

LETTER OPINION
97-L-163

October 6, 1997

Honorable Gary J. Nelson
State Senator
Chairman, Legislative Council
600 East Boulevard Avenue
Bismarck, ND 58505-0360

Dear Senator Nelson:

Thank you for your letter on behalf of the Legislative Audit and Fiscal Review Committee requesting an opinion concerning whether the charging of indirect costs to internal service funds by the University of North Dakota (UND) is within the limits of the law.

According to documents you forwarded with your letter, the question relates to an issue raised by the office of the State Auditor in the North Dakota University System Financial Statement Audit for the Period Ended June 30, 1996. The audit report concludes that UND made five separate transfers exceeding \$50,000 out of internal service funds, for which Budget Section approval was required, without seeking that approval. University System officials dispute this finding arguing that the transactions in question were for routine operating expenditures associated with the funds and therefore excepted from expenditures or transfers requiring Budget Section approval.

The question which was specifically asked and which this opinion will address is whether the allocation of indirect costs to internal service funds by UND is unlawful. Whether UND should allocate indirect costs to internal service funds is an accounting question and a question of public policy and will not be addressed in this opinion.

North Dakota law does not prohibit charging indirect costs to internal service funds. The only regulation which would affect such charging would be the requirement for colleges and universities to seek Budget Section approval for expenditures or transfers of funds over \$50,000 from internal service funds. The 1995 Legislative Assembly amended Senate Bill 2015 to add the following provision relating to internal service funds at higher education institutions:

Colleges and universities must receive approval from the budget section to expend or transfer amounts greater than \$50,000 from the accumulated moneys in these funds except for: (1) mandatory transfers for servicing related debt; and (2) routine operating expenditures associated with the funds.

1995 N.D. Sess. Laws ch. 37, § 22. (Emphasis added.)

In determining whether the reimbursement for indirect costs by the internal service funds violated this section, the first consideration to be addressed is whether "routine operating expenditures" can include indirect costs. The second consideration is whether the indirect costs were associated with the funds.

The phrase "routine operating expenditures" is not defined in the North Dakota statutes, nor is there anything in the legislative history of 1995 N.D. Sess. Laws ch. 37, § 22 which shows a general understanding of this term by the Legislature. Mr. Ed Nagel of the State Auditor's Office testified that the State Auditor would interpret "routine operating expenditures" as expenditures that are related to the nature of the internal service fund, and that such expenditures "could include salaries, capital equipment purchases, and supplies." Testimony of Ed Nagel before the Legislative Council Budget Section (June 21, 1995). Use of the words "could include" indicates examples which would fit within the category but does not limit the category to the examples given. Further, salaries, capital equipment purchases and supplies can be either direct or indirect costs depending on which particular expenditures are being considered. Consequently, the interpretation given by Ed Nagel does not prohibit the inclusion of indirect costs as "routine operating expenditures."

In the absence of a statutory definition, words and phrases are to be interpreted according to their common meanings, unless a contrary intention plainly appears. N.D.C.C. § 1-02-02. Under standard accounting practices, operating costs include indirect or overhead costs. This is demonstrated by the fact that the expenditure cost codes developed by the North Dakota State Office of Management and Budget for use by state agencies include both the indirect cost distribution and the indirect cost recovery codes under operating costs.¹ In addition, the state-wide cost allocation plan developed under N.D.C.C. § 54-44.1-15 also allocates central services to various state agencies as indirect costs to be paid from the agencies' operating funds. See also United States v. R. W. Meyer, Inc., 889 F.2d 1497 (6th Cir. 1989).²

¹ The State Office of Management and Budget has responsibility under N.D.C.C. § 54-44-04 to establish a central accounting system for use by state agencies and to coordinate the development of accounting and financial related systems.

² The United States Court of Appeals for the Sixth Circuit, in determining whether overhead costs could be recovered under CERCLA, held that the government's "response costs" which were recoverable necessarily included both direct and indirect costs. The court pointed out that the indirect costs are essentially overhead costs which are widely recognized and understood in the business community and that the use of direct and indirect costs in calculating total cost comports with standard accounting practices, citing to C.

In addition, the federal Office of Management and Budget (OMB) Circular A-21 "Cost Principles for Educational Institutions" specifically provides for the allocation of indirect costs to benefited activities or cost centers. Also, the North Dakota University System in 1995 published a policy on recharge centers,³ i.e., internal service funds, which provides for full costing, including indirect costs. Included in this policy is the following language: "All recharge center rates will be developed and charged consistent with the respective institutions federally approved indirect cost rate structure, NDUS policy and established institutional policy/procedure." Id. at p.1. This published policy was revised March 12, 1996 and again on August 29, 1996. Therefore, presumably the Legislature was aware of the practice of allocating indirect costs to the internal service funds during the 1997 session and did nothing to preclude such allocations as part of the operating expenses of the centers. Virtually the same language as that quoted above from 1995 N.D. Sess. Laws ch. 37, § 22, was included in 1997 N.D. Sess. Laws ch. 15, § 26. No changes were made to address the University System policy.

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The word "routine" is defined as "not special; ordinary". The American Heritage Dictionary (2d coll. ed. 1991) p. 1074. It is the costs which must be routine to qualify as "routine operating expenditures". Whether it is the practice of the majority of the colleges and universities to allocate these costs to the internal service centers is not the relevant question. Consequently, if the expenses are regularly occurring, ordinary expenses, they would be "routine operating expenditures" even if they were indirect costs. Staff from the State Auditor's Office have indicated that indirect costs can never be allocated to internal service centers but that expenditures for the items which have been allocated must be paid directly from the internal service fund. Nothing is state law requires this, and the allocation of indirect costs comports with standard accounting practices. See footnote 2.

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Horngren & G. Foster, Cost Accounting: A Managerial Emphasis, pp.20-36 (6th ed. 1987). 889 F.2d at 1504.

³ The term "internal service funds" is defined by the State Auditor as those funds which "provide goods or services primarily to other funds or departments of the institution." Testimony of Ed Nagel before the Legislative Council Budget Section (June 21, 1995). The University System uses the synonymous term "recharge centers" for "those units which provide goods or services primarily to other funds or departments of the institution." Policy for the North Dakota University System: Recharge Centers (rev. 3-12-96), p. 2. The phrase "internal service funds" will be used in this opinion to refer to "recharge centers" as well.

Based on the above analysis, it is my opinion that routine operating costs include indirect costs.

The next consideration is whether the indirect costs⁴ allocated have a relationship to or are associated with the internal service funds to which they were allocated. The indirect costs which were allocated by UND to the internal service funds were allocated based on the indirect cost plan submitted to the federal government and approved under OMB Circular A-21. The State Auditor believes these indirect costs are not routine operating expenses because "indirect costs do not further the objectives of the internal service fund." Procedures Performed on NDUS Internal Service Funds During Financial Statement Audit for the Period Ended June 30, 1996, p. 50. For indirect costs to be properly classified as routine operating expenditures under 1995 N.D. Sess. Laws ch. 37, § 22, they must be "associated with the funds." It is important to note, however, that what happens to the money which is received from the internal service funds for the indirect costs is not determinative of the appropriateness of the charges. The relationship of the internal service funds to the indirect costs allocated is the determining factor in whether the costs allocated are routine operating expenditures of the internal service fund.

For indirect costs to be properly allocated to internal service funds they must benefit the funds. OMB Circular A-21 defines allocation as "the process of assigning a cost, or a group of costs, to one or more cost objectives, in reasonable and realistic proportion to the benefit provided or other equitable relationship." OMB Circular A-21, Section B.3. A cost is allocable to a particular cost objective only if the goods or services involved are chargeable or assignable to the cost objective in accordance with the relative benefits received or other equitable relationship. OMB Circular A-21, Section C.4(a). Consequently, if the costs were allocated appropriately under the cost allocation plan developed under OMB Circular A-21, the costs allocated benefit and are related to the internal service fund to which they are allocated.

It is my opinion that if the indirect costs benefited the internal service funds, the costs are associated with the funds and therefore fit within the meaning of "routine operating expenditures" if they are regularly occurring expenses. Because the payment of regularly occurring associated indirect costs by the internal service funds constitutes a routine operating expenditure, the payments do not trigger the requirement under 1995 N.D. Sess. Laws ch. 37, § 22 to seek Budget Section approval. Whether the indirect costs allocated to

⁴ Indirect costs are basically overhead costs. These costs are referred to as "facilities and administrative costs" (F&A) in the Office of Management and Budget Circular A-21 "Cost Principles for Educational Institutions" and are defined as "costs that are incurred for common or joint objectives and, therefore cannot be identified readily and specifically with a particular sponsored project."

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the internal service funds by UND in fact benefited the internal service funds is a question of fact which I am unable to address.

Once a relationship has been established between the costs being allocated and the internal service funds to which they are being allocated, the next question is the method of allocation. According to the State Auditor's report, because UND does not have a computerized cost accounting system or the resources to maintain one, UND utilized the indirect cost allocation plan developed under OMB Circular A-21 to allocate the indirect costs to the internal service funds. The State Auditor questioned the use of this indirect cost allocation plan for billing internal service funds. In the absence of a more specific method of allocating the costs to the various internal service funds, use of the allocation plan developed for federal purposes is not unreasonable and actually may be prudent. Use of a different cost allocation method could jeopardize federal funds received due to the federal requirement that cost allocation to the federal government not discriminate between federally and nonfederally supported activities. See OMB Circular A-21, Section G.1(a)(3).

Whether the indirect costs are being allocated by UND to the internal service funds in the best way or even a reasonable way involves questions of fact which I cannot answer. However, it is my opinion that the allocation of the indirect costs to the internal service funds to be paid as routine operating expenditures is not unlawful.

The use of different allocation methods and whether the indirect cost allocation plan developed by UND under OMB Circular A-21 is being properly applied to the internal service funds are difficult accounting questions which require more factual information than was presented to this office. Staff of the Auditor's Office have indicated that UND had ulterior motives in allocating indirect costs to internal service centers in 1996 to a greater extent than it had in the past. The motives of UND in allocating these costs to the internal service funds is not known and is irrelevant in determining whether such allocations were lawful.

The Legislative Audit and Fiscal Review Committee has the responsibility under N.D.C.C. § 54-35-02.1 to review the financial transactions of the state and determine whether those transactions constitute sound financial practices and whether legislative action is needed to improve the fiscal transactions of the state. The use of internal service funds and the charging of indirect costs to them are matters which can be controlled by legislative action.

Sincerely,

Heidi Heitkamp
ATTORNEY GENERAL

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