# Cost Accounting Standards In Higher Education: Impact of Required Changes

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**Abstract**

*Beginning in January of 1995, certain institutions of higher education are required to comply with four Cost Accounting Standards and complete a disclosure statement. This study outlines these changes in cost accounting procedures and provides descriptive comments gathered through a survey of seventy universities with regards to these changes. Results indicate that complying with the revised rules affords universities the opportunity to review their costing practices and better train employees in costing procedures. However, the process has been costly in terms of both time and cash expenditures.*

## Introduction

Prior to 1995, the Office of Budget and Management (OMB) Circular A-21 provided guidance for cost accounting procedures in institutions of higher education (hereafter universities). The relationship between universities and the Federal Government was one of respect and trust and the rules reflected that positive relationship. Under OMB Circular A-21, universities were required to consistently allocate costs and only charge costs that were reasonable and necessary. Universities did not find these standards particularly burdensome to comply with. However, in the wake of the investigation into Stanford's cost accounting practices in the early 1990s[1], the OMB through the Cost Accounting Standards Board (CASB) moved to hold universities to more stringent cost accounting standards.

Beginning in January of 1995, universities that receive in excess of $25 million in federal awards are required to comply with four Cost Accounting Standards (CASs) when accounting for federal contracts. In 1996, the OMB extended the applicability of the CASs to all federal contracts, grants and cooperative agreements by including the CASs in OMB Circular A-21. Moreover, some universities were required to complete a disclosure statement documenting costing practices and procedures. The purpose of this paper is to outline these changes in university cost accounting procedures and to provide descriptive comments gathered through a survey of universities with regards to these changes.

Using data from 24 universities, we find that universities believe that there are both costs and benefits to complying with the more stringent federal requirements. Complying with the CAS and completing a disclosure statement afforded universities the opportunity to review their costing practices and better train employees in costing procedures. However, the process has been costly

*Readers with comments or questions are encouraged to contact the authors via email.*

in terms of both time and cash expenditures.

The remainder of this paper is organized as follows. The next section provides a brief overview of the investigation into Stanford's cost accounting practices. We then discuss the Cost Accounting Standards Board and provide an overview of the new rules that universities are now required to comply with followed by a discussion of the survey method and descriptive results. Finally, we present our conclusions and suggestions for future research.

**Overview of the Stanford Cost Accounting Irregularity**

Stanford is a prestigious research university and second only to Johns Hopkins University in the amount of federal research awards. Stanford's federal cognizant agency is the Department of Defense, which means that the Department of Defense awards the largest percentage of Stanford's federal research money. The Office of Naval Research (ONR), within the Department of Defense, negotiates cost rates with Stanford. The Defense Contract Audit Agency (DCAA) audits Stanford for the Department of Defense. Because of the large amount of federal research awards, the ONR has a resident representative at Stanford that oversees the negotiating function on behalf of the ONR (Sarkar and Huddart, 1997).

Paul Biddle became the ONR resident representative at Stanford in 1988. Biddle accused Stanford of overcharging the federal government by $200 million in indirect cost charges. In late 1990, the Defense Contract Audit Agency, Office of Naval Research, General Accounting Office, and Congressman Dingell's House Energy and Commerce Subcommittee on Oversight and Investigations investigated Stanford for fraud and misrepresentation (Sarkar and Huddart, 1997).

The television show *20/20* reported in March, 1991 questionable costs charged by Stanford included the depreciation of the yacht, Victoria; liquor provided for a University event; the restoration of several items including a piano, dining room chairs, and a cedar lined closet; the President's wedding reception; and a $1,600 shower curtain (Problems at Stanford, 1991). These questionable costs were included as indirect costs in Stanford's negotiated overhead rate charged to federal awards.

During the investigation, Stanford claimed they had not overcharged the federal government. But from December 1990 to March 1991, Stanford withdrew questionable costs, including errors and allowable but politically sensitive charges, totaling $1.3 million (Sarkar and Huddart, 1997). Furthermore, after an investigation and high profile congressional hearings, Stanford agreed to repay $1 million (Klinger, 1997). As part of this agreement, the Navy agreed not to claim that Stanford had engaged in fraud, misrepresentation or other wrongdoing (Council on Governmental Relations Meeting Report, 1998).

