resulting in an effective percentage of 73 percent that was charged to Head Start during the audit period. The grantee also stated that our use of revenue to allocate costs was inaccurate. Finally, the grantee stated that it procured new accounting software in 2012 that will properly identify the grant or cost center for each work activity.

Office of Inspector General Response

We acknowledge that the grantee had an allocation system in place to account for administrative salaries. However, this system did not meet Federal requirements to adequately support, with personnel activity reports, the distribution of salaries and wages. Additionally, we did not question the allocation method for nonadministrative salaries that the grantee outlined in its response.

The grantee used a single budgeted estimate for each calendar year when determining the amount of administrative salaries to charge to Head Start. Budget estimates do not qualify as support for the distribution of salaries and wages to Federal awards. We reviewed the grantee's support for these estimates, but the grantee could not provide documentation to support the number of children that were used when calculating the mixed classroom percentages. Without the supporting documentation, we could not determine whether the budgeted percentages were reasonable and accurate. Therefore, we used an alternative method based on the grantee's Head Start funding as a percentage of the total revenue received during our audit period to estimate the allowable portion of administrative salaries. Using the number of children in mixed classrooms as an estimate base for administrative salaries is inadequate, considering that the grantee operates other nonchildcare programs. On the basis of the payroll records the grantee provided, 96 percent of all administrative salaries were charged to Head Start during our audit period.

We disagree with the grantee's comments that we should revise the finding associated with the improper allocation of executive and administrative salaries. Because the grantee implemented its new accounting software after we completed our audit work, we did not review its implementation or capability. We maintain that our finding is valid and encourage the grantee to work with ACF to determine the allowable portion of administrative salaries.

The grantee's comments, excluding attachments, are included as Appendix C.

APPENDIX A: AUDIT SCOPE AND METHODOLOGY

SCOPE

The review covered $6,722,789 of Head Start costs that the grantee claimed during the audit period of January 1, 2009, through December 31, 2011. The costs that we reviewed were expended by the grantee solely for executive and administrative staff payroll, lease and rental payments, and miscellaneous costs incurred at the administrative offices. We did not review program costs that the grantee incurred at the Head Start centers. We reviewed the grantee's organizational structure, financial systems, facilities management, methodology for allocating payroll to grant awards, and lease agreements. We reviewed the allocation methodology associated with $4,287,883 in executive and administrative staff payroll, as well as $1,624,384 in costs associated with lease and rental payments. We also reviewed 82 judgmentally selected expenditures from the grantee's check register totaling $810,522.

We did not perform an overall assessment of the grantee's internal control structure. Rather, we reviewed only the internal controls that pertained to our objective.

We performed our fieldwork at the grantee's administrative office in Piqua, Ohio, in October 2012.

METHODOLOGY

To accomplish our audit objective, we:

- reviewed applicable Federal criteria;
- reviewed the grantee's bylaws, minutes of board of directors' meetings, and organizational chart;
- reviewed the grantee's policies and procedures on finance and internal controls;
- reviewed the grantee's audited financial statements and supporting documentation;
- reviewed tax returns for both the grantee and ALP;
- reviewed cost allocation methodology for payroll and other shared costs;
- reviewed the grantee's total funding from Federal, State, and local sources and calculated an equitable allocation percentage for costs that benefited multiple programs;
- reviewed lease agreements and associated payments made to ALP for the grantee's rental properties located in Piqua, Ohio, and Troy, Ohio;
- reviewed classroom rental payments made to ALP;

- judgmentally selected and reviewed 82 expenditures from the grantee's check register; and

- reviewed the grantee's annual Financial Status Reports (SF-269) for Head Start grants.

We verified the reliability of the data by reconciling it with the grantee's audited financial statements and by discussing the data with the grantee. In our opinion, the data obtained from the grantee was sufficiently reliable for this audit.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX B: FEDERAL REQUIREMENTS FOR HEAD START GRANTEES

FINANCIAL MANAGEMENT SYSTEMS

Federal regulations (45 CFR § 74.21(b)) state that grantees must maintain financial management systems that provide for, among other things:

- accurate, current, and complete disclosure of the financial results of each HHS-sponsored project or program in accordance with the reporting requirements in 45 CFR § 74.52;
- records that identify adequately the source and application of funds for HHS-sponsored activities; and
- written procedures for determining the reasonableness, allocability, and allowability of costs in accordance with the provisions of the applicable Federal cost principles and the terms and conditions of the award.

COST PRINCIPLES FOR NONPROFIT ORGANIZATIONS

Federal regulations (45 CFR § 74.27(a)) provide that nonprofit organizations that receive Head Start funds must comply with the Federal cost principles in 2 CFR pt. 230, *Cost Principles for Non-Profit Organizations* (Office of Management and Budget Circular A-122).

COST ALLOCATION

Federal regulations (2 CFR pt. 230, Appendix A, § A.2.g) state that "[t]o be allowable under an award, costs must … [b]e adequately documented." Additionally, pt. 230, Appendix A, § A.4, states that a cost is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received. Any cost allocable to a particular award or other cost objective under these principles may not be shifted to other Federal awards to overcome funding deficiencies or to avoid restrictions imposed by law or by the terms of the award.

