

EXECUTIVE OFFICE OF THE PRESIDENT  
BUREAU OF THE BUDGET  
WASHINGTON, D.C. 20503

August 15, 1967

CIRCULAR NO. A-21  
Revised  
Transmittal Memorandum No. 1

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Principles for determining costs applicable to research and development under grants and contracts with educational institutions

1. Purpose. This Transmittal Memorandum amends section J.7.c. of Attachment A to Circular No. A-21 (Revised), dated March 3, 1965. The principal purpose of this amendment is to permit those individuals involved in academic instructing to report their effort on the basis of the academic term, rather than the quarter.

2. Amendment. The last sentence of section J.7.c. of Attachment A is amended to read:

.... "In order to qualify as current and reasonable, estimates must be made no later than one month (though not necessarily a calendar month) after the month in which the services were performed; provided, however, that in the case of professorial staff and of any others whose compensation is chargeable in part to instruction and in part to organized research, the estimates of effort expended will be made for the academic period (semester, trimester, quarter or summer period) but in no case less frequently than three times each year."

3. Effective date. This amendment is effective at the beginning of each educational institution's 1967 fall academic period.

PHILLIP S. HUGHES  
Acting Director

Principles for Determining Costs Applicable to  
**RESEARCH AND DEVELOPMENT**  
Under Grants and Contracts with Educational  
Institutions

CIRCULAR NO. A-21 (Revised)

Executive Office of the President • Bureau of the Budget

MARCH 3, 1965

EXECUTIVE OFFICE OF THE PRESIDENT

BUREAU OF THE BUDGET

WASHINGTON, D.C. 20503

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CIRCULAR NO. A-21  
Revised

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Principles for determining costs applicable to research and development under grants and contracts with educational institutions

1. Purpose. This Circular promulgates attached revised Principles For Determining Costs Applicable To Research And Development Under Grants And Contracts With Educational Institutions. Previous issuances dated September 10, 1958, and January 7, 1961, are superseded in their entirety by this revision of Circular No. A-21.
2. Changes. In general, the changes are intended to clarify and refine the methods used in identifying, classifying, and distributing indirect costs, and to provide more definitive standards concerning the allowability of costs, both direct and indirect, applicable to government research grants and contracts.
3. Additional copies. Additional copies of the revised Circular may be obtained by sending requisitions directly to the Government Printing Office. These requisitions should be placed not later than March 19, 1965, in order that total agency requirements may be printed at the same time.
4. Effective date. The revised principles will be applied at the earliest practicable date.

KERMIT GORDON  
Director

Attachment

(No. A-21)



ATTACHMENT A  
Circular No. A-21 (Revised)

PRINCIPLES FOR DETERMINING COSTS APPLICABLE TO RESEARCH

AND DEVELOPMENT UNDER GRANTS AND CONTRACTS WITH

EDUCATIONAL INSTITUTIONS

Executive Office of the President  
Bureau of the Budget  
March 3, 1965

BUREAU OF THE BUDGET CIRCULAR NO. A-21 (REVISED)

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PRINCIPLES FOR DETERMINING COSTS APPLICABLE TO  
RESEARCH AND DEVELOPMENT UNDER GRANTS AND  
CONTRACTS WITH EDUCATIONAL INSTITUTIONS

A. Purpose and scope.

1. Objectives. This Circular provides principles for determining the costs applicable to research and development work performed by educational institutions under grants from and contracts with the Federal Government. These principles are confined to the subject of cost determination and make no attempt to identify the circumstances or dictate the extent of agency and institutional participation in the financing of a particular research or development project. The principles are designed to provide recognition of the full allocated costs of such research work under generally accepted accounting principles. No provision for profit or other increment above cost is intended.

2. Policy guides. The successful application of these principles requires development of mutual understanding between representatives of universities and of the Federal Government as to their scope, applicability, and interpretation. It is recognized that--

a. The arrangements for agency and institutional participation in the financing of a research and development project are properly subject to negotiation between the agency and the institution concerned in accordance with such government-wide criteria as may be applicable.

b. Each college and university, possessing its own unique combination of staff, facilities and experience, should be encouraged to conduct research in a manner consonant with its own academic philosophies and institutional objectives.

c. Each institution, in the fulfillment of its contractual obligations, should be expected to employ sound management practices.

d. The application of the principles established herein should require no significant changes in the generally accepted accounting practices of colleges and universities.

3. Application. All Federal agencies that sponsor research and development work at educational institutions should apply these principles and related policy guides in determining the costs incurred for such work under grants and cost-reimbursement type contracts and subcontracts. These principles should also be used as a guide in the pricing of fixed price contracts and subcontracts.



B. Definition of terms.

1. Organized research means all research activities of an institution that are separately budgeted and accounted for.

2. Departmental research means research activities that are not separately budgeted and accounted for. Such research work, which includes all research activities not encompassed under the term organized research, is regarded for purposes of this document as a part of the instructional activities of the institution.

3. Research agreement means any valid arrangement to perform federally-sponsored research, including grants, cost-reimbursement type contracts, cost-reimbursement type subcontracts, and fixed-price contracts and subcontracts for research.

4. Other institutional activities means all organized activities of an institution not directly related to the instruction and research functions, such as residence halls, dining halls, student hospitals, student unions, intercollegiate athletics, bookstores, faculty housing, student apartments, guest houses, chapels, theaters, public museums, and other similar activities or auxiliary enterprises. Also included under this definition is any category of cost treated as "unallowable," provided such category of cost identifies a function or activity to which a portion of the institution's indirect costs (as defined in section E.1) are properly allocable.

5. Apportionment means the process by which the indirect costs of the institution are assigned as between (a) instruction and research, and (b) other institutional activities.

6. Allocation means the process by which the indirect costs apportioned to instruction and research are assigned as between (a) organized research, and (b) instruction, including departmental research.

C. Basic considerations.

1. Composition of total costs. The cost of a research agreement is comprised of the allowable direct costs incident to its performance, plus the allocable portion of the allowable indirect costs of the institution, less applicable credits.

2. Factors affecting allowability of costs. The tests of allowability of costs under these principles are: (a) they must be reasonable; (b) they must be allocable to research agreements under the standards and methods provided herein; (c) they must be accorded consistent treatment through application of those generally accepted accounting principles appropriate to the circumstances; and (d) they must conform to any limitations or exclusions set forth in these principles or in the research agreement as to types or amounts of cost items.

3. Reasonable costs. A cost may be considered reasonable if the nature of the goods or services acquired or applied, and the amount involved therefor, reflect the action that a prudent person would have taken under the circumstances prevailing at the time the decision to incur the cost was made. Major considerations involved in the determination of the reasonableness of a cost are: (a) whether or not the cost is of a type generally recognized as necessary for the operation of the institution or the performance of the research agreement; (b) the restraints or requirements imposed by such factors as arm's length bargaining, federal and state laws and regulations, and research agreement terms and conditions; (c) whether or not the individuals concerned acted with due prudence in the circumstances, considering their responsibilities to the institution, its employees, its students, the Government, and the public at large; and (d) the extent to which the actions taken with respect to the incurrence of the cost are consistent with established institutional policies and practices applicable to the work of the institution generally, including government research.

4. Allocable costs.

a. A cost is allocable to a particular cost objective (i.e., a specific function, project, research agreement, department, or the like) if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to research agreement if it is incurred solely to advance the work under the research agreement; or it benefits both the research agreement and other work of the institution in proportions that can be approximated through use of reasonable methods; or it is necessary to the overall operation of the institution and, in the light of the standards provided in this Circular, is deemed to be assignable in part to organized research. Where the purchase of equipment or other capital items are specifically authorized under a research agreement, the amounts thus authorized for such purchases are allocable to the research agreement regardless of the use that may subsequently be made of the equipment or other capital items involved.

b. Any costs allocable to a particular research agreement under the standards provided in this Circular may not be shifted to other research agreements in order to meet deficiencies caused by overruns or other fund considerations, to avoid restrictions imposed by law or by terms of the research agreement, or for other reasons of convenience.

5. Applicable credits.

a. The term applicable credits refers to those receipt or negative expenditure types of transactions which operate to offset or reduce expense items that are allocable to research agreements as direct or indirect costs. Typical examples of such transactions are: purchase discounts, rebates, or allowances; recoveries or indemnities on losses; sales of scrap or incidental services; and adjustments of overpayments or erroneous charges.

b. In some instances, the amounts received from the Federal Government to finance institutional activities or service operations should be treated as applicable credits. Specifically, the concept of netting such credit items against related expenditures should be applied by the institution in determining the rates or amounts to be charged to government research for services rendered whenever the facilities or other resources used in providing such services have been financed directly, in whole or in part, by Federal funds. (See sections F.6., J.10.b., and J.37. for areas of potential application in the matter of direct Federal financing.)

D. Direct costs.

1. General. Direct costs are those that can be identified specifically with a particular cost objective. For this purpose, the term cost objective refers not only to the ultimate objectives against which costs are finally lodged such as research agreements, but also to other established cost objectives such as the individual accounts for recording particular objects or items of expense, and the separate account groupings designed to record the expenses incurred by individual organizational units, functions, projects and the like. In general, the administrative functions and service activities described in section F are identifiable as separate cost objectives, and the expenses associated with such objectives become eligible in due course for distribution as indirect costs of research agreements and other ultimate cost objectives.