**Cost Accounting Standards Board and the Application of CASB to Universities**

Congress created the CASB in 1970. It was formally organized in 1971 and CASB rules became effective in 1972. The CASB's purpose is to promulgate cost accounting standards designed to achieve uniformity and consistency for defense contractors and subcontractors operating under federal contracts (U.S. CASB, 1974). The CASB, as originally formulated, was disbanded in 1980. In 1988, Congress re-instituted CASB and assigned oversight to the Office of Federal Procurement Policy within the OMB.

In 1978, educational institutions were exempted from CASB rules. In November of 1994, in the wake of the Stanford cost accounting investigation, the OMB determined that some institutions of higher education were improperly allocating indirect costs to federal research programs and charging unallowable costs to allocable indirect cost pools (U.S. OMB, 1994). Consequently, the OMB proposed that universities who receive more than $25 million in federal awards or who are included in the top 99 research institutions listed in Exhibit A of OMB Circular A-21 be subject to four CASB rules and file a disclosure statement (Bruce, 1995).

The OMB revised and released Circular A-

21 "Cost Principles for Educational Institutions" on May 8, 1996 (U.S. OMB, 1996). It extended the original CASB pronouncements to apply to all federal contracts, grants and cooperative agreements and requires applicable institutions of higher education to file a disclosure statement and comply with CAS 501, CAS 502, CAS 505 and CAS 506. The following subsections will briefly discuss the disclosure statement and each of the cost accounting standards that universities must now comply with. The last subsection will discuss the impact of these new standards on universities.

*Disclosure Statement*

The OMB required universities to complete a disclosure statement. In the disclosure statement universities must specifically disclose information as to the nature of costs that form a cost pool, the basis used to allocate pools, depreciation methods, pension plans and other fringe benefits (Bruce, 1993). The date required to complete the disclosure statement was phased in over an 18-month period. The larger universities in the ranking of top 99 research institutions were required to complete the disclosure statement at earlier dates.

A university official is required to certify that the disclosure statement is current, accurate and complete. The certification carries with it grounds for criminal prosecution and possible jail time for the signer under the False Statements Act if the document contains false statements (Lemmer and Pompeo, 1994). The explicit nature and severity of the penalty is illustrative of the change in relationship between universities and granting agencies from the mutual trust that existed in the past.

*Applicable Cost Accounting Standards (CAS)*

CAS 501 requires that "An educational institution's practices used in estimating costs in pricing a proposal shall be consistent with the institution's cost accounting practices used in accumulating and reporting costs" (U.S. OMB, 1994). CAS 501 ensures that the same type of costs proposed and awarded in a research contract are the same types of costs charged to the sponsor of the research in the contract billing. Under CAS 501, universities must closely examine the categories of costs and monitor their proposals to ensure that the proposed costs are easily captured and identified in a university's accounting system. A university may also incur more time reviewing costs charged to awards to ensure the costs had been previously included and approved in the proposal.

CAS 502 requires that "All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to the final cost objectives" (US OMB, 1994). In other words, a particular type of cost can either be charged as a direct or indirect cost, but not as both. A former Director of the Grants Management Office at the Department of Health and Human Services and currently a consultant with KPMG believes that CAS 502 is based on the principle of equity (Talesnik, 1997). If an award is charged directly for routine postage and then is charged indirectly for the university's postage, that particular award is being charged twice for the same cost. However, if there are "unlike" circumstances, when the project requirements are different from the routine level of effort required by any other activity then the cost in question may be charged as both a direct and indirect cost. For example, a project could be directly charged for the postage associated with a major survey mailing requiring above the routine level of postage and also be indirectly charged for other routine postage. However, postage directly charged to a grant or award must not also be included in an indirect cost pool. CAS 502 also requires that the university's disclosure statement set forth the distinction between direct costs and indirect costs, and the specific criteria and circumstances for making such distinctions.