Federal regulations (2 CFR pt. 230, Appendix A, § C.1) state that indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. After direct costs have been determined and assigned directly to awards or other work as appropriate, indirect costs are those remaining to be allocated to benefiting cost objectives. Additionally, 2 CFR pt. 230, Appendix A, § C.2, states that typical examples of indirect cost for many nonprofit organizations may include depreciation or use allowances on buildings and equipment, the costs of operating and maintaining facilities, and general administration and general expenses, such as the salaries and expenses of executive officers, personnel administration, and accounting.

Federal regulations (2 CFR pt. 230, Appendix A, § D.4) state that joint costs must be prorated using a base that accurately measures the benefits provided to each award. The base must be established in accordance with reasonable criteria and be supported by current data.
Federal regulations (2 CFR pt. 230, Appendix B, § 8.m(1)) state that the distribution of salaries and wages must be supported by personnel activity reports, unless the cognizant agency (the Federal agency responsible for negotiating and approving indirect cost rates) has approved a substitute system in writing. Nonprofit organizations must maintain personnel activity reports that meet the standards in 2 CFR pt. 230, Appendix B, § 8.m(2)(a)-(d). The reports must:

- reflect an after-the-fact determination of the actual activity of each employee,
- account for the total activity for which each employee is compensated,
- be signed by the employee or by a responsible supervisory official having firsthand knowledge of the activities performed, and
- be prepared at least monthly and coincide with one or more pay periods.

RENTAL COSTS UNDER LESS-THAN-ARMS-LENGTH LEASES

Federal regulations (2 CFR pt. 230, Appendix B, § 43.c.) state that rental costs under "less-than-arms-length" leases are allowable only up to the amount (as explained in subparagraph 43.b of this appendix) that would be allowed had title to the property vested in the nonprofit organization. For this purpose, a less-than-arms-length lease is one under which one party to the lease agreement is able to control or substantially influence the actions of the other. Such leases include, but are not limited to, those between divisions of a nonprofit organization; nonprofit organizations under common control through common officers, directors, or members; and a nonprofit organization and a director, trustee, officer, or key employee of the nonprofit organization or his immediate family, either directly or through corporations, trusts, or similar arrangements in which they hold a controlling interest.

Federal regulations (2 CFR pt. 230, Appendix B, § 43.b) state that rental costs under "sale and lease back" arrangements are allowable only up to the amount that would be allowed had the nonprofit organization continued to own the property. This amount would include expenses such as depreciation or use allowance, maintenance, taxes, and insurance.

GOODS OR SERVICES FOR PERSONAL USE

Federal regulations (2 CFR pt. 230, Appendix B, § 19) state that costs of goods or services for personal use of the organization's employees are unallowable regardless of whether the cost is reported as taxable income to the employees.

Federal regulations (2 CFR pt. 230, Appendix B, § 13.a) state that costs of employee information publications, health or first-aid clinics and/or infirmaries, recreational activities, employee counseling services, and any other expenses incurred in accordance with the nonprofit organization's established practice or custom for the improvement of working conditions, employer-employee relations, employee morale, and employee performance are allowable.

Federal regulations (2 CFR pt. 230, Appendix B, § 8.j) state that incentive compensation to employees based on cost reduction, or efficient performance, suggestion awards, safety awards, etc., are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the organization and the employees before the services were rendered, or pursuant to an established plan followed by the organization so consistently as to imply, in effect, an agreement to make such payment.

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June 24, 2013

VIA EMAIL AND FEDERAL EXPRESS
Ms. Sheri L. Fulcher
Regional Inspector General for Audit Services
DHHS/Office of Inspector General
Office of Audit Services, Region V
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Re: OIG Draft Report # A-05-12-00089

Dear Ms. Fulcher:

We represent the Council on Rural Service Programs, Inc. (CORS) and are responding on its behalf to your office's draft report, dated May 17, 2013, entitled *The Council on Rural Service Programs, Inc. Claimed Unallowable Head Start Costs* (the "Draft Report"). As discussed below, the discussion in the Draft Report of OIG's less-than-arms-length finding fails to disclose at least one key fact: that the Administration for Children and Families (ACF) reviewed the relationship between CORS and the other entity, A Learning Place, Inc. (ALP), seven years ago and found in a written decision that it was at arms-length. At a minimum, the Draft Report should have disclosed this fact and explained why your office issued a finding contrary to the binding determination of the funding agency.

In addition, your office used incomplete business information about ALP to assert that ALP had no business purpose other than serving CORS. In fact, during the period audited, ALP had between 15 and 22 employees, operated a restaurant, and routinely sold meeting and conference room space to the public for corporate events and weddings. To find that despite these facts the relationship between CORS and ALP is at less-than-arms-length is wholly inconsistent with longstanding decisions of the Department of Health and Human Services Departmental Appeals Board (HHS DAB). The finding should be removed.

