DAB Decisions Highlight Importance of Effective Financial Management and Good Governance

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***Renaissance III*, DAB No. 2034 (June 22, 2006)[1]**
By Rafael Munoz, CAPLAW

In a decision that underscores the continuing need for strong financial management among recipients of federal funds, as well as the crucial role played by a recipient organization's board of directors, the Departmental Appeals Board (DAB) of the U.S. Department of Health and Human Services (HHS) ruled that the Centers for Disease Control (CDC) properly terminated two cooperative agreements with a Texas nonprofit because the corporation failed to safeguard federal assets. The DAB concluded that the nonprofit, Renaissance III (Renaissance), which received federal funds for HIV prevention programs, had violated HHS standards for its financial management systems[2] and therefore materially failed to comply with the terms of the cooperative agreements.[3]

HHS regulations require that nonprofit recipients of federal funds implement financial management systems that effectively safeguard federal funds and ensure that they are used only for their authorized purposes.[4] These systems must also provide for effective control over and accountability for all funds, property and other assets.[5] In addition, recipients must keep records that identify the source and application of the funds.[6]

The CDC argued that it had properly terminated Renaissance's cooperative agreements because the organization had violated these requirements. It found that Renaissance had used the federal funds for unauthorized purposes and had operated with serious deficiencies in its financial management. Specifically, it discovered that the organization had "an inactive [b]oard of [d]irectors, ineffective or nonexistent oversight of employees' financial transactions, and an accounting system that did not ensure a proper allocation of allowable expenses to the corporation's federal funding sources." The DAB concluded that the findings clearly showed a violation of HHS' financial management requirements.

Renaissance conceded that federal funds were spent for purposes unrelated to its HIV prevention activities, including, apparently, the political campaign activities and other personal expenses of its former executive director. However, it argued that the organization's former executive director and accounting personnel were responsible for the noncompliance, not the organization itself. The DAB rejected this argument, noting that the board of directors was ultimately responsible for adopting sound managerial policies, hiring necessary and competent personnel, overseeing the financial affairs of the corporation, and assuring compliance with applicable law. It also pointed out that, by entering into the cooperative agreements, the board became a fiduciary of federal funds and therefore took on the obligation of ensuring that the funds were spent appropriately. This included supervising employees, including the executive director and accounting staff, and putting a system of financial management in place that prevented employees from misusing federal funds.

Renaissance also contended that termination was inappropriate because, following the CDC review, it had corrected the noncompliance by: appointing a new board of directors and treasurer; obtaining the resignation of both its former executive director and former accounting manager; prohibiting the former executive director from coming onto the organization's premises; seeking reimbursement from him for the misspent funds; and changing the name of the organization.
However, the DAB found these actions irrelevant. It concluded that the CDC was well within its authority to terminate the agreements because Renaissance had admittedly failed to comply with their terms, which required adherence to HHS' financial management requirements. Moreover, the DAB concluded that the corrective actions Renaissance had taken were not meaningful. The appeals board noted that although Renaissance had appointed a new board of directors, it provided no evidence indicating that this board would competently and reliably meet its fiduciary obligation to safeguard federal funds. And, according to the DAB, although Renaissance had appointed a new treasurer, it provided no evidence indicating what the treasurer's role, authority or responsibilities were. Nor did Renaissance submit evidence showing that it had improved its accounting system to ensure that expenses were properly allocated to federal funding sources and that the board was receiving timely and accurate information about the organization's financial condition.

Finally, Renaissance argued that the CDC's decision should be overturned because the community it served would be adversely affected. It maintained that it was the only organization in the area with the necessary expertise and experience to effectively administer the much needed HIV prevention programs. The DAB nevertheless rejected the idea that need for the programs alone was enough to prevent termination. It emphasized that recipients are also responsible for ensuring that taxpayer money is spent in accordance with federal regulations.

Recovery Resource Center, DAB No. 2063 (Jan. 31, 2007)
By Richard Halfmann, CAPLAW

In another case that illustrates how important it is for grantees to comply with the financial requirements of their grant awards, the DAB upheld the denial of continued funding to a discretionary grantee of the Substance Abuse and Mental Health Services Administration (SAMHSA).

SAMHSA had awarded the nonprofit grantee, Recovery Resource Center, Inc. (RRC), a four-year discretionary grant to run an addiction recovery support program. RRC was required to apply yearly to SAMHSA on a noncompetitive basis for "continuation" funding.

After identifying problems with RRC's financial management and corporate governance, SAMHSA the next year named RRC as a "high-risk" grantee because of deficiencies related to the control of and accounting for grant funds and imposed a special award condition prohibiting RRC from drawing down grant funds without prior written approval. SAMHSA then conducted three on-site visits to evaluate RRC's compliance with the grant requirements. After extending the deadline for requested information from RRC in order to form and implement a corrective plan, SAMHSA received an incomplete response and later a supplemental response.