2. Application to research agreements. Identifiable benefit to the research work rather than the nature of the goods and services involved is the determining factor in distinguishing direct from indirect costs of research agreements. Typical transactions chargeable to a research agreement as direct costs are the compensation of employees for the time or effort devoted to the performance of work under the research agreement, including related staff benefit and pension plan costs to the extent that such items are consistently treated by the educational institution as direct rather than indirect costs; the costs of materials consumed or expended in the performance of such work; and other items of expense incurred for the research agreement, including extraordinary utility consumption. The cost of materials supplied from stock or services rendered by specialized facilities or other institutional service operations may be included as direct costs of research agreements provided such items are consistently treated by the institution as direct rather than indirect costs and are charged under a recognized method of costing or pricing designed to recover only actual costs and conforming to generally accepted cost accounting practices consistently followed by the institution.

E. Indirect costs.

1. General. Indirect costs are those that have been incurred for common or joint objectives, and thus are not readily subject to treatment as direct costs of research agreements or other ultimate cost objectives. At educational institutions such costs normally are classified under the

Following functional categories: general administration and general expenses; research administration expenses; operation and maintenance expenses; library expenses; and departmental administration expenses.

## 2. Criteria for distribution.

a. Base period. A base period for distribution of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed within that period. The base period normally should coincide with the fiscal year established by the institution, but in any event the base period should be so selected as to avoid inequities in the distribution of costs.

b. Need for cost groupings. The overall objective of the allocation and apportionment process is to distribute the indirect costs described in section F to organized research, instruction, and other activities in reasonable proportions consistent with the nature and extent of the use of the institution's resources by research personnel, academic staff, students, and other personnel or organizations. In order to achieve this objective with reasonable precision, it may be necessary to provide for selective distribution by establishing separate groupings of cost within one or more of the functional categories of indirect costs referred to in section E.1. In general, the cost groupings established within a functional category should constitute, in each case, a pool of those items of expense that are considered to be of like character in terms of their relative contribution to (or degree of remoteness from) the particular cost objectives to which distribution is appropriate. Each such pool or cost grouping should then be distributed individually to the appertaining cost objectives, using the distribution base or method most appropriate in the light of the guides set out in (c) below.

c. Selection of distribution method. Actual conditions must be taken into account in selecting the method or base to be used in distributing to applicable cost objectives the expenses assembled under each of the individual cost groupings established as indicated under (b) above. Where a distribution can be made by assignment of a cost grouping directly to the area benefited, the distribution should be made in that manner. Where the expenses under a cost grouping are more general in nature, the distribution to appertaining cost objectives should be made through use of a selected base which will produce results which are equitable to both the government and the institution. In general, any cost element or cost-related factor associated with the institution's work is potentially adaptable for use as a distribution base provided (1) it can readily be expressed in terms of dollars or other quantitative measure (total direct expenditures, direct salaries, man-hours applied, square feet utilized, hours of usage, number of documents processed, population served, and the like); and (2) it is common to the appertaining cost objectives during the base period. The essential consideration in selection of the distribution base in each instance is that it be the one best suited for assigning the pool of costs to appertaining cost objectives in accord with the relative benefits derived; the traceable cause and effect relationship; or logic and reason, where neither benefit nor cause and effect relationship is determinable.

d. General considerations on cost groupings. The extent to which separate cost groupings and selective distribution would be appropriate at an institution is a matter of judgment to be determined on a case by case basis. Typical situations which may warrant the establishment of two or more separate cost groups (based on account classification or analysis) within a functional category include but are not limited to the following:

- (1) Where certain items or categories of expense relate solely to one of the three major divisions of the institution (instruction, organized research or other institutional activities) or to any two but not the third, such expenses should be set aside as a separate cost grouping for direct assignment or selective distribution in accordance with the guides provided in (b) and (c) above.
- (2) Where any types of expense ordinarily treated as general administration and general expenses or departmental administration expenses are charged to research agreements as direct costs, the similar type expenses applicable to other activities of the institution must, through separate cost groupings, be excluded from the indirect costs allocable to research agreements.
- (3) Where it is determined that certain expenses are for the support of a service unit or facility whose output is susceptible of measurement on a workload or other quantitative basis, such expenses should be set aside as a separate cost grouping for distribution on such basis to organized research and other activities at the institution or within the department.
- (4) Where organized activities (including identifiable segments of organized research as well as the activities cited in section B.4.) provide their own purchasing, personnel administration, building maintenance or similar service, the distribution of general administration and general expenses or operation and maintenance expenses to such activities should be accomplished through cost groupings which include only that portion of central indirect costs (such as for overall management) which are properly allocable to such activities; and
- (5) Where the institution elects to treat as indirect charges the cost of the pension plan and other staff benefits, such costs should be set aside as a separate cost grouping for selective distribution to appertaining cost objectives, including organized research.

e. Materiality. Where it is determined that the use of separate cost groupings and selective distribution are necessary to produce equitable results, the number of such separate cost groupings within a functional category should be held within practical limits, after taking into consideration the materiality of the amounts involved and the degree of precision attainable through less selective methods of distribution.

### 3. Administration of limitations on allowances for indirect costs.

a. Research grants may be subject to laws that limit the allowance for indirect costs under each such grant to a stated percentage of the direct costs allowed. Agencies that sponsor such grants will establish procedures which will assure that: (1) the terms and amounts authorized in each case conform with the provisions of sections C, D, and J of this Circular as they apply to matters involving the consistent treatment and allowability of individual items of cost; and (2) the amount actually allowed for indirect costs under each such research grant does not exceed the maximum allowable under the limitation or the amount otherwise allowable under this Circular, whichever is the smaller.

b. Where the actual allowance for indirect costs on any research grant must be restricted to the smaller of the two alternative amounts referred to in (a) above, such alternative amounts should be determined in accordance with the following guides: (1) the maximum allowable under the limitation should be established by applying the stated percentage to a direct cost base which shall include all items of expenditure authorized by the sponsoring agency for inclusion as part of the total cost for the direct benefit of the work under the grant; and (2) the amount otherwise allowable under this Circular should be established by applying the current institutional indirect cost rate to the appropriate elements of direct cost under the grant, i.e., to total salaries and wages in the case of rates developed under section G, or to total expenditures exclusive of capital expenditures in the case of rates developed under section H of this Circular.

c. When the maximum amount allowable under a statutory limitation or the terms of a research agreement is less than the amount otherwise allocable as indirect costs under this Circular, the amount not recoverable as indirect costs under the research agreement involved may not be shifted to other research agreements.

### F. Identification and assignment of indirect costs.

#### 1. General administration and general expenses.

a. The expenses under this heading are those that have been incurred for the general executive and administrative offices of educational institutions and other expenses of a general character which do not relate solely to any major division of the institution, i.e., solely to (1) instruction;

(2) organized research; or (3) other institutional activities. The general administration and general expense category should also include the staff benefit and pension plan costs applicable to the salaries and wages included therein, an appropriate share of the costs of the operation and maintenance of the physical plant, and charges representing use allowances and/or depreciation applicable to the buildings and equipment utilized in performing the functions represented thereunder.

b. The expenses included in this category may be apportioned and allocated on the basis of total expenditures exclusive of capital expenditures in situations where the results of the distribution made on this basis are deemed to be equitable both to the government and the institution; otherwise the distribution of general administration and general expenses should be made through use of selected bases applied to separate cost groupings established within this category of expenses in accordance with the guides set out in section E.2.

## 2. Research administration expenses.

a. The expenses under this heading are those that have been incurred by a separate organization or identifiable administrative unit established solely to administer the research activity, including such functions as contract administration, security, purchasing, personnel administration, and editing and publishing of research reports. They include the salaries and expenses of the head of such research organization, his assistants, and their immediate secretarial staff together with the salaries and expenses of personnel engaged in supporting activities maintained by the research organization, such as stock rooms, stenographic pools, and the like. The salaries of members of the professorial staff whose academic appointments or formal assignments require the performance of such administrative work may also be included to the extent that the portion so charged to research administration is supported as required by section J.7.b. The research administration expense category should also include the staff benefit and pension plan costs applicable to the salaries and wages included therein, an appropriate share of the costs of the operation and maintenance of the physical plant, and charges representing use allowance and/or depreciation applicable to the buildings and equipment utilized in performing the functions represented thereunder.

b. The expenses included in this category should be allocated to organized research and, where necessary, to departmental research on any basis reflecting the proportion fairly applicable to each. (See section E.2.)

## 3. Operation and maintenance expenses.

a. The expenses under this heading are those that have been incurred by a central service organization or at the departmental level for the administration, supervision, operation, maintenance, preservation, and protection of the institution's physical plant. They include expenses

normally incurred for such items as janitorial and utility services; repairs and ordinary or normal alterations of buildings, furniture and equipment; and care of grounds and maintenance and operation of buildings and other plant facilities. The operation and maintenance expense category should also include the staff benefit and pension plan costs applicable to the salaries and wages included therein, and charges representing use allowance and/or depreciation applicable to the buildings and equipment utilized in performing the functions represented thereunder.

b. The expenses included in this category should be apportioned and allocated to applicable cost objectives in a manner consistent with the guides provided in section E.2. on a basis that gives primary emphasis to space utilization. The allocations and apportionments should be developed as follows: (1) where actual space and related cost records are available or can readily be developed and maintained without significant change in the accounting practices, the amount distributed should be based on such records; (2) where the space and related cost records maintained are not sufficient for purposes of the foregoing, a reasonable estimate of the proportion of total space assigned to the various cost objectives normally will suffice as a means for effecting distribution of the amounts of operation and maintenance expenses involved; or (3) where it can be demonstrated that an area or volume of space basis of allocation is impractical or inequitable, other bases may be used provided consideration is given to the use of facilities by research personnel and others, including students.