With respect to the other major finding in the Draft Report, concerning the allocation of administrative expenses, CORS welcomes the opportunity to work with ACF to demonstrate the allowability of the charges to the Head Start and Early Head Start awards during the period audited. However, the suggestion in the Draft Report that as much as $ 1.0 million could be unallowable is inaccurate since the Draft Report failed to acknowledge or account for the fact that CORS did have a system of

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internal allocations for administrative costs. This system, while not perfect, did a reasonable job of ensuring that each funding source paid its fair share of administrative costs. CORS has implemented a number of improvements to its accounting methods in the past year that it believes will improve the accuracy of its process for allocating administrative costs to their funding sources.

Finally, CORS has various comments on the smaller findings in the audit and believes that in a number of instances the Draft Report either overstated the amount of grant funds at issue or misstated applicable law.

Our specific comments follow.

I. Background

CORS is a private, not-for-profit 501(c)(3) tax-exempt organization headquartered in Piqua, Ohio. It has provided Head Start services since 1975. CORS currently serves nine counties. Its mission is to provide comprehensive education and support services to individuals and families. CORS provides services under both Head Start and Early Head Start, and also offers preschool to private-pay students. CORS provides early childhood education services through a variety of program options that include home-based, center-based, full- and part-day services. In addition to Head Start and Early Head Start, CORS offers other social service programs including a program for at-risk youth and a retired and senior volunteer program. In addition, in 2011, CORS was awarded an AmeriCorps for Entrepreneurial Success grant for Head Start parent career development.

CORS has earned a three-star rating, the highest rating available in the State of Ohio's Step Up to Quality program, a voluntary quality initiative for licensed child care programs. CORS has 20 separate Head Start locations that are currently star-rated under this system.

II. Responses to Draft Findings and Recommendations

A. *Recommendation #1: "Refund unallowable less-than-arms-length lease payments totaling $944,654."*

CORS does not concur with OIG's recommendation.

The conclusion in the Draft Report that the relationship between CORS and ALP was not at arms-length disregarded the fact that CORS' funding agency, ACF, in 2006 concluded that the relationship between the two entities was proper and the lease payments allowable. Despite the fact that CORS took corrective actions to ensure that the relationship was at arms-length and the explicit conclusion of ACF that those actions were sufficient to resolve any arms-length issues, the Draft Report relies almost entirely on facts and events that took place prior to 2006 and in some cases over five years earlier. The Draft Report then is premised on two incorrect assumptions: 1) that the ACF approval had no legal significance, and 2) that two private corporations can never restructure and separate their relationship.

The Draft Report also applies throughout an incorrect interpretation of the "substantial influence" prong of the cost principles. Under the cost principles, substantial influence must be tantamount to legal control, not something as commonplace providing management and accounting services pursuant to a contract under the direction of an independently constituted and fully functioning Board of Directors. Indeed, the Draft Report fails to cite a single fact that would support the conclusion that CORS explicitly or implicitly controls ALP or vice versa.

The conclusions of the Draft Report, therefore, are contrary to longstanding decisions of the HHS DAB and by failing to acknowledge, much less analyze, the ACF decision, the Draft Report contains a material omission. Accordingly, the finding should be withdrawn or, at a minimum, the Draft Report should be reissued with a revised finding so that CORS will have the opportunity to comment on OIG's analysis of the ACF decision.

1. Background – A Learning Place and Its Relationship With CORS

ALP is a nonprofit organization founded in December 1998 in Greenville, Ohio. ALP's articles of incorporation state the following mission: "to provide educational opportunities to the public for the purpose of planning, operating or coordinating programs designed to combat the problems of poverty and to seek the elimination of conditions of poverty in Ohio and to do all things necessary and incident thereof. . . ." (Attachment A, ALP Articles of Incorporation.) CORS Executive Director Shirley Hathaway was one of ALP's incorporators, and ALP and CORS had overlapping board members for several years; however, since 2006, no overlap has existed between the organizations' voting board members.

a. ALP's Operations

During the audit period (calendar years 2009-2011), ALP had on its payroll between fifteen and twenty-two employees carrying out its business activities. (Attachment B, List of ALP Employees in Calendar Years 2009-2011.) Those activities included operating a restaurant, the Backyard Bistro, and maintaining and managing rental facilities. In its Piqua facility, ALP maintains a conference / event space that it leases on a weekly basis for weddings and corporate events. (Attachment C, ALP event space brochure.) A supervisory employee (variously termed "office manager" and "business development manager" during the audit period) supervised the other employees and effectively served as executive director. (Attachment D, Position Description, Business Development Manager.)