Soon after, SAMHSA denied RRC's application for continuation funding on the basis of RRC's consistent inability to manage funds properly, RRC's failure to comply with the terms of the grant, and the impossibility of formulating a corrective plan in time for the fourth and final budget period of RRC's award. In a prior telephone call, SAMHSA had indicated that service delivery, corporate governance, and data collection and reporting were also deficiencies that merited denial of RRC's application for continuing funding.

DAB Rejects Inadequate Notice Argument

The DAB rejected RRC's argument that SAMHSA failed to comply with the notice requirements of HHS's grants administration regulations for nonprofit grantees by not citing violations of laws, regulations or award conditions in its decision letters denying continuation funding. According to the HHS notice requirements, a "final decision" concerning an award must contain a "complete statement" of the background and basis for the decision, including references to relevant statutes, regulations, or other governing documents, and must provide enough information to allow the recipient to understand the reason for the awarding agency's decision.[7] The DAB did not resolve the issue based on the adequacy of the decision letters, but found instead that SAMHSA had resolved any potential deficiencies in the decision letters in the briefs it submitted for the appeal. Relying on its 1987 Vanderbilt University decision[8] the DAB concluded that since RRC had more than a month to review SAMHSA's detailed briefs and respond to the claims they contained, SAMHSA's briefs satisfied the applicable notice requirements.

Failure to Comply with Award Conditions

RRC's grant terms and conditions incorporated the requirements of the HHS grants administration regulations for nonprofit grantees, including those on financial management and reporting. Under these regulations, a grantee must accurately disclose the financial status of its project on forms specified by HHS, keep accurate and complete records of how grant funds are used, provide for "effective control and accountability for all funds, property, and other assets," adequately safeguard assets and use grant funds "solely for authorized purposes."[9] On appeal, SAMHSA contended that it was justified in denying continued funding because RRC did not comply with these rules. In particular, according to SAMHSA, RRC failed to implement check signing procedures recommended by SAMHSA and lacked other internal controls over check-writing, submitted required financial reports almost nine months late, failed to account for expenditures of over $100,000 in grant funds, and spent grant funds on unallowable costs.

Lack of Internal Controls over Check Writing

SAMHSA argued that RRC did not have adequate check-writing procedures in place. Despite SAMHSA's recommendation that RRC require two signatures on checks, RRC's executive director was the only person with the authority to sign checks. Because the executive director was rarely in the office, other employees regularly signed checks in her name over their initials. During an on-site review conducted by SAMHSA, RRC's executive director presented the reviewer with an affidavit alleging that an RRC employee had forged five checks. RRC also incurred approximately $1,200 in overdraft fees. The DAB held that these actions were clear evidence of weaknesses in RRC's ability to manage, account for, and safeguard federal funds.

Failure to Submit Financial Reports on Time and to Account for Expenditures

SAMHSA also argued that RRC did not comply with its financial reporting requirements. RRC was required to submit an SF-269 Financial Status Report (FSR) no more than 90 days after the end of each budget period.[10] RCC submitted the FSR for its second budget period nine months late and less than one month before the fourth budget period was scheduled to begin. The late FSR failed to account for at least $108,000 in expenditures. The DAB held that the timely submission of the FSRs is "no mere formality or technicality," but a highly important part of the grant requirements. According to the grant terms, SAMHSA was to decide whether to continue RRC's funding prior to the start of each budget period and needed the FSR information to make this decision. The FSRs were especially important for RRC, which had twice been identified as ineffectively managing federal funds[11]

Grant Funds Spent on Unallowable Costs
SAMHSA asserted that RRC violated the requirement that it only use federal funds for allowable costs – those that are "necessary and reasonable for the performance of the federally-supported project."[12] SAMHSA questioned the allowability of expenditures such as registration fees for a charity golf event, cell phone stipends, and the purchases of an LCD television, video games, and exercise machines. Although RRC argued that SAMHSA failed to adequately identify the unallowable expenditures, RRC did not submit any evidence that the expenditures were "necessary or reasonable" for carrying out an addiction recovery program. The DAB rejected RRC's argument that SAMHSA was required to produce evidence that the expenditures were not grant-related, holding that once SAMHSA questioned the allowability of the expenditures, it became RRC's burden to prove they were allowable.[13]

SAMHSA also argued that RRC used grant funds for impermissible "organization costs," including payment of fees to an unrelated organization for incorporating RRC and helping it obtain tax-exempt status. Under the terms of the grant, which incorporated the requirements of Office of Management and Budget Circular A-122, expenditures "in connection with the establishment or reorganization of an organization" were allowable only with SAMHSA's prior consent,[14] which RRC did not obtain.

HHS OIG Audit Findings
An audit of RRC conducted by the HHS Office of the Inspector General (OIG) found similar deficiencies in RRC's ability to manage federal funds. The audit identified a discrepancy of over $113,000 between the FSRs submitted by RRC and RRC's official accounting records. The OIG also found that RRC incurred over $14,000 in "unallowable or unjustified" expenses during the same three-year period. Furthermore, the audit showed that RRC's records of equipment inventory were inadequate and that RRC was unable to present over 40 percent of the items listed in the inventory for inspection.

On-Site Review Findings
SAMHSA's on-site reviews revealed similar problems with RRC's financial and corporate structure. The report from the first review described a board of directors in "disarray" that did not properly oversee RRC's financial affairs. The report from the second review described RRC's "unstable" financial management structure and identified a lack of "adequate internal controls or fiscal policies" to ensure that the grant funds were spent in accordance with the terms of the grant.

SAMHSA's third on-site review showed that, in addition to mismanaging funds, RRC was not achieving the goals of its addiction recovery program. According to the report, there was little evidence that RRC focused on the main elements of its addiction recovery program, i.e., "peer coaching," "recreational recovery," and "recovery education and administration." RRC records indicated that the majority of documented time was devoted to allowing program clients access to phones and computers to help them gain employment. However, the program was only open between 10 a.m. and 4 p.m., which would not allow clients who obtained daytime work to continue to participate in the program. Moreover, the DAB noted that RRC also failed to comply fully with the requirement of the Government Performance and Results Act (GPRA) that it keep records of performance data. As a result, SAMHSA lacked much of the data necessary to evaluate RRC's ability to achieve its objectives. RRC offered no evidence to dispute these findings.

No Entitlement to an Opportunity to Correct Deficiencies
RRC argued that, despite the deficiencies it found, SAMHSA was unjustified in discontinuing RRC's funding without first giving the program an opportunity to correct the deficiencies. RRC argued that HHS Grants Policy Directive (GPD)[15] 3.0715 requires such an opportunity.

The DAB disagreed, stating that GPD 3.07 only states that an awarding agency should notify grantees of problems discovered during the monitoring process. According to SAMHSA, the policy directive did not require it to give RRC an opportunity to correct the deficiencies, but allowed it to do so "as appropriate." The DAB interpreted the words "as appropriate" as allowing an awarding DAB Decisions cont. from page 6 agency the discretion to decline a grantee an opportunity to correct deficiencies if immediate action is necessary. To support its interpretation, the DAB cited two other sections of the GPD, which allow awarding agencies to act immediately to terminate a grant, if it is "necessary to protect the interest of the Government and the public."

The DAB also noted that although SAMHSA was not required to do so, SAMHSA in fact gave RRC an opportunity to comply with the grant requirements. However, upon receiving RRC's incomplete and late responses to requests for information to facilitate the development of a corrective action plan, SAMHSA decided there was insufficient time to develop such a plan and that, even with an effective plan and assistance, RRC was unlikely to perform at an acceptable level within "the foreseeable future."

Lessons for Recipients of SAMHSA Grants

- The DAB will give leeway to awarding agencies with respect to notice requirements. If at any time up to and including the time of the appeal, the awarding agency provided the grantee with an opportunity to review and respond to the agency's specific reasons for discontinuing funding, notice will be deemed sufficient.
- An awarding agency is not required to allow the grantee to implement corrective action prior to denying continuation funding.
- A grantee seeking assistance in implementing a corrective action plan should provide relevant information to the awarding agency quickly so a plan can be formulated before the next budget period begins.
- If the awarding agency questions the allowability of certain expenditures, the grantee bears the burden of proving the expenditures were allowable.

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[1] This and other DAB decisions are available online at http://www.hhs.gov/dab/search.html.
[2] See 45 C.F.R §74.21(b).
[3] See 45 C.F.R. § 74.61(a)(1).
[4] 45 C.F.R. § 74.21(b)(3).
[5] Id.
[6] 45 C.F.R. § 74.21(b)(2).
[7] 45 C.F.R. § 74.90(c).
[8] DAB No. 903.
[9] 45 C.F.R. § 74.21(b)(1)-(4).
[10] 45 C.F.R. § 74.52(a)(1)(iv).
[11] See *Utica Head Start Children and Families, Inc.*, DAB No. 1749, at 31 (2000).
[12] See *Kuigpaymiut, Inc*., DAB No. 1780, at 3 (2001).
[13] See 45 C.F.R. § 74.21(b)(7) (requiring the grantee to have a financial management system that maintains accounting records – including cost accounting records – supported by source documentation).

[14] Office of Management and Budget Circular A-122, Att. B, ¶ 31.
[15] HHS Grants Policy Directives are internal HHS documents that guide agency operations.