#### 4. Library expenses.

a. The expenses under this heading are those that have been incurred for the operation of the library, including the costs of books and library materials purchased for the library, less any items of library income that qualify as applicable credits under section C.5. The library expense category should also include the staff benefit and pension plan costs applicable to the salaries and wages included therein, an appropriate share of the costs of the operation and maintenance of the physical plant, and charges representing use allowances and/or depreciation applicable to the buildings and equipment utilized in the performance of the functions represented thereunder.

b. The expenses included in this category should be allocated on the basis of population including students and other users. Where the results of the distribution made on this basis are deemed to be inequitable to the government or the institution, the distribution should then be made on a selective basis in accordance with the guides set out in section E.2. Such selective distribution should be made through use of reasonable methods which give adequate recognition to the utilization of the library attributable to faculty, research personnel, students and others. The method used will be based on data developed periodically on the respective institution's experience for representative periods.



## 5. Departmental administration expenses.

a. The expenses under this heading are those that have been incurred in the department for the administrative and supporting service operations that jointly benefit the instructional activities and organized research of the department. They include the salaries and expenses of deans or heads, or associate deans or heads, of colleges, schools, departments or divisions, and their immediate secretarial staff together with the salaries and expenses of personnel engaged in supporting activities maintained by the department, such as stockrooms, stenographic pools, and the like provided such supporting services are consistently treated as indirect costs. The salaries of other members of the professorial staff whose academic appointments or formal assignments require the performance of such administrative work may also be included to the extent that the portion so charged to departmental administration expenses is supported as required by section J.7.b. The departmental administration expense category should also include the staff benefit and pension plan costs applicable to the salaries and wages included therein, an appropriate share of the costs of the operation and maintenance of the physical plant, and charges representing use allowances and/or depreciation applicable to the buildings and equipment utilized in performing the functions represented thereunder.

b. No particular distribution base is suggested for general use in allocating the expenses included in this category, since the situations which influence the incurrence of such expenses and the nature of the administrative support provided therefrom may vary considerably as between institutions or departments within the same institution. Accordingly, the distribution of departmental administration expenses should be made through use of selected bases applied to separate cost groupings established within this category of expenses in accordance with the guides set out in section E.2.

## 6. Set-off for indirect expenses otherwise provided for by the government.

a. The items to be accumulated under this heading are the reimbursements and other receipts from the Federal Government which are used by the institution to support directly, in whole or in part, any of the administrative or service (indirect) activities described in the foregoing (sections F.1. through F.5.). They include any amounts thus applied to such activities which may have been received pursuant to an institutional base grant or any similar contractual arrangement with the Federal Government other than a research agreement as herein defined (section B.3.).

b. The sum of the items in this group shall be treated as a credit to the total indirect cost pool before it is apportioned to organized research and to other activities. Such set-off shall be made prior to the determination of the indirect cost rate or rates as provided in section G.

G. Determination and application of indirect cost rate or rates.

1. Indirect cost pools.

a. Subject to (b) below, indirect costs allocated to organized research should be treated as a common pool, and the costs in such common pool should then be distributed to individual research agreements benefiting therefrom on a single rate basis.

b. In some instances a single rate basis for use across the board on all government research at an institution may not be appropriate, since it would not take into account those different environmental factors which may affect substantially the indirect costs applicable to a particular segment of government research at the institution. For this purpose, a particular segment of government research may be that performed under a single research agreement or it may consist of research under a group of research agreements performed in a common environment. The environmental factors are not limited to the physical location of the work. Other important factors are the level of the administrative support required, the nature of the facilities or other resources employed, the scientific disciplines or technical skills involved, the organizational arrangements used, or any combination thereof. Where a particular segment of government research is performed within an environment which appears to generate a significantly different level of indirect costs, provision should be made for a separate indirect cost pool applicable to such work. The separate indirect cost pool should be developed during the course of the regular distribution process, and the separate indirect cost rate resulting therefrom should be utilized provided it is determined that (1) such indirect cost rate differs significantly from that which would have obtained under (a) above, and (2) the volume of research work to which such rate would apply is material in relation to other government research at the institution.

2. The distribution base. Indirect costs allocated to organized research should be distributed to applicable research agreements on the basis of direct salaries and wages. For this purpose, an indirect cost rate should be determined for each of the separate indirect cost pools developed pursuant to section G.1. The rate in each case should be stated as the percentage which the amount of the particular indirect cost pool is of the total direct salaries and wages of all research agreements identified with such pool.

3. Negotiated lump sum for overhead. A negotiated fixed amount in lieu of indirect costs may be appropriate for self-contained or off-campus research activities where the benefits derived from an institution's indirect services cannot be readily determined. Such amount negotiated in lieu of indirect costs will be treated as an offset to total indirect expenses before apportionment to instruction, organized research, and other institutional activities. The base on which such remaining expenses are allocated should be appropriately adjusted.

4. Predetermined fixed rates for indirect costs. Public Law 87-638 (76 Stat 437) authorizes the use of predetermined fixed rates in determining the indirect costs applicable under research agreements with educational institutions. The stated objectives of the law are to simplify the administration of cost-type research and development contracts with educational institutions, to facilitate the preparation of their budgets, and to permit more expeditious closeout of such contracts when the work is completed. In view of the potential advantages offered by this procedure, consideration should be given to the negotiation of predetermined fixed rates for indirect costs in those situations where the cost experience and other pertinent facts available are deemed sufficient to enable the contracting parties to reach an informed judgment as to the probable level of indirect costs during the ensuing accounting period.

H. Simplified method for small institutions.

1. General.

a. Where the total direct cost of all government-sponsored research and development work at an institution does not exceed \$500,000 in a year, the use of the abbreviated procedure described in H.2. below may be acceptable in the determination of allowable indirect costs. Under this abbreviated procedure, data taken directly from the institution's most recent annual financial report and immediately available supporting information will be utilized as a basis for determining the indirect cost rate applicable to research agreements at the institution.

b. The rigid formula approach provided under the abbreviated procedure has limitations which may preclude its use at some institutions, either because the minimum data required for this purpose are not readily available, or because the application of the abbreviated procedure to the available data produces results which appear inequitable to the government or the institution. In any such case, indirect costs should be determined through use of the regular procedure rather than the abbreviated procedure.

2. Abbreviated procedure.

a. Total expenditures as taken from the most recent annual financial report will be adjusted by eliminating from further consideration the following items or categories of expenditure: capital items as defined in J.3; unallowable costs as defined under various headings in section J; and payments for annuities and student aid.

b. Total expenditures as adjusted under the foregoing will then be distributed as between (1) expenditures applicable to overhead functions, and (2) expenditures for all other purposes. The first group should include amounts associated with general administration, operation and maintenance of the physical plant, and the library, to which may be added an amount not to exceed 20% of the salaries and expenses of deans and heads of departments. The second group--expenditures for all other purposes--should include the

amounts applicable to all other activities, namely instruction, organized research, and other institutional activities as defined under section B.4.

c. The indirect cost rate will then be computed as the percentage relationship between the two categories of expenditures developed under (b), i.e., the rate should be stated as the percentage which the total of expenditures applicable to overhead functions is of the total for all other purposes.

J. General standards for selected items of cost.

Sections J.1. through J.46 provide standards to be applied in establishing the allowability of certain items involved in determining cost. These standards should apply irrespective of whether a particular item of cost is properly treated as direct cost or indirect cost. Failure to mention a particular item of cost in the standards is not intended to imply that it is either allowable or unallowable; rather determination as to allowability in each case should be based on the treatment or standards provided for similar or related items of cost. In case of discrepancy between the provisions of a specific research agreement and the applicable standards provided, the provisions of the research agreement should govern.

1. Advertising costs. The term advertising costs means the costs of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, exhibits, and the like. The only advertising costs allowable are those which are solely for (a) the recruitment of personnel required for the performance by the institution of obligations arising under the research agreement, when considered in conjunction with all other recruitment costs, as set forth in J.32; (b) the procurement of scarce items for the performance of the research agreement; or (c) the disposal of scrap or surplus materials acquired in the performance of the research agreement. Costs of this nature, if incurred for more than one research agreement or for both research agreement work and other work of the institution, are allowable to the extent that the principles in sections D and E are observed.

2. Bad debts. Any losses, whether actual or estimated, arising from uncollectible accounts and other claims, related collection costs, and related legal costs, are unallowable.

3. Capital expenditures. The costs of equipment, buildings, and repairs which materially increase the value or useful life of buildings or equipment, are unallowable except as provided for in the research agreement.

4. Civil defense costs. Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire-fighting training, posting of additional exit notices and directions, and other approved civil defense

measures) undertaken on the institution's premises pursuant to suggestions or requirements of civil defense authorities are allowable when distributed to all activities of the institution. Capital expenditures for civil defense purposes will not be allowed, but a use allowance or depreciation may be permitted in accordance with provisions set forth elsewhere. Costs of local civil defense projects not on the institution's premises are unallowable.

5. Commencement and convocation costs. Costs incurred for commencements and convocations apply only to instruction and therefore are not allocable to research agreements, either as direct costs or indirect costs.