Under CAS 505, "Costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim or proposal applicable to a Government contract" (U.S. OMB, 1994). This means that there are three types of costs and classifications. First, costs that are expressly unallowable in any circumstance, such as alcoholic beverages. Second, there are costs that are mutually agreed to be unallowable. These are costs that the federal agency states are not allowable on that particular award. The third type is one that could be easily overlooked. These are costs directly associated with the mutually agreed unallowable costs. This means if the agency denies a specific person, such as welder, to work on an award the welders' fringe benefits, travel and other associated costs are also not allowable.

CAS 506 requires that educational institutions use their fiscal year as their cost accounting period. This standard prevents the institution from moving the dates on the cost accounting period to provide for an extra long fiscal year of costs as being representative of the cost accounting period for indirect costs.

*Impact of Compliance with Cost Accounting Standards*

In the past universities were exempt from complying with CASs. Now, that universities must comply with the revised A-21 Circular there may be cause for some concern. Before revision, the A-21 Circular set guidelines for university cost accounting; however, the guidelines were viewed as general rather than restrictive. Examples of guidelines under the old A-21 Circular were that costs were required to be reasonable and necessary. Additionally, institutions were allowed to change the categorization of costs in the proposal if the costs were accounted for under a different category. For example, prior to the implementation of the Revised A-21 Circular a university could change the categorization from supplies to salaries on award budgets up to 10% without the granting agency's approval. This would now violate CAS 501 unless the university had participated in a pilot study under the Federal Demonstration Partnership (FDP). Participating in a pilot study under the FDP allows the university to change categories on budgets under the Federal agency's administrative provisions.

Universities are now subject to additional audit and compliance requirements since they are accountable for compliance with four CASs and a disclosure statement. Universities need to review their practices to ensure they are in compliance with the rules and regulations and to ensure that their practices are consistent among the departments on campus. By disclosing cost accounting practices in a formal document, once the disclosure statement is approved universities will now be audited against those practices in the disclosure statement and in future project audits.

## Survey Findings

A survey[2] was sent to the Office of Sponsored Research at 70 major research institutions across the U.S. Confidentially was promised to the individual respondents. Of the 70 surveys sent, 24 universities responded to the survey for a response rate of 34%. The purpose of the survey was to gain descriptive information on implementation issues, audit findings and perceived costs and benefits of being subjected to the Revised Circular A-21 and the CASs.

*Implementation Issues*

Twenty-one of the twenty-four respondents indicated that they developed a comprehensive plan to comply with the CASs and disclosure statements. Many universities formulated teams of administrators, faculty and consultants to handle the implementation process. Fifteen of the twenty-four respondents provided an estimate of their implementation costs. Even though the federal government had foreseen no additional costs to implement the CASs and disclosure statement (U.S. OMB, 1998), respondents estimated their average cost of implementation at $181,000. The estimated implementation costs ranged from a low of $15,000 to a high of $490,000. Most of the fifteen schools indicated that they had expenditures for training of employees and for consultation fees. See Table 1 for a summary of cost estimates.

*Audit Findings*

Universities are subject to being audited either by the Department of Health and Human Services (HHS) or the Department of Defense. HSS plans to focus their audit on high-risk areas. HHS has identified high risk areas to be treatment of clerical and administrative costs, unallowable

**Table 1.**
**Summary of Estimated Implementation Costs Reported by Respondents**

| Type of Cost | No. of Respondents | Minimum Costs | Maximum Costs | Mean Costs |
|---|---|---|---|---|
| Planning/Surveying | 7 | $5,000 | $120,000 | $24,429 |
| Reviewing Policies | 10 | 5,000 | 173,000 | 54,300 |
| Writing Disclosure Statement | 9 | 3,000 | 40,000 | 13,833 |
| Time With Auditors | 4 | 5,000 | 200,00 | 11,375 |
| Training | 11 | 5,000 | 245,000 | 47,827 |
| Consulting | 13 | 15,000 | 225,000 | 68,385 |
| Other | 5 | 4,500 | 96,500 | 43,600 |

costs, specialized service center rates, cost sharing and cost transfers. The HHS compliance review focuses on whether the practices described in the disclosure statement are compliant with the CASs and OMB Circular A-21 descriptions. Audits investigating whether actual practices are compliant with the disclosure statement descriptions are left to a university's independent auditor (Council on Governmental Relations, 1997).

In contrast, the Department of Defense will determine both adequacy and compliance with regard to compliance with the CASs and OMB Circular A-21. They will also require university's actual practices to be consistent with the disclosure statement description of those practices prior to accepting the disclosure statements as complete.

Twelve of the twenty-four respondents in the survey had been audited or were in the audit process at the time of the survey. Two of the twelve universities had been audited by the Department of Defense while the remainder were either being audited or had been audited by HHS. Five of the respondents had already received official audit findings and four respondents had received potential audit findings during the exit conference held with the auditors. Seven respondents indicated that the university and the auditors interpreted disclosure statements differently; however, most of the findings were insignificant. The audit findings will require a change in the way universities conduct business, but will not result in major cost differences to the federal government. A current update of audit progress according to HHS is in Table 2.

**Table 2.**
**Status of Disclosure Statements**
**(as of March, 2000) with HSS[3]**

| | |
|---|---|
| Disclosure Statements to be Submitted to HHS | 146 |
| Disclosure Statements Received by Division of Cost Allocation (first step in process) | 142 |
| Disclosure Statements Forward to Office of Inspector General for Review (second step in process) | 138 |
| OIG Completed Audits | 45 |
| OIG Audits in Progress | 16 |
| Additional Audits Planned for Fiscal Year 2000 | 12 |
| Approved Disclosure Statements | 19 |

*Perceived Costs and Benefits*

Universities' perceptions of the CASs and disclosure statement varied among respondents. Respondents perceived three primary costs or drawbacks associated with implementation and compliance. First, respondents indicate that there is a cost associated with the time commitment necessary to implement and comply with the CASs. Additionally, respondents indicated that there is a lack of training for both government officials and auditors making it difficult for university officials to receive clarification and interpretation of the rules. Second, universities have many different missions including teaching, research and service functions. Respondents believe that it is difficult to apply rigid rules of cost accounting and allocation when working in such a diverse environment. Third, respondents believe that the rigid standards were implemented due to public perception that universities were misusing federal funds; however, audit findings are not providing evidence of cost disallowances. Therefore, the costs of implementing and complying with the standards are outweighing the benefits received from the implementation process.

Although respondents noted the costs associated with the implementation and compliance with the CASs, they also noted that there are least two benefits. First, complying with the new standards and completing the disclosure statement provided many universities with the impetus to thoroughly review their cost accounting practices and procedures. During this review, university officials were able to determine if their cost accounting practices were consistent across the university and were also able to note weaknesses in their cost accounting system and implement controls. Secondly, compliance increased awareness by university administrators and researchers of how costs should be allocated to research projects and enable university officials to develop more rapport with academic departments.

## Conclusion

Allegations of abuse and fraud in higher education's accounting for government awards caused Congress to investigate and subsequently change the cost accounting standards universities must follow. In order to safeguard the public's funds, the OMB issued a revised Circular A-21 that subjects universities' cost accounting procedures to increased oversight and mandates additional reporting requirements. Respondents to our survey indicated that there are both perceived costs and benefits to this increased regulation. However, respondents reported that although there have been audit findings, there have been no significant findings that result in cost discrepancies with the federal government. Furthermore, they reported an estimated average implementation cost of $181,000. The additional costs of implementing the new standards are borne by the institutions in administrative cost pools, which are capped by the federal government and; therefore, there is no recourse to reclaim the additional costs as part of future overhead charges. These findings could indicate that the increased oversight and regulation may not be cost beneficial for the taxpayer.

## Suggestions for Future Research

One interesting line of future research would be to more directly investigate the costs and benefits of the increased oversight over university cost accounting. The monetary results of audit findings could be investigated and compared against the implementation costs borne by universities thus gaining insight into whether the increased oversight is deriving benefits.

## Endnotes

1. Stanford was accused of misuse of federal funds in the early 1990s. In 1994, Stanford agreed to repay $1 million to the federal government relating to their improper charges of indirect costs (Klinger, 1997). For more information see section 2 and for a description of the case see Sarkar and Huddart, 1997.
2. The survey is available from the authors upon request.
3. As reported by Gary Talesnik (2000).

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Notes