Given that ALP and CORS both have missions of serving the community and combating poverty in the same region, "ALP has a working relationship with [CORS] as an agency serving a common community." (Attachment E, Letter from William M. Sullivan, Team Administrator, ACF Region V, to Shirley Hathaway, Exec. Dir., CORS, dated Feb. 15, 2006.) The business relationship between ALP and CORS is memorialized in a purchase of services agreement under which members of CORS staff provide administrative, management and other services on an hourly basis; a commercial lease of two ALP properties by CORS for Head Start classrooms; and various daily rentals of space in ALP buildings for CORS events.

b. Administrative Services Agreement

The administrative services agreement between CORS and ALP was first executed in 2004 and was revised in 2005, 2006, 2007, and 2012. In years in which no new agreement was executed (including the audit period, 2009-2011), the parties continued under the terms of the last-executed agreement. Under the agreement, CORS personnel performed services for ALP in five areas: management, clerical, payroll preparation, financial statement preparation, and MIS/marketing. (*See* Attachment F, Administrative Services Agreement.) The agreement provided for fees at fair market rates for each category of services, to be invoiced quarterly. CORS furnished ALP with quarterly invoices documenting the services in each category performed by each CORS employee, and the hourly rate charged. (Attachment G, quarterly invoices from CORS to ALP for administrative services in calendar years 2009-2011).

As noted above, ALP had on its payroll between 15 and 22 employees during the audit period, carrying out the main functions of that organization, ranging from food service in its restaurant, to marketing of its conference/event menu, to the supervision of all ALP employees. Information that CORS obtained from ALP indicates that the number of hours of work performed by ALP employees during the audit period (11,170.75 in calendar year 2009; 14,785.75 in calendar year 2010; 16,160.25 in calendar year 2011) exceeded by an order of magnitude the number of hours performed by CORS employees for ALP under the administrative services agreement (295.25 in 2009; 214.75 in 2010; and 208.25 in 2011). (Attachment B.)

c. Lease of Classrooms

CORS has leased space from ALP under commercial leases in two of ALP's buildings in Troy and Piqua, Ohio since 2004 and 2002, respectively. (Attachment H, CORS-ALP leases.) Total lease payments made by CORS to

ALP during each calendar year of the audit period equaled $424,116. (Attachment I (CORS Analysis of Lease Payments).)

CORS also rented classrooms, computer labs and seminar halls from ALP on a daily or other short-term basis during the audit period, and these payments ranged from $60,675 in 2009 to $97,550 in 2010. (Attachment I.)

Although CORS was its largest tenant, ALP also, as noted above, leased spaces during the audit period to a variety of other individuals and entities.

2. Legal Analysis

Office of Management and Budget (OMB) Circular A-122 provides that rental costs under less-than-arms-length leases "are allowable only up to the amount . . . that would be allowed had title to the property vested in the nonprofit organization." 2 C.F.R. Part 230, App. B, ¶43(c). The Circular defines a less-than-arms-length lease as "one under which one party to the lease agreement is able to control or substantially influence the actions of the other." *Id.* The clear gist of the decisions of the HHS DAB interpreting this standard is that absent a situation where the grantee and lessor entity are units of the same organization or are under common ownership or control, the key inquiry is whether one organization, in fact, "substantially influences" the other.

To show substantial influence is a high standard. Substantial influence is a level of influence tantamount to "control," *i.e.*, even if one organization does not technically control the other's board of directors, its influence over the other organization may be so overweening as to be the legal equivalent of control. In determining if substantial influence exists, the DAB examines a variety of factors, most notably whether the non-grantee (lessor) organization has any independent existence and whether the available evidence (such as minutes of Board meetings) shows that one corporation directs the actions of the other. Here, ALP has numerous employees and an independent board of directors; it leases space to the public on a regular basis; and during the grant period it operated a restaurant. The relationship between CORS and ALP is nothing like the DAB cases where the Board found substantial influence. The finding should be removed in the final audit report.

a. Failure to Consider Legal Opinion of ACF Regional Office

As noted above, the Draft Report contained a significant omission in that it failed to acknowledge the opinion of ACF Region V that the relationship between CORS and ALP is an arms-length relationship.

The HHS DAB has reversed disallowances where a grantor agency based its disallowance of federal funds on a premise that contradicted its own prior approval of a grant or state plan provision relevant to the disallowance. *See, e.g., Minnesota Dep't of Human Servs.*, DAB No. 2122 (Oct. 25, 2007), at HHS 17 (2007 WL 4331190). This is consistent with the basic rule in administrative law that federal agencies must act consistently with past actions unless they provide a clear rationale for changing their behavior. *See, e.g., Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

More specifically, decisions of the HHS DAB have made clear that in the context of determining whether lease payments are at less-than-arms-length, prior findings on the issue by a relevant federal agency -- and the grantee's response to those comments -- are of utmost importance. *See Home Educ. Livelihood Prog., Inc.*, DAB No. 1598, 1996 WL 599832 (Sept. 20, 1996) (*HELP*). In the *HELP* decision, the HHS DAB held that the grantee (HELP) did have an arms-length relationship the with lessor organization during the audit period. Among the key factors the DAB identified as relevant was that HELP had "become aware of the possible less-than-arms-length transaction issue as a result of [lessor's] dealings with the Department of Labor, and had made efforts to correct any conflict of interest" such that the conflict was cured during the audit period. HHS DAB noted that in light of these facts, "HELP has convinced us that it made a good faith effort to correct this potential conflict of interest and that a conflict of interest did not exist during the relevant time period."

Applying these principles here, it is clear that CORS took the appropriate measures to ensure that the relationship was arms-length and the lease payments proper during the audit period. In 2005, CORS received noncompliance findings relating to the less-than-arms-length issue during an ACF routine monitoring review. In a follow-up review issued May 8, 2006, ACF concluded that the identified problems had been corrected. Specifically, in a memorandum from William M. Sullivan, Team Leader, Region V, to CORS' Board chair, ACF found that CORS had implemented appropriate conflict-of-interest policies; that "there is no legal relationship" between the entities; and that "the Executive Director of [CORS] does not hold a position in ALP, nor does she have any direct managerial influence over the operation of that program." (Attachment J, ACF May 8, 2006 Overview of Findings.)

ACF stated similar conclusions in a letter dated February 15, 2006 from Mr. Sullivan to Ms. Hathaway. (Attachment E.) At that time, ACF advised CORS to "end the sharing of a Board member." CORS promptly complied with that request. (Attachment K, CORS bylaws, revised June 14, 2006.)[1] ALP's bylaws contain no requirement that a CORS board member serve on the ALP board. (Attachment M, ALP bylaws, approved January 4, 2002.) Mr. Sullivan also stated in the letter that "when ALP or [CORS] seek to contract for services each should do so competitively." (Attachment E.) As discussed elsewhere in this response, both the commercial leases and the administrative services agreements reflected competitive, commercially reasonable terms.

Mr. Sullivan, who issued the February 15, 2006 opinion letter and May 8, 2006 follow-up review, is a high-ranking ACF official who, among other things, certifies fund availability for CORS' Head Start grant. (Attachment N, Notice of Grant Award for budget period Dec. 1, 2011 through June 30, 2013.) CORS responded with diligence to Mr. Sullivan's comments. During the audit period and since, CORS has carried out its relationship with ALP in a manner consistent with guidance from ACF officials. If the OIG believes that ACF's decision was in error, it should state the reasons for that conclusion in the Draft Report and allow CORS an opportunity to review and comment on a revised report. To fail to even mention the existence of this federal approval is clearly a material omission that undermines the validity of the proposed finding.

b. *Less-Than-Arms-Length Analysis*

The Draft Report cited factors that allegedly demonstrate improper control or influence. CORS respectfully submits that each cited factor rests on incorrect facts or unfounded legal premises. The following, instead, are the relevant considerations, as set forth by the DAB in in its decision *Enterprise for Progress in the Community (EPIC),* DAB No. 1558 (Jan. 29, 1996). Consideration of each factor demonstrates that CORS and ALP have an arms-length relationship.

i. Is there evidence that the lessor entity has an independent organizational purpose other than serving the grantee?

Yes. ALP has an independent organizational purpose and identity from CORS. As noted above, its mission, as stated in its articles of incorporation, is "to provide educational opportunities to the public for the

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[1] The opinions that ACF expressed on these issues in 2006 grew out of detailed conversations with CORS staff during the on-site review process, and entailed ACF's extensive consultation with the HHS Office of General Counsel (OGC). OGC set forth detailed facts it needed in order to address the less-than-arms-length issue, and Region V staff gathered this information, leading OGC to conclude that the relationship between the two entities was appropriate. (See Attachment L, Aug. 10, 2005 Memorandum from Christina Rivera, Team Leader, ACF Region V, to Ted Yasuda, Coordinating Attorney, OGC.) Thus, ACF's opinion had the support of HHS OGC.

purpose of planning, operating or coordinating programs designed to combat the problems of poverty and to seek the elimination of conditions of poverty in Ohio. . . ." (Attachment A.) ALP carries out its organizational purpose by marketing its spaces to a variety of individuals and businesses to rent for educational and other events.

This is not a case where, as in *EPIC,* it was "undisputed that [lessor's] principal reason for existence was to acquire facilities to house [grantee's] Head Start programs."

ii. Does the record reflect that the grantee in fact exercises substantial influence over the lessor entity?

No. The Draft Report does not contain a single fact or even a suggestion that CORS or its personnel exercised substantial influence over ALP's operation during the period audited. As Mr. Sullivan's May 8, 2006 letter recognized, Ms. Hathaway holds no leadership position in ALP. No CORS Board member serves as a voting member of ALP's board. The Draft Report cited no example of a business decision made by ALP during the audit period that OIG considered to be unduly influenced by CORS. In short, there is no evidence to support this factor.

iii. Do the grantee and lessor coordinate their business activities in a manner uncharacteristic of an arms-length relationship?

No. CORS and ALP did not coordinate their business activities during the audit period. Their business relationship was governed by agreements (the leases and administrative services agreements described above) with transparent and commercially reasonable terms.

iv. Is there evidence to show that, without the grantee, the lessor entity would have independent economic viability?

Yes. The assertion in the Draft Report that ALP "has no economic viability without the income from the grantee" is incorrect. As noted above, ALP's mission, per its articles of incorporation, is to provide educational opportunities to the public for the purpose of planning, operating, or coordinating programs, particularly those combating poverty. As such, ALP leases space to CORS, but it also markets its facilities to other organizations and individuals for both commercial leases and short-term rentals for conferences and other events. The terms of the rental are competitive and the rates consistent with other commercial rental properties in the area.[2] (See Attachment D.) ALP could lease the facilities to other parties if CORS

[2] In connection with each lease, an unbiased appraiser has determined the rental rate using comparable rents in the area each lease.

chose not to renew its lease. The mere fact that CORS is ALP's major tenant does not prove that ALP lacks economic viability.

Factually, CORS contests the accuracy of the conclusion in the Draft Report that CORS' lease payments constituted 93% of ALP's total revenue during the audit period. CORS' analysis, conducted using financial statements and tax returns obtained from ALP, demonstrates that during the audit period, CORS' payments to ALP under the leases of the Piqua and Troy facilities constituted 62.7%, 59.5%, and 58.8% of ALP's revenue in calendar years 2009, 2010, and 2011 respectively.[3] (*See* Attachment I.)

v. Is the lessor entity dependent upon the grantee to operate?

No. ALP is an independent business from CORS. As noted above, ALP's Board of Directors is fully independent (and was equally so during the audit period), and during the audit period ALP had a workforce of 15-22 employees. Work hours performed by CORS employees under the administrative services agreement – falling under the general categories of management, clerical, payroll preparation, financial statement preparation, and marketing – comprised less than two percent of the work hours performed by ALP's own employees. Accordingly, the assertion in the Draft Report that "ALP is highly dependent on the grantee to operate" in the manner described in the HHS DAB decisions (that is, ALP could not operate without CORS staff) is, to put it mildly, off base.

The Draft Report also claims that CORS' "executive director and administrative staff performed many critical functions on behalf of ALP such as management and financial statement preparation. The grantee and ALP did not have a consultant agreement for this arrangement." These assertions are factually incorrect in several respects.

First, CORS and ALP did have an administrative services agreement in effect. During the audit period, no new agreement was executed, but the two parties continued under the terms of the last-executed (2007) agreement.

Second, the functions that CORS personnel performed under the agreement, while important, by no means amounted to CORS personnel running ALP. Hence, this is a very different situation from situations where the DAB has determined a relationship between grantee and lessor to be less than arms-length because the lessor was effectively a shell entity. *See, e.g., Enter. For Progress in the Community,* DAB No. 1558 (Jan. 1, 1996) (emphasis added) (holding relationship was improper where it was

[3] These percentages do not include CORS' payments to ALP for short-term classroom and conference room rentals. With the short-term rentals included, the percentages are 71.7% (2009), 73.2% (2010), and 69.1% (2011).

"undisputed that [lessor's] principal reason for existence was to acquire facilities to house EPIC's Head Start programs," there was "no evidence to show that [lessor] had any economic viability," and "[lessor] had *no employees at all* during the period in issue"). HHS DAB held in the *HELP* decision that the fact, on its own, that a grantee's executive employee performs functions for the lessor pursuant to a written agreement, does not provide "evidence that [the employee] was in a position to exert substantial influence over both organizations." *Home Educ. Livelihood Prog.,* DAB No. 1598 (Sept. 20, 1998).

The Draft Report also emphasizes the fact that Ms. Hathaway had credit card and check-signing privileges for ALP. This fact alone means very little. The relevant question here is whether Ms. Hathaway has unfettered authority to spend ALP funds. The answer to this question is, of course, no. In this regard, the HHS DAB noted in the *HELP* decision that the fact that a CEO exercised check-writing privileges was "not of material significance" in determining whether the lease relationship was at less-than-arms-length. The DAB proceeded to conclude that the entities were independent and the lease proper. *Home Educ. Livelihood Prog.,* DAB No. 1598 (Sept. 20, 1998). Both here and in *HELP,* the CEO exercised the privilege only as an administrative function for purchases below a certain dollar threshold. Ms. Hathaway's credit card privileges (as documented in ALP board minutes) were limited to purchases of less than $2500, and checks that she signed were for accounts payable; she did not approve or authorize expenditures, but instead signed checks that paid costs after they were incurred. Effective in 2012, Ms. Hathaway no longer has check-signing and credit card privileges for ALP.

B. Recommendation #2: "Refund unallowable classroom rental payments totaling $59,489."

The Draft Report asserts that of $225,427 in short-term classroom and conference space rental payments that OIG reviewed, "the grantee claimed $165,938 that was allowable under applicable Federal regulations and the terms of grants. The remaining $59,489, however, was unallowable."

This finding is flawed in several respects. First, some of the line-by-line disallowances of the short-term rentals are premised on incorrect assumptions. For example, OIG appears to have concluded that $17,425 in expenses associated with instruction in Microsoft Excel, Outlook, and Access and other computer-related training sessions was unallowable in its entirety on the ground that these were "public events." This is incorrect. The trainings are primarily for CORS employees, not the public. Members of the public are permitted to enroll in the trainings for a fee, but CORS' records reflect that no non-employee attended the trainings during the audit period.

Second, more generally, while CORS acknowledges that it over-allocated a portion of the short-term classroom rental costs to the Head Start program for those rentals that benefited multiple grant programs, CORS disagrees with OIG's method for determining the portion of the costs allocable to Head Start. OIG's allocation rate was based on revenue from each grant program as a percentage of CORS' total revenue. As explained in more detail below in our response concerning OIG's draft finding on executive and administrative salary costs, CORS believes that this allocation methodology results in an under-allocation of expenses to Head Start.

This finding should, at a minimum, be modified to remove the funds associated with the so-called "public events."

Recommendation #3: "Refund costs totaling $70,209 for gift cards and other costs that did not benefit the Head Start program."

This response focuses on the first component of the finding: that CORS improperly charged to the grant $65,750 for department store gift cards that CORS gave to its employees at year-end in 2009 and 2010. This portion of the finding is erroneous and should be removed.

The Draft Report provides no rationale for the assertion that the expenditure was an unallowable cost, but it cites as authority OMB Circular A-122, App. B, ¶ 19, which provides, "Costs of goods or services for personal use of the organization's employees are unallowable regardless of whether the cost is reported as taxable income to the employees." The Draft Report's conclusion that gift cards, which are essentially cash equivalents, are "goods or services for personal use" is contrary to the plain language of ¶ 19 as applied by the HHS DAB.

Specifically, ¶ 19 prohibits a grantee organization from using grant funds to purchase goods and services that are then used by employees for personal not business reasons, hence the language "goods or services." Accordingly, the DAB has disallowed grant funds which were used to provide employees with perks such as the use of a company car for personal purposes rather than work-related transportation. *See, e.g., Marie Detty Youth & Fam. Servs. Ctr., Inc.,* DAB No. 2024 (2006 WL 1337432) (Apr. 27, 2006). The situation described in the *Marie Detty* case bears little resemblance to gift cards given to improve employee morale if, for no other reason, than the fact that gift cards are not "goods or services" any more than giving an employee a $100 bill is a good or service. Gift cards are clearly a cash equivalent, fully transferrable and can be used for any purpose desired by the employee. The only difference between a gift card and cash is that a gift card is limited to a single store, and cash can be used at any store.

Gift cards, in the case here, are allowable as an employee morale cost. Under Circular A-122, the costs of

> employee information publications, health or first-aid clinics and/or infirmaries, recreational activities, employee counseling services, and any other expenses incurred in accordance with the non-profit organization's established practice or custom for the improvement of working conditions, employer-employee relations, employee morale, and employee performance are allowable.

2 C.F.R. Part 230, App. B, ¶ 13. CORS presented the gift cards to its employees to recognize their contributions to the organization during the prior year and to keep morale high. This action was consistent with CORS' custom of presenting some form of holiday gift to employees annually. Moreover, this practice was common among Head Start agencies within Region V during the time period at issue.[4]

Finally, it bears noting that the DAB implicitly recognized that gift cards may be an appropriate employee morale expenditure in *Northwest Tennessee Economic Development Council,* DAB No. 2200, 2008 WL 4534199 (Sept. 25, 2008). There, the DAB sustained ACF's disallowance of amounts allegedly expended on gift cards, but only for the reason that the expenditures were not properly documented. The DAB did not question whether gift cards could be an acceptable employee morale expenditure. Here, CORS' expenditures were accurately documented, and it is clear that the cards were not purchased for an unallowable purposes, such as gifts to Head Start students or parents.

OIG should remove this finding.

C. *Recommendation #4: "Either refund $4,287,883 to the Federal Government for inadequately supported executive and administrative salary and fringe benefit costs, of which as much as $1 million could have been for non-Head Start costs, or work with OHS to determine what portion of the costs was allowable."*

In the Draft Report, OIG questioned CORS' methods for determining the portion of salary allocable to Head Start / Early Head Start for twenty-five executive and administrative employees during the audit period. OIG opined that CORS had "allocated salary and fringe benefit costs for its executive and administrative staff almost exclusively to Head Start grants."

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[4] It is well-recognized that early childhood education workers including those employed in the Head Start program are underpaid. Accordingly, a small gift card to boost morale in lieu of, for example, paying market salaries is hardly an egregious use of federal funds. *See e.g.,* p. 13 of the February 2012 report of the General Accountability Office at http://gao.gov/assets/590/588577.pdf.

OIG estimated that CORS "could have improperly received $1 million of Head Start funds for executive and administrative payroll costs that did not benefit the Head Start program."

CORS acknowledges that its systems for allocating executive and administrative costs during the audit period needed improvement. Indeed, CORS has subsequently overhauled (effective in calendar year 2013) its systems for both time-and-effort reporting and allocation of costs for executive and administrative salary and fringe benefits. However, the assertion in the Draft Report that there is a potential overcharge to the Head Start program of $1.0 million grossly overstates the issue.

1. Personnel Activity Reports

OIG's Draft Report implies that CORS did not require employees to document their time during the audit period. This is incorrect; however, CORS acknowledges that its policies in this area needed improvement during the audit period.

During the audit period, CORS required its employees who are non-exempt under the Fair Labor Standards Act (FLSA) to complete timesheets under the Time Track system. Non-exempt employees clocked in and out, and so the system accurately recorded their hours worked. Moreover, all CORS employees were charged to a single cost center obviating the need for a specific distribution of time. Administrative employees were charged and their cost allocated as discussed below.

CORS has taken corrective action on this item since the audit period. In 2012, CORS competitively procured new accounting software after an in-depth evaluation of system needs. The new accounting system is called Financial Edge. The contractor also modified CORS' preexisting Time Track time-and-effort reporting system in order to include additional components including a requirement to identify the grant or cost center associated with each work activity. CORS looks forward to discussing with ACF the improvements it has made in this area.

2. Allocation of Salary to Grants

The Draft Report states that CORS "allocated salary and fringe benefit costs for its executive and administrative staff almost exclusively to Head Start grants." OIG further concludes in the Draft Report that CORS "could have improperly received $1 million of Head Start funds for administrative and payroll costs that did not benefit the Head Start program." This conclusion is flawed because it fails to take into account that CORS had a system for internal allocation of these costs and that, more importantly, the Head Start program did not bear the full amount of these costs. While CORS agrees that its systems needed revision, it disagrees with the conclusions of the Draft Report primarily in two areas.

First, OIG was incorrect to conclude that salaries for twenty-five administrative and executive employees had been charged almost exclusively to Head Start during the audit period. In fact, in each year of the audit period, a significant portion of CORS' total executive and administrative expenses associated with the childcare program – including wages for administrative and executive employees – was subtracted from amounts classified as allowable under the Head Start/Early Head Start grants, using a system referred to as the "internal collaboration rate." This was effectively a global offset from the Head Start/Early Head Start grant cost center to reflect administrative costs not attributable to the Head Start and Early Head Start programs.

Specifically, the internal allocation system worked as follows. In its financial statements, CORS allocated a portion of salary for administrative and executive employees, as well as other administrative costs associated with "mixed classrooms," to a cost center generically identified as "childcare." Use of this generic cost center was premised on the fact that mixed classrooms include some students funded by Head Start, some by Early Head Start, some funded by the Ohio Department of Jobs and Family Services childcare subsidy program, and some private-pay students, but costs are incurred collectively for students in the classroom. The "childcare" cost center therefore included expenditures associated with all of these funding sources.

On a monthly basis, CORS offset from the accounting of allowable costs under the Head Start grant a percentage of the executive and administrative costs associated with the childcare cost center. The deduction was based on the percentage of enrolled children in the early childhood education program who were receiving services through a funding source other than Head Start/Early Head Start. As a result of this system, the effective percentage of the relevant employees' salaries charged to Head Start/Early Head Start during the audit period was approximately seventy-three percent during the audit period. CORS is ready to provide documentation and analysis to ACF demonstrating this percentage. The conclusion in the Draft Report, therefore, that CORS charged to the Head Start grant almost all the executive and administrative compensation costs associated with the childcare cost center is incorrect.[5]

Second, it is well settled that the amount of any disallowance depends on whether the grantee "misappropriated," *i.e.* misspent grant funds. *Home Educ. Livelihood Prog.*, DAB No. 1598 (Sept. 20, 1996) ("ACF has not

[5] CORS also disagrees with OIG's proposed method for determining whether CORS allocated excessive administrative and executive salary costs to Head Start. OIG developed its proxy allocation percentages using Head Start revenue as a percentage of CORS' total revenue. CORS believes that OIG's proxy method is not accurate.

produced any evidence showing us that HELP misappropriated, misspent, or otherwise wasted the federal dollars which it did spend during these years."). Put another way, did the grantee have sufficient allowable costs to justify its charges to the grant? CORS acknowledges that the "internal collaboration rate" system CORS used during the audit period was not sufficiently precise. However, that imprecision does not mean a disallowance is appropriate. CORS has begun to develop an alternative proxy method to determine the portion of the twenty-five employees' salary costs that should have been allocated to Head Start. CORS' proposed methodology is based on the number of actual, direct employee work hours expended on each grant program (or other cost center). We believe that this method will show that CORS internal allocation method resulted in only minor (if any) overcharges to the Head Start and Early Head Start grants not the $1.0 million suggested in the report. CORS will be glad to share with ACF the results of this analysis as recommended in the finding.

CORS accordingly requests that in the final report, OIG revise its finding to explicitly recognize the internal allocation method and to remove the assertion that Head Start paid the full amount of administrative costs.

D. *Recommendation #5: "Take corrective action to ensure that [CORS] makes lease payments for less-than-arms-length lease agreements in accordance with federal requirements, maintains personnel activity reports for employees working on Federal awards, and institutes proper policies and procedures for allocating costs that benefit multiple programs."*

CORS has taken a number of steps already to improve its time and effort and cost allocation systems. This work continues and CORS will work with ACF to ensure that it is satisfied with any corrective actions. As to the arms-length issues, as noted above, CORS has worked with ACF to ensure compliance with all legal requirements and intends to continue to do so.

Please let me know if you have further questions or need additional information.

Sincerely,

Edward T. Waters

ETW/SVG:ma
Attachments
cc: Shirley Hathaway, Executive Director

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[13] Technical comments in the grantee's response to the draft have been omitted from the final report and all appropriate changes have been made.