

DAB Decision Upholds Cost Disallowance, Highlights Responsibility to Maintain Oversight over Contracts

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On June 7, 2021, the Department of Health and Human Services' Departmental Appeals Board (DAB) [upheld](#) an Administration for Children and Families (ACF) decision disallowing \$195,763 in costs that Kanawha Institute for Social Research, Inc. (KISRA) charged to its federal Community Economic Development (CED) grant, which is awarded under the Community Services Block Grant (CSBG) Act for economic development projects benefitting low-income individuals and families. 42 U.S.C. § 9921(a)(2)(A). The disallowed costs were for equipment that KISRA purchased for its CED program, but never received from the vendor. This cost disallowance illustrates that it is the federal grantee's responsibility to maintain oversight over its vendor contracts, and the grantee must ensure that the criteria for cost allowability under the Uniform Guidance, [45 C.F.R. Part 75](#), are met before allocating such costs to federal funds

The Case

In this case, KISRA used its CED award to purchase "grow lights" for a hydroponic farm that KISRA intended to build as part of its CED project. KISRA worked with its state agricultural office to identify a recommended vendor and entered into an arrangement with the vendor to purchase the lighting. KISRA paid the vendor an initial 50% deposit (\$130,680) pursuant to a purchase order, prior to receiving any lighting equipment at that time. This payment was made despite the terms of KISRA's own disbursement policy, which required the agency to pay for items only after they have been ordered, received, and are ready to use. Nearly two years later, KISRA paid the remaining balance on the lighting order, despite not having received lighting equipment from the vendor. When KISRA still had not received the equipment a year later (now more than three years after the initial order and deposit), and after making efforts to recoup their payments, KISRA sued the vendor for breach of contract and won a judgment to recover the costs (totaling \$195,763) it had paid for the lighting.

Subsequently, ACF notified KISRA that it was disallowing the \$195,763 in payments for the equipment KISRA never received, partially based on KISRA's own independent audit that classified the payments to the lighting vendor as a questioned cost. KISRA appealed the ACF ruling, arguing that (1) it contracted with the vendor in good faith on the recommendation of a trusted state official and after the exercise of due diligence, (2) it took corrective action by obtaining a judgment against the vendor for the return of the funds, and (3) requiring repayment of the disallowed amount would be unduly harsh and seriously impede KISRA's ability to operate the CED program.

The DAB ultimately upheld ACF's disallowance, finding that the costs charged to the grant were not reasonable because (1) they violated KISRA's own disbursement policy and did not benefit

the CED award, (2) KISRA failed to maintain proper oversight over the vendor agreement, and (3) despite KISRA's efforts to recover the payments from the vendor, the DAB cannot overturn or waive a disallowance based on "mitigating circumstances" or other equitable arguments.

Key Takeaways

Be Careful About Paying for What You Haven't Received. This case indicates that if grantees pay upfront for goods and services they have not received, they must be diligent in maintaining oversight over their vendors to ensure delivery of those goods and services. For costs to be allowable under a federal award, they must be "reasonable for the performance of the Federal award and be allocable thereto." [45 C.F.R. § 75.403\(a\)](#). In determining the reasonableness of a cost, consideration must be given to whether the grantee complied with "sound business practices." [45 C.F.R. § 75.404\(b\)](#). A cost is allocable to a federal award "if the goods or services involved" are chargeable to that federal award "in accordance with relative benefits received." [45 C.F.R. § 75.405\(a\)](#). Procurement standards in Part 75 also require that grantees "maintain oversight to ensure that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders." [Id. § 75.327\(b\)](#).

In this case, KISRA's payment to the lighting vendor of the full purchase amount, without delivery or anticipated delivery of the equipment, was not reasonable for the performance of the award. Paying the vendor in full prior to delivery directly violated KISRA's own disbursement policy. KISRA also failed to show that it took any steps to engage in oversight over the lighting vendor.

The DAB did not rule out the possibility that upfront payments to a vendor, prior to taking delivery, could be reasonable under certain circumstances. Instead, the DAB focused on how KISRA did not adhere to "sound business practices", see [45 C.F.R. § 75.404\(b\)](#), when it violated its own disbursement policy, and then failed to maintain effective internal control over the vendor.

Thus, grantees should have proper measures in place to ensure that a vendor will perform according to the terms of an agreement, especially when charging costs for goods and services that are paid in advance of delivery. Such measures may be included in a CAA's procurement and disbursement policies and outline the conditions for payment (e.g., putting a hold on the payment until shipment of the good or reasonable expectation of performance of the service) as well as practices for monitoring vendor performance in accordance with the terms and conditions of the agreement. Just having a policy in place isn't sufficient; CAAs must spend their federal funds in a manner consistent with their policies and procedures.

The Buck Stops with You. The DAB decision also highlights the extent to which grantees are held responsible for the use of their federal awards. Under the Uniform Guidance, grantees are required to "[e]stablish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award." [45 C.F.R. § 75.303\(a\)](#). General cost principles under the Uniform Guidance are also based on the fundamental premise that grantees are "responsible for the efficient and effective administration of the Federal award through the application of sound management practices" and "for administering Federal funds in a manner consistent with underlying agreements, program objectives, and the terms and conditions of the Federal award." [45 C.F.R. § 75.400\(a\), \(b\)](#).

As this case illustrates, these requirements hold true even where the misuse of federal funds is instigated from outside the federal grantee's organization. KISRA's due diligence prior to

purchasing the equipment (including getting a referral from a state agency and conducting a visit to the lighting vendor's facilities before agreeing to purchase lights) did not absolve them from their responsibility to maintain effective internal control over their federal funding throughout their relationship with the vendor. This is true despite KISRA otherwise doing business with the vendor in good faith, being defrauded by the vendor, and winning its breach of contract lawsuit for the full amount paid to the vendor. The DAB simply notes that, as the grantee, KISRA bears the ultimate responsibility for ensuring that federal funds awarded to it are properly spent in accordance with the applicable statutes and regulations.

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