6. Communication costs. Costs incurred for telephone services, local and long distance telephone calls, telegrams, radiograms, postage and the like, are allowable.

7. Compensation for personal services.

a. General. Compensation for personal services covers all remuneration paid currently or accrued to employees of the institution for services rendered during the period of performance under government research agreements. Such remuneration includes salaries, wages, staff benefits (see section J.39), and pension plan costs (see section J.23). The costs of such remuneration are allowable to the extent that the total compensation to individual employees is reasonable for the services rendered and conforms to the established policy of the institution consistently applied, and provided that the charges for work performed directly on government research agreements and for other work allocable as indirect costs to organized research are determined and supported as hereinafter provided.

b. Payroll distribution. Amounts charged to organized research for personal services, regardless of whether treated as direct costs or allocated as indirect costs, will be based on institutional payrolls which have been approved and documented in accordance with generally accepted institutional practices. In order to develop necessary direct and indirect allocations of cost, supplementary data on time or effort, as provided in (c) below, normally need be required only for individuals whose compensation is properly chargeable to two or more research agreements or to two or more of the following broad functional categories: (1) instruction; (2) organized research; (3) indirect activities as defined in section E.1; or (4) other institutional activities as defined in section B.4.

c. Reporting time or effort. Charges for salaries and wages of individuals other than members of the professional staff will be supported by time and attendance and payroll distribution records. For members of the professional staff, current and reasonable estimates of the percentage distribution of their total effort may be used as support in the absence of actual time records. The term professional staff includes professors, instructors, research associates and assistants, graduate students, and other persons performing professional work. In order to qualify as current and reasonable, estimates must be made no later than one month (though not

necessarily a calendar month) after the month in which the services were performed; provided however, that in the case of professorial staff and of any others whose compensation is chargeable in part to instruction and in part to organized research, the estimates of effort expended must be made at appropriate time intervals as determined by the sponsoring agency, but in no case less frequently than once each quarter.

d. Preparation of estimates of effort. Where required under (c) above, estimates of effort spent by a member of the professional staff on each research agreement should be prepared by the individual who performed the services, or by a responsible individual such as a department head or supervisor having firsthand knowledge of the services performed on each research agreement. Estimates must show the allocation of effort between organized research and all other university activities in terms of the percentage of total effort devoted to each of the broad functional categories referred to in (b) above. The estimate of effort spent on a research agreement may include a reasonable amount of time spent in activities contributing and intimately related to work under the agreement, such as preparing and delivering special lectures about specific aspects of the ongoing research, writing research reports and articles, participating in appropriate research seminars, consulting with colleagues and graduate students with respect to related research, and attending appropriate scientific meetings and conferences. The term "all other university activities" would include departmental research, instruction, student services, administration, committee work, and public services undertaken on behalf of the university. In no case should effort spent in lecturing for or preparing for formal courses listed in the catalog and offered for degree credit, or effort devoted to committee or administrative work related to university business be included in the estimate of effort spent on research agreements.

e. Application of budget estimates. Estimates determined before the performance of services, such as budget estimates on a monthly, quarterly, semester, or yearly basis do not qualify as estimates of effort spent. However, such estimates may be accepted as support for charges made if subsequently found to be valid in the light of effort actually expended as reflected in the individual's report of effort made in accordance with the above. Where the cumulative effort actually expended from month to month varies from cumulative effort budgeted or forecasted, the amount claimed should be based on effort actually expended as supported under the individual's report of effort, or the claim may be deferred.

f. Non-university professional activities. A university must not alter or waive university-wide policies and practices dealing with the permissible extent of professional services over and above those traditionally performed without extra university compensation, unless such arrangements are specifically authorized by the sponsoring agency. Where university-wide policies do not adequately define the permissible extent of consultantships or other non-university activities undertaken for extra pay, the government may require that the effort of professional staff working under research agreements be allocated as between (1) university activities, and (2) non-university professional activities. If the sponsoring agency should consider the extent of non-university professional effort excessive, appropriate arrangements governing compensation will be negotiated on a case by case basis.

g. Salary rates for academic year. Charges for work performed on government research by faculty members during the academic year will be based on the individual faculty member's regular compensation for the continuous period which, under the practice of the institution concerned, constitutes the basis of his salary. Charges for work performed on research agreements during all or any portion of such period would be allowable at the base salary rate. In no event will the charge to research agreements, irrespective of the basis of computation, exceed the proportionate share of the base salary for that period, and any extra compensation above the base salary for work on government research during such period would be unallowable. This principle applies to all members of the faculty at an institution and, since intra-university consulting is assumed to be undertaken as a university obligation requiring no compensation additional to full-time base salary, the principle also applies to those who function as consultants or otherwise contribute to a research agreement conducted by another faculty member of the same institution; provided, however, that in unusual cases where consultation is across departmental lines or involves a separate or remote operation, and the work performed by the consultant is in addition to his regular departmental load, any charges for such work representing extra compensation above the base salary are allowable provided such consulting arrangement is specifically provided in the research agreement or approved in writing by the sponsoring agency.

h. Salary rates for periods outside the academic year. Charges for work performed by faculty members on government research during the summer months or other periods not included in the base salary period will be determined for each faculty member at a rate not in excess of that which would be applicable under his base salary and will be limited to that effort actually expended on such research.

i. Salary rates for part-time faculty. Charges for work performed on government research by faculty members having only part-time appointments for teaching will be determined at a rate not in excess of that for which he is regularly paid for his part-time teaching assignments. Example: An institution pays \$5,000 to a faculty member for half-time teaching during the academic year. He devoted one-half of his remaining time (25% of his total available time) to government research. Thus his additional compensation, chargeable by the institution to government research agreements, would be one-half of \$5,000 or \$2,500.

8. Contingency provisions. Contributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, intensity, or with an assurance of their happening, are unallowable.

9. Deans of faculty and graduate schools. The salaries and expenses of deans of faculty and graduate schools, or their equivalents, and their staffs, are allowable.

## 10. Depreciation and use allowances.

a. Institutions may be compensated for the use of buildings, capital improvements, and usable equipment on hand through use allowances or depreciation. Use allowances are the means of providing such compensation when depreciation or other equivalent costs are not considered. However, a combination of the two methods may not be used in connection with a single class of fixed assets.

b. Due consideration will be given to government-furnished facilities utilized by the institution when computing use allowances and/or depreciation if the government-furnished facilities are material in amount. Computation of the use allowance and/or depreciation will exclude both the cost or any portion of the cost of buildings and equipment borne by or donated by the Federal Government, irrespective of where title was originally vested or where it presently resides and, secondly, the cost of grounds. Capital expenditures for land improvements (paved areas, fences, streets, sidewalks, utility conduits and similar improvements not already included in the cost of buildings) are allowable provided the systematic amortization of such capital expenditures has been provided in the institution's books of account, based on reasonable determinations of the probable useful lives of the individual items involved, and the share allocated to organized research is developed from the amount thus amortized for the base period involved.

c. Where the use allowance method is followed, the use allowance for buildings and improvements will be computed at an annual rate not exceeding two percent of acquisition cost. The use allowance for equipment will be computed at an annual rate not exceeding six and two-thirds percent of acquisition cost of usable equipment in those cases where the institution maintains current records with respect to such equipment on hand. Where the institution's records reflect only the cost (actual or estimated) of the original complement of equipment, the use allowance will be computed at an annual rate not exceeding ten percent of such cost. Original complement for this purpose means the complement of equipment initially placed in buildings to perform the functions currently being performed in such buildings; however, where a permanent change in the function of a building takes place, a redetermination of the original complement of equipment may be made at that time to establish a new original complement. In those cases where no equipment records are maintained, the institution will justify a reasonable estimate of the acquisition cost of usable equipment which may be used to compute the use allowance at an annual rate not exceeding six and two-thirds percent of such estimate.

d. Where the depreciation method is followed, adequate property records must be maintained. The period of useful service (service life) established in each case for usable capital assets must be determined on a realistic basis which takes into consideration such factors as type of construction, nature of the equipment used, technological developments in the particular research area, and the renewal and replacement policies followed for the individual items or classes of assets involved. Where the



depreciation method is introduced for application to assets acquired in prior years, the annual charges therefrom must not exceed the amounts that would have resulted had the depreciation method been in effect from the date of acquisition of such assets.

e. Where an institution elects to go on a depreciation basis for a particular class of assets, no depreciation, rental or use charge may be allowed on any such assets that, under (d) above, would be viewed as fully depreciated; provided, however, that reasonable use charges may be negotiated for any such assets if warranted after taking into consideration the cost of the facility or item involved, the estimated useful life remaining at time of negotiation, the actual replacement policy followed in the light of service lives used for calculating depreciation, the effect of any increased maintenance charges or decreased efficiency due to age, and any other factors pertinent to the utilization of the facility or item for the purpose contemplated.

11. Employee morale, health, and welfare costs and credits. The costs of house publications, health or first-aid clinics and/or infirmaries, recreational activities, employees' counseling services, and other expenses incurred in accordance with the institution's established practice or custom for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs will be equitably apportioned to all activities of the institution. Income generated from any of these activities will be credited to the cost thereof unless such income has been irrevocably set over to employee welfare organizations.

12. Entertainment costs. Costs incurred for amusement, social activities, entertainment, and any items relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable.

13. Equipment and other facilities. The cost of equipment or other facilities are allowable where such purchases are approved by the sponsoring agency concerned or provided for by the terms of the research agreement.

14. Fines and penalties. Costs resulting from violations of, or failure of the institution to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the research agreement, or instructions in writing from the contracting officer.

15. Insurance and indemnification.

a. Costs of insurance required or approved, and maintained, pursuant to the research agreement, are allowable.

b. Costs of other insurance maintained by the institution in connection with the general conduct of its activities, are allowable subject to the following limitations: (1) types and extent and cost of coverage

must be in accordance with sound institutional practice; (2) costs of insurance or of any contributions to any reserve covering the risk of loss of or damage to government-owned property are unallowable except to the extent that the government has specifically required or approved such costs; and (3) costs of insurance on the lives of officers or trustees are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

c. Contributions to a reserve for an approved self-insurance program are allowable to the extent that the types of coverage, extent of coverage, and the rates and premiums would have been allowed had insurance been purchased to cover the risks.

d. Actual losses which could have been covered by permissible insurance (through an approved self-insurance program or otherwise) are unallowable unless expressly provided for in the research agreement, except that costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound management practice as well as minor losses not covered by insurance, such as spoilage, breakage and disappearance of small hand tools, which occur in the ordinary course of operations, are allowable.

e. Indemnification includes securing the institution against liabilities to third persons and other losses not compensated by insurance or otherwise. The government is obligated to indemnify the institution only to the extent expressly provided for in the research agreement, except as provided in (d) above.

16. Interest, fund raising, and investment management costs.

a. Costs incurred for interest on borrowed capital or temporary use of endowment funds, however represented, are unallowable.

b. Costs of organized fund raising, including financial campaigns, endowment drives, solicitation of gifts and bequests, and similar expenses incurred solely to raise capital or obtain contributions, are not allocable to government research agreements.

c. Costs of investment counsel and staff and similar expenses incurred solely to enhance income from investments are not allocable to government research agreements.

d. Costs related to the physical custody and control of monies and securities are allowable.

17. Labor relations costs. Costs incurred in maintaining satisfactory relations between the institution and its employees, including costs of labor management committees, employees' publications, and other related activities, are allowable.

18. Losses on other research agreements or contracts. Any excess of costs over income under any other research agreement or contract of any

nature is unallowable. This includes, but is not limited to, the institution's contributed portion by reason of cost-sharing agreements or any under-recoveries through negotiation of flat amounts for overhead.

19. Maintenance and repair costs. Costs incurred for necessary maintenance, repair or upkeep of property (including government property unless otherwise provided for) which neither add to the permanent value of the property nor appreciably prolong its intended life but keep it in an efficient operating condition, are allowable.

20. Material costs. Costs incurred for purchased materials, supplies, and fabricated parts directly or indirectly related to the research agreement, are allowable. Purchases made specifically for the research agreement should be charged thereto at their actual prices after deducting all cash discounts, trade discounts, rebates, and allowances received by the institution. Withdrawals from general stores or stockrooms should be charged at their cost under any recognized method of pricing stores withdrawals conforming to sound accounting practices consistently followed by the institution. Incoming transportation charges are a proper part of material cost. Direct material cost should include only the materials and supplies actually used for the performance of the research agreement, and due credit should be given for any excess materials retained, or returned to vendors. Due credit should be given for all proceeds or value received for any scrap resulting from work under the research agreement. Where government-donated or furnished material is used in performing the research agreement, such material will be used without charge.

21. Memberships, subscriptions and professional activity costs.

a. Costs of the institution's membership in civic, business, technical, and professional organizations are allowable.

b. Costs of the institution's subscriptions to civic, business, professional, and technical periodicals are allowable.

c. Costs of meetings and conferences, when the primary purpose is the dissemination of technical information, are allowable. This includes costs of meals, transportation, rental of facilities, and other items incidental to such meetings or conferences.

22. Patent costs. Costs of preparing disclosures, reports, and other documents required by the research agreement and of searching the art to the extent necessary to make such invention disclosures, are allowable. In accordance with the clauses of the research agreement relating to patents, costs of preparing documents and any other patent costs, in connection with the filing of a patent application where title is conveyed to the government, are allowable. (See also J.33. below.)

23. Pension plan costs. Costs of the institution's pension plan which are incurred in accordance with the established policies of the institution are allowable, provided such policies meet the test of reasonableness and the methods of cost allocation are not discriminatory, and provided appropriate adjustments are made for credits or gains arising out of normal and abnormal employee turnover or any other contingencies that can result in forfeitures by employees which inure to the benefit of the institution.

24. Plant security costs. Necessary expenses incurred to comply with government security requirements, including wages, uniforms and equipment of personnel engaged in plant protection, are allowable.

25. Preresearch agreement costs. Costs incurred prior to the effective date of the research agreement, whether or not they would have been allowable thereunder if incurred after such date, are unallowable unless specifically set forth and identified in the research agreement.

26. Professional services costs.

a. Costs of professional services rendered by the members of a particular profession who are not employees of the institution are allowable, subject to (b) and (c) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the government. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

b. Factors to be considered in determining the allowability of costs in a particular case include (1) the past pattern of such costs, particularly in the years prior to the award of government research agreements; (2) the impact of government research agreements on the institution's total activity; (3) the nature and scope of managerial services expected of the institution's own organizations; and (4) whether the proportion of government work to the institution's total activity is such as to influence the institution in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under government research agreements.

c. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization or the prosecution of claims against the government, are unallowable. Costs of legal, accounting and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the research agreement.

27. Profits and losses on disposition of plant, equipment, or other capital assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short- or long-term investments, shall be excluded in computing research agreement costs.

28. Proposal costs. Proposal costs are the costs of preparing bids or proposals on potential government and non-government research agreements or projects, including the development of engineering data and cost data necessary to support the institution's bids or proposals. Proposal costs of the current accounting period of both successful and unsuccessful bids and proposals normally should be treated as indirect costs and allocated currently to all activities of the institution, and no proposal costs of past accounting periods will be allocable in the current period to the government research agreement. However, the institution's established practices may be to treat proposal costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

29. Public information services costs. Costs of news releases pertaining to specific research or scientific accomplishment are unallowable unless specifically authorized by the sponsoring agency.

30. Rearrangement and alteration costs. Costs incurred for ordinary or normal rearrangement and alteration of facilities are allowable. Special arrangement and alteration costs incurred specifically for the project are allowable when such work has been approved in advance by the sponsoring agency concerned.

31. Reconversion costs. Costs incurred in the restoration or rehabilitation of the institution's facilities to approximately the same condition existing immediately prior to commencement of government research agreement work, fair wear and tear excepted, are allowable.

32. Recruiting costs.

a. Subject to (b), (c), and (d) below, and provided that the size of the staff recruited and maintained is in keeping with workload requirements, costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate staff, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, travel costs of applicants for interviews for prospective employment, and relocation costs incurred incident to recruitment of new employees, are allowable to the extent that such costs are incurred pursuant to a well managed recruitment program. Where the institution uses employment agencies, costs not in excess of standard commercial rates for such services are allowable.

b. In publications, costs of help wanted advertising that includes color, includes advertising material for other than recruitment purposes, or is excessive in size (taking into consideration recruitment purposes for which intended and normal institutional practices in this respect), are unallowable.

c. Costs of help wanted advertising, special emoluments, fringe benefits, and salary allowances incurred to attract professional personnel from other institutions that do not meet the test of reasonableness or do not conform with the established practices of the institution, are unallowable.

d. Where relocation costs incurred incident to recruitment of a new employee have been allowed either as an allocable direct or indirect cost, and the newly hired employee resigns for reasons within his control within 12 months after hire, the institution will be required to refund or credit such relocation costs to the government.

33. Royalties and other costs for use of patents. Royalties on a patent or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the research agreement and applicable to tasks or processes thereunder, are allowable unless the government has a license or the right to free use of the patent, the patent has been adjudicated to be invalid or has been administratively determined to be invalid, the patent is considered to be unenforceable, or the patent has expired.

34. Sabbatical leave costs. Costs of leave of absence to employees for performance of graduate work or sabbatical study, travel, or research are allowable provided the institution has a uniform policy on sabbatical leave for persons engaged in instruction and persons engaged in research. Such costs will be allocated on an equitable basis among all appertaining activities of the institution. Where sabbatical leave is included in fringe benefits for which a cost is determined for assessment as a direct charge, the aggregate amount of such assessments applicable to all work of the institution during the base period must be reasonable in relation to the institution's actual experience under its sabbatical leave policy.

35. Scholarships and student aid costs. Costs of scholarships, fellowships and other forms of student aid apply only to instruction and therefore are not allocable to research agreements, either as direct costs or indirect costs. However, in the case of students actually engaged in work under research agreements, any tuition remissions to such students for work performed are allocable to such research agreements provided consistent treatment is accorded such costs (see section J.39).

36. Severance pay.

a. Severance pay is compensation in addition to regular salaries and wages which is paid by an institution to employees whose services are being terminated. Costs of severance pay are allowable only to the extent that such payments are required by law, by employer-employee agreement, by established policy that constitutes in effect an implied agreement on the institution's part, or by circumstances of the particular employment.

b. Severance payments that are due to normal, recurring turnover and which otherwise meet the conditions of (a) above may be allowed provided the actual costs of such severance payments are regarded as expenses applicable to the current fiscal year and are equitably distributed among the institution's activities during that period.

c. Severance payments that are due to abnormal or mass terminations are of such conjectural nature that allowability must be determined on a case-by-case basis. However, the government recognizes its obligation to participate, to the extent of its fair share, in any specific payment.

37. Specialized service facilities operated by institution.

a. The costs of institutional services involving the use of highly complex and specialized facilities such as electronic computers, wind tunnels, and reactors are allowable provided the charges therefor meet the conditions of (b) or (c) below, and otherwise take into account any items of income or federal financing that qualify as applicable credits under section C.5.

b. The costs of such institutional services normally will be charged directly to applicable research agreements based on actual usage or occupancy of the facilities at rates that (1) are designed to recover only actual costs of providing such services, and (2) are applied on a nondiscriminatory basis as between organized research and other work of the institution, including commercial or accommodation sales and usage by the institution for internal purposes.

c. In the absence of an acceptable arrangement for direct costing as provided in (b) above, the costs incurred for such institutional services may be assigned to research agreements as indirect costs, provided the methods used achieve substantially the same results. Such arrangements should be worked out in coordination with all government users of the facilities in order to assure equitable distribution of the indirect costs.

38. Special services costs. Costs incurred for general public relations activities, catalogs, alumni activities, and similar services, are unallowable.

39. Staff benefits.

a. Staff benefits in the form of regular compensation paid to employees during periods of authorized absences from the job, such as for annual leave, sick leave, military leave, and the like, are allowable provided such costs are absorbed by all institutional activities, including organized research, in proportion to the relative amount of time or effort actually devoted to each. (See J.34. for treatment of sabbatical leave.)

b. Staff benefits in the form of employer contributions or expenses for social security, employee insurance, workmen's compensation insurance, the pension plan (see section J.23.), tuition or remission of tuition for individual employees or their families (see section J.35.), and the like, are allowable provided such benefits are granted in accordance with established institutional policies, and provided such contributions and other expenses, whether treated as indirect costs or as an increment of direct

Labor costs, are distributed to particular research agreements and other activities in a manner consistent with the pattern of benefits accruing to the individuals or groups of employees whose salaries and wages are chargeable to such research agreements and other activities.

40. Student activity costs. Costs incurred for intramural activities, student publications, student clubs, and other student activities, apply only to instruction and therefore are not allocable to research agreements, either as direct costs or indirect costs.

41. Student services costs. Costs of the deans of students, administration of student affairs, registrar, placement offices, student advisers, student health and infirmary services, and such other activities as are identifiable with student services apply only to instruction and therefore are not allocable to research agreements, either as direct costs or indirect costs. However, in the case of students actually engaged in work under research agreements, a proportion of student services costs measured by the relationship between hours of work by students on such research work and total student hours including all research time may be allowed as a part of research administration expenses.

42. Taxes.

a. In general, taxes which the institution is required to pay and which are paid or accrued in accordance with generally accepted accounting principles, and payments made to local governments in lieu of taxes which are commensurate with the local government services received are allowable, except for (1) taxes from which exemptions are available to the institution directly or which are available to the institution based on an exemption afforded the government and in the latter case when the sponsoring agency makes available the necessary exemption certificates; and (2) special assessments on land which represent capital improvements.

b. Any refund of taxes, interest, or penalties, and any payment to the institution of interest thereon, attributable to taxes, interest, or penalties which were allowed as research agreement costs, will be credited or paid to the government in the manner directed by the government provided any interest actually paid or credited to an institution incident to a refund of tax, interest and penalty will be paid or credited to the government only to the extent that such interest accrued over the period during which the institution had been reimbursed by the government for the taxes, interest, and penalties.

43. Transportation costs. Costs incurred for freight, express, cartage, postage, and other transportation services relating either to goods purchased, in process, or delivered, are allowable. When such costs can readily be identified with the items involved, they may be charged directly as transportation costs or added to the cost of such items. Where



identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the institution follows a consistent, equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the research agreement, should be treated as a direct cost.

#### 44. Travel costs.

a. Travel costs are the expenses for transportation, lodging, subsistence, and related items incurred by employees who are in travel status on official business of the institution. Such costs may be charged on an actual basis, on a per diem or mileage basis in lieu of actual costs incurred, or on a combination of the two, provided the method used is applied to an entire trip and not to selected days of the trip, and results in charges consistent with those normally allowed by the institution in its regular operations.

b. Travel costs are allowable subject to (c) and (d) below, when they are directly attributable to specific work under a research agreement or are incurred in the normal course of administration of the institution or a department or research program thereof.

c. The difference in cost between first-class air accommodations and less than first-class air accommodations is unallowable except when less than first-class air accommodations are not reasonably available to meet necessary mission requirements, such as where less than first-class accommodations would (1) require circuitous routing, (2) require travel during unreasonable hours, (3) greatly increase the duration of the flight, (4) result in additional costs which would offset the transportation savings, or (5) offer accommodations which are not reasonably adequate for the medical needs of the traveler.

d. Costs of personnel movements of a special or mass nature are allowable only when authorized or approved in writing by the sponsoring agency or its authorized representative.

#### 45. Termination costs applicable to contracts.

a. Contract termination generally gives rise to the incurrence of costs or to the need for special treatment of costs, which would not have arisen had the contract not been terminated. Items peculiar to termination are set forth below. They are to be used in conjunction with all other provisions of this Circular in the case of contract termination.

b. The cost of common items of material reasonably usable on the institution's other work will not be allowable unless the institution submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the institution, consideration should be given to the

institution's plans and orders for current and scheduled work. Contemporaneous purchases of common items by the institution will be regarded as evidence that such items are reasonably usable on the institution's other work. Any acceptance of common items as allowable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

c. If in a particular case, despite all reasonable efforts by the institution, certain costs cannot be discontinued immediately after the effective date of termination, such costs are generally allowable within the limitations set forth in this Circular, except that any such costs continuing after termination due to the negligent or willful failure of the institution to discontinue such costs will be considered unacceptable.

d. Loss of useful value of special tooling, and special machinery and equipment is generally allowable, provided (1) such special tooling, machinery, or equipment is not reasonably capable of use in the other work of the institution; (2) the interest of the government is protected by transfer of title or by other means deemed appropriate by the contracting officer; and (3) the loss of useful value as to any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other government contracts for which the special tooling, special machinery, or equipment was acquired.

e. Rental costs under unexpired leases are generally allowable where clearly shown to have been reasonably necessary for the performance of the terminated contract, less the residual value of such leases, if (1) the amount of such rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable; and (2) the institution makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease. There also may be included the cost of alterations of such leased property, provided such alterations were necessary for the performance of the contract, and of reasonable restoration required by the provisions of the lease.

f. Settlement expenses including the following are generally allowable: (1) accounting, legal, clerical, and similar costs reasonably necessary for the preparation and presentation to contracting officers of settlement claims and supporting data with respect to the terminated portion of the contract, and the termination and settlement of subcontracts; and (2) reasonable costs for the storage, transportation, protection, and disposition of property provided by the government or acquired or produced by the institution for the contract.

g. Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor are generally allowable.

46. Use allowances. See section J.10. above.

EXECUTIVE OFFICE OF THE PRESIDENT  
BUREAU OF THE BUDGET  
WASHINGTON, D.C. 20503

December 13, 1965

CIRCULAR NO. A-74

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Participation in the costs of research supported by  
Federal grants

1. Purpose. This Circular provides guidelines for Federal agencies concerning participation by colleges and universities and other institutions in the cost of research supported through Federal grants.

These guidelines take into account provisions in the appropriation acts for the fiscal year 1966 for the Department of Defense (P.L. 89-213), the Departments of Labor and Health, Education, and Welfare (P.L. 89-156), and the Independent Offices (P.L. 89-128), that prohibit Federal agencies from paying any recipient of a grant for the conduct of a research project an amount equal to as much as the entire cost of such a project. These guidelines also take into account the removal of statutory limitations on the payment of the indirect costs of research financed by Federal grants.

This Circular does not affect existing policies and practices of Federal agencies concerning cost participation in research financed through contracts.

2. Effective date. The guidelines set forth in this Circular should be applied as soon as practicable to all research grants awarded subsequent to the issuance of this Circular and not later than March 1, 1966.

3. Background of cost participation. The conduct of research is a significant function and important responsibility of institutions of higher education. In addition to contributing to the advancement of knowledge, academic research is an essential element in the advanced training of scientists and engineers. At the same time, the Federal Government relies heavily upon research conducted in non-Federal institutions, and particularly in colleges and universities, to assist in the accomplishment of the missions of Federal agencies. Thus, Federal research grants generally serve the objectives both of the institutions and of the Federal Government. Cost participation reflects this mutuality of interest.

In the past, cost participation by the grantee institution has been accomplished through: (a) cost participation as a consequence of legal limitations on the proportion of indirect costs payable by the Federal

agencies under research grants; (b) cost participation through continued payment by grantee institutions of part or all the salaries of faculty members or professional personnel participating in sponsored research, and (c) payment by grantee institutions of a portion of other costs such as equipment.

#### 4. Guidelines for Federal agencies.

a. Agencies should generally continue their present policies and practices concerning the extent of cost participation by grantee institutions:

(1) Except for increased indirect cost allowances which may be paid as a result of the removal of statutory limitations on payment of such allowances;

(2) Except that in cases where Federal agencies would otherwise pay all research costs, the applicant institution must share in such research costs on more than a token basis.

b. The costs which may be charged to a research grant include direct costs and their associated indirect costs, as determined in accordance with Bureau of the Budget Circular No. A-21 (Revised), dated March 3, 1965.

c. The extent of cost participation by grantees may vary in accordance with a number of factors relating to both the granting agency and the grantee institution, e.g.:

(1) A higher degree of cost participation should ordinarily exist when the cost of the research consists primarily of the efforts of senior faculty during the academic year, or when the grantee institution's long range interests are best served by substantial cost participation;

(2) Cost participation should generally be lower when a major portion of the research cost consists of equipment, when the grant provides for a large component of services to be made available on a regional or national basis, or when in the view of a Federal agency an area of research requires special stimulus in the national interest.

#### 5. Administration.

a. Federal agencies will require that proposals for each research grant include:

(1) The amount requested for direct expenses, by category of direct expense;

(2) The amount requested for indirect expenses related to the requested direct expenses;

(3) The total grant request;

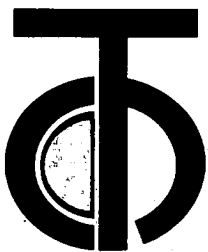
(4) The additional amount which the grantee institution proposes as its contribution from non-Federal sources to the planned research.

b. Federal agencies will require each grantee institution to maintain records to demonstrate a total actual contribution by the grantee institution of an amount which is not less, in proportion to the actual charges against the grant, than the total amount proposed in the application, or any subsequent revision thereof, approved by the agency. The amount of the grantee institution's contribution will be subject to audit.

6. Agency reports on cost participation. Each agency which awards research grants will report to the Bureau of the Budget by November 1 of each year on cost participation by grantee institutions in the immediately preceding fiscal year. This report should provide information on the overall amount obligated for grants in the preceding fiscal year and the overall additional amount which grantee institutions proposed to contribute to the research supported by these grants. (The report to be submitted by November 1, 1966, should cover grants awarded from the date of implementation of this Circular through June 30, 1966.)

CHARLES L. SCHULTZE  
Director

(No. A-74)



12. What contributes to care of patient should be a change.

MATT F. McNULTY, JR.  
B-etc. over

COUNCIL OF TEACHING HOSPITALS • ASSOCIATION OF AMERICAN MEDICAL COLLEGES  
1346 CONNECTICUT AVENUE, N. W. • WASHINGTON, D. C. 20036 • (202) 223-5364

11. Space - Any principle for distribution of research & viewing of same.

10. Time consumption space consumption equipt. - material consumption longer need. for teaching

AGENDA

JOINT COMMITTEE ON FINANCIAL PRINCIPLES  
SEVEN CONTINENTS V.I.P. LOUNGE  
O'HARE AIRPORT  
CHICAGO, ILLINOIS  
OCTOBER 17, 1967  
(10:00 a.m. - 4:00 p.m.)

- I. Call to Order: 10:00 a.m.
- II. Background Information Relating to the Formation of the Committee on Financial Principles.
- III. Documents and Studies of Interest to the Activities of the Committee.

Reimb GERE  
1. N.Y.U.  
2. JEFF  
3. N.C. Baptist  
4. Mich. 9 on  
5. Iowa  
6. Ohio  
7. Utah

- 1. Yale-New Haven Study
- 2. Protocol for Teaching Hospital Section of HEW-AAMC Program Cost Information Study
- 3. Bureau of Budget Circulars A-21 and A-74
- 4. American Hospital Association's Statement of Reimbursement - Approved by Board of Trustees - August 28, 1965
- 5. A Guide to Hospitals: Establishing Indirect Cost Rates for Research Grants and Contracts with the Department of Health, Education and Welfare

TOM Campbell/minn Grad.  
Hopkins Res.  
Asso Dir  
Kanaso C. H.  
Kanaso  
Gen.

Tab 1

Tab 2

Tab 3

IV. Discussion of Purposes and Development of Objectives and Goals of the Committee.

V. Determination of Methodological Approach for Attainment of Established Goals.

VI. Other Business.

VII. Date of Next Meeting.

VIII. Adjournment: not later than 4:00 p.m.

ASK  
Bus Carroll  
FOR list of  
prices. p. 10  
who should be  
etc.

Principles  
1. House staff  
2. Innovation  
3. Operational  
4. Basic Res  
5. Black Model  
6. Need to  
7. General Med  
8. Power Educ  
9. student  
10. staff

9. Diagnostic  
10. Therapeutic  
11. Rehabilitative  
12. Supportive  
13. Preventive  
14. Also  
Committee  
RHS

COMMITTEE MEMBERSHIP

- Charles R. Goulet, Chairman
- Richard D. Wittrup, Vice-Chairman
- Vernon L. Harris Gerhard Hartman, Ph.D. Reid T. Holmes Bernard J. Lackner Lawrence E. Martin Roger B. Nelson, M.D. Irvin G. Wilmot
- STAFF
- Matthew F. McNulty, Jr.
- Fletcher H. Bingham, Ph.D.
- A.J. Carroll
- ROBERVERS
- Roger L. Amidon
- John W. Colloton

g. installing  
RHS

7. Criteria for establishing paramedical students while 5 students 6 student staff

13. Switchboard - Info. Desk  
etc. need ~~new~~ added staff.
14. In suc educ efforts are  
more severe in teaching  
logically.

15. <sup>Additional</sup> Adm. cost as present of existing  
in a med. Ctr & Univ.

# American Hospital Association

840 NORTH LAKE SHORE DRIVE CHICAGO ILLINOIS 60611

TELEPHONE 312 645-9400 CABLE ADDRESS: AMHOSP

## STATEMENT ON REIMBURSEMENT

Approved by Board of Trustees  
August 28, 1965

### PREAMBLE

The hospital system in the United States has been created by multiple interests and agencies but carries a strong precedent of creativity through voluntary action. It must be remembered that the hospital system in the United States is characterized by a diversity of ownership, government (local, state, and federal), nonprofit voluntary (community or religious sponsored), and proprietary. Financing for hospital service is provided through direct payment by the patient, taxation, nonprofit hospital service plans, and insurance. To some extent the acceptance of varying financial arrangements depends on the ownership and sponsorship of hospitals.

The object of every hospital is to provide services of the quality and quantity needed by the public it serves. It is essential that hospitals receive sufficient revenues to meet their current as well as future needs in order that they may fulfill this objective. The stewardship responsibility for the operation, preservation and development of hospitals is vested in a governing body charged with the establishment of policy and control in keeping with the hospital's fundamental purpose of achieving and maintaining optimum health care. In the total sense of exercising stewardship responsibilities and in the effective organization, management, and control of hospitals, the governing body, administration and medical staff share interrelated responsibilities.

The community in turn must recognize that the provision of optimum health care is influenced by various conditions such as physical structure, availability of skilled personnel, availability of adequate financing and many others. These factors vary with size, location and primary purpose of a hospital. Other elements in the cost pattern of a hospital are the extent of research and educational programs being carried out in its joint pursuit of the goal of optimum care and community service.

Ultimate responsibility for control of operating cost is best exercised by the governing body through policy and guidelines developed to meet the financial need. The prerogative of determining whether expenses may or may not be incurred cannot be exercised by other than the responsible governing body, because this could adversely affect the goal of optimum care.

*Standards of Financing*  
*Use Charge or Amortization Charge in lieu of depreciation.*  
*Repairs & Alterations to Plant.*

*H. Expertise in forms of Reimbursement*  
*① Replacement of existing Equipmt - Repl. cost Basis*  
*② Addition of new Equipmt - Certain # level of expense beyond that of a community hospital*  
*③ Beyond level of community hospital - Repl. cost Basis*  
*④ Repl. cost Basis - beyond level of community hospital*  
*⑤ Repl. cost Basis - beyond level of community hospital*  
*⑥ Repl. cost Basis - beyond level of community hospital*  
*⑦ Repl. cost Basis - beyond level of community hospital*  
*⑧ Repl. cost Basis - beyond level of community hospital*  
*⑨ Repl. cost Basis - beyond level of community hospital*  
*⑩ Repl. cost Basis - beyond level of community hospital*

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In order to serve the public and to maintain and preserve the voluntary system, hospitals should receive remuneration for their services under a reimbursement program designed to meet the total fiscal needs of an ongoing organization. It must be recognized that the community responsibilities of hospitals create income needs that go beyond the simple recovery of out-of-pocket expenditures. Some of the specific items that create requirements for additional income include the acquisition and replacement of physical plant and equipment, the need for adequate working capital, the conduct of educational and research programs, and the provision of funds to provide services for indigent patients.

A hospital must demonstrate financial needs based on efficient and economical operation that embodies the highest standard of care possible within the facility's working environment. Uniform principles of accounting and uniform gathering of statistics should be followed to justify need. In addition, hospitals should involve themselves in areawide planning to prevent duplication of facilities when such duplication will lower quality of care and increase operating cost to the community. Further, there should be greater integration among the facilities designed to serve the various aspects of total community health needs, such as extended care and psychiatric units. Finally, it should be the joint responsibility of hospitals and the medical profession to administer the utilization of beds and ancillary services so that their efficient use is assured in treating the sick and injured and restoring them to the highest possible level of health.

In summary, hospitals are institutions of public trust. In the administration of the trust, the governing body must attend to the quality and quantity of care as well as assure the public of economical and efficient operation. It can only uphold these responsibilities through sound fiscal operation. In turn, the governing body has the right to expect that all purchasers of hospital services will accept the responsibility of adequately meeting current and future financial needs.

ENDORSEMENT OF PRINCIPLES OF PAYMENT FOR HOSPITAL CARE

The first edition of the Principles of Payment for Hospital Care was approved by the House of Delegates of the American Hospital Association in 1953\*. In 1961 a special study led to a reappraisal and clarification of their basic substance. They were slightly modified again in 1963.

From this brief background, several observations can be drawn.

1. The principles have withstood the buffeting of an extended period of constant change brought about by the development and growth of hospitals and their subsequent accelerated financial needs.
2. The principles themselves have not been allowed to remain static, but have, in light of changing attitudes and conditions, been subject to repeated reevaluation.
3. Such reevaluation has resulted only in minor modifications.

Therefore, the American Hospital Association looks to the Principles of Payment for Hospital Care as its basic document in establishing its position regarding reimbursement to hospitals for services that they provide.

The Principles of Payment for Hospital Care set forth standards of adequacy and equity for reimbursement to hospitals.

\*Adopted by the House of Delegates, September 1953.  
Revised January 1962, September 1962, and August 1963.

## INTRODUCTORY COMMENT

"The growth of programs by which third-party agencies pay hospital bills for groups of beneficiaries has raised important questions as to the amounts which should be paid to hospitals for care. Individual patients require different services and individual hospitals establish different regular charges for nominally similar services.

"The differences in patient needs and hospital charges require special agreements between hospitals and third-party agencies whenever the former agree to furnish specific services, and the latter agree to make payments for those services. The payments must be adequate in total and equitable among hospitals.

"The third-party's liability to a hospital may be merely the payment of a certain dollar amount (indemnity or cash benefit) toward the charges for services rendered. Such liability does not require a contractual arrangement between the hospitals and the third-party agencies, except for such matters as extension of credit to patients or authority to make payments directly to the hospitals.

"Any contract to provide services should protect a hospital's financial interest and its program of public service. Payments should encourage high standards, administrative efficiency, institutional freedom, and the rendering of service in the interest of patient welfare.

"Two broad bases are available for developing a method of reimbursement of hospitals for service benefits, namely, the 'charges' established by the hospitals and the 'costs' incurred by them. The American Hospital Association publications, Uniform Chart of Accounts and Definitions for Hospitals<sup>1</sup> and Cost Finding for Hospitals,<sup>2</sup> are suggested guides for the determination of costs.

"The prevailing sociologic and economic factors and medicohospital relationships in a given area determine the degree of success or failure of any method of payment for hospital care. Because of the general public interest in hospital operations, any method of payment which enables a single agency to control the number of services rendered to patients and the charges established for such services is undesirable. Such control leads to interference in hospital management and can affect adversely the quality of care rendered to patients. Therefore, a system of payment which permits purchasers of large quantities of hospital care to gain control of hospital management is to be avoided.

"Payment of existing charges, as established from time to time by each institution, requires no special contractual arrangement.

"The conferences sponsored by the American Hospital Association and attended by representatives of both hospitals and third-party agencies, made only passing reference to established charges as the basis of

contract payment for services in hospitals. The conference reports expressed the view that reimbursement from third parties should not exceed the total amounts charged to noncontract patients receiving similar care in the same hospitals.

"Under the principle of free enterprise, individual full-pay patients would expect to pay approximately the same amounts for the same services in the same community. But in the long run, established charges to individual patients cannot be expected to control the amounts paid by large-scale contractors who guarantee definite payments for all their clients. The amount paid by such a contracting agency will tend to equal the cost of the services rendered to its clients.

"A hospital or group of hospitals must, over a period of time, be reimbursed for the cost of services which they provide. Conversely, all responsible third-party contractors should be prepared to pay for the costs of services furnished to their beneficiaries. Many problems must be solved in the application of this fundamental principle.

"Individual hospitals face different financial problems. But they must deal with contracting agencies as a group. A contractual arrangement within a community must be guided by equity for the majority of hospitals which agree to provide service.

"The following principles of payment are intended to outline standards of adequacy and equity for contract payments for services furnished by hospitals to beneficiaries of third-party agencies, such as Blue Cross Plans, governmental bodies and other organizations which engage in the purchase of hospital services on behalf of groups of individuals."

## 1.000 BASIS FOR PAYMENT

1.100

"The amount and method of payment to hospitals should be such as (1) to pay fairly and adequately for services purchased, (2) to maintain essential services, and (3) to encourage the development of higher standards of service to meet the needs of the community.

"COMMENT . . . The financing of hospital care requires recognition of local differences in the financial needs of hospitals. The economic factors which influence financial solvency vary from community to community. The methods and amounts of reimbursement should recognize the financial needs of the hospital, should permit protection of capital assets, and should allow for the orderly implementation and expansion of necessary health services. The implementation and expansion of necessary health services should be guided through areawide planning and should be such as to protect the public from construction of facilities unrelated to real need, and should limit unnecessary duplication. The hospital administrator, the governing board, and the medical staff must have assurance that the amount and method of payment will be adequate to cover the current costs of providing the services which are requisite to necessary care, and that payments can be adjusted from time to time to meet the cost of expanded and improved quality of care."

INTERPRETATION . . . The American Hospital Association directs attention to the comment under Principle 2.304, which recognizes that deficits resulting from bad debts and the net loss sustained in the care of indigent and medically indigent must be recovered if essential services are to be retained. The comment under Principle 2.304 establishes the appropriateness of including these items as factors of reimbursement under Principle 1.100. The American Hospital Association also recognizes that in equitable financing there is need for working capital and funds to develop higher standards of service to meet the needs of the community.

1.200

"Agencies purchasing hospital services should pay the cost incurred in providing services for which they are responsible under their agreements with hospitals. Total payments to a hospital for such services for an accounting period should not exceed total hospital charges for these services.

"COMMENT . . . Hospital income from patients whose bills are the responsibility of a third party should equal the cost incurred by the hospital in providing a high quality of care. The term cost as used here assumes the acceptance of definitions of cost in the succeeding sections of this report. This principle also implies that both parties (agency and hospital) are agreed as to contract services that are to be provided and as to the method of computing the contract payments that are to be made."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

1.201

"A hospital should apply uniform principles for determining rates of reimbursement for similar services for third-party agencies.

"COMMENT . . . The formulas used for establishing contract payments by third-party agencies should be applied uniformly for all such organizations. The amount of contract payment necessarily will vary for different third-party agencies, if the agencies contract to pay for different types of services for their beneficiaries. The most important principle is that each third-party agency should contract to pay the cost for whatever services are agreed upon."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

1.202

"Third-party agencies should not be expected to pay for that portion of the cost of specific cases which has been or will be paid for from other revenues designated for such cases.

"COMMENT . . . A hospital should not receive income for the same service from two separate sources. A hospital, however, should not be expected to furnish services below cost to third-party agencies merely because it receives income for general purposes from some other source."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

1.203

"Established charges to self-paying patients for similar services and accommodations should be based upon and be reasonably related to the cost.

"COMMENT . . . Where established charges for self-paying patients are less than cost, it is difficult to justify contract payments from third-party agencies that are based on cost. Charity and other allowances should be granted on an individual basis and should not be a factor in setting charges. It is not practicable for the charge for every item of service to reflect its individual cost, but the composite regular charges for contract service should at least equal the composite costs of such care. (Further details refer to the Guiding Policy for Hospitals in Pricing Their Services to the Public.<sup>3</sup>)"

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 1.300

"Hospitals which are paid the cost of services they render to beneficiaries of third-party purchasers must accept the obligation of making available essential facilities and a high quality of service, with due regard to economy and efficiency.

"COMMENT . . . Hospitals which are paid cost must assume basic obligations to provide essential facilities and high quality service at minimal expense and maximal operational efficiency. The acceptance of this principle involves both self-imposed and externally applied judgments of adequacy, deficiency or extravagance of hospital administration."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 1.400

"Rates of payment should reflect current hospital costs.

"COMMENT . . . Rates of payment should be related directly to cost in the period in which care is given, insofar as administratively possible. A procedure for retroactive adjustment to current costs, or for determining an acceptable estimate of current costs, should be mutually agreed upon. This principle is important in that hospital costs must be met in terms of current price and wage levels. It is, therefore, in the interest of the third-party agency and the hospital to devise a method by which costs may be computed and payments adjusted promptly to reflect current variations."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 1.500

"Payments to different hospitals for the same service may differ.

"COMMENT . . . Hospitals differ in physical design, equipment, accessibility, location, legal responsibilities, community responsibilities, medical staff, percentage of utilization, and in many other details. For these reasons hospitals may provide comparable quality in specific patient services at varying unit costs.

"One hospital frequently is unable to maintain as high a percentage of occupancy or as complete utilization of diagnostic facilities as another institution. This adversely affects costs. But even the resultant higher costs may be justified because of the need for stand-by service in the community."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

## 2.000 DETERMINATION OF REIMBURSABLE COST

### 2.100

"The determination of reimbursable cost requires acceptance and use of uniform definitions, accounting, statistics, and reporting.

"COMMENT . . . Any systematic payment program requires an orderly procedure of reporting in order that the payment program may be administered fairly and expeditiously. Hospitals must agree to provide the basic information necessary for comparable analysis of cost and equitable distribution of payments for third-party purchasers. Reimbursement at cost by third-party agencies is dependent upon their knowledge of the procedures used in providing the data. Only through uniformity of records and reports can third-party agencies be assured that they are paying for similar services in different hospitals on comparable bases."

INTERPRETATION . . .

1. The American Hospital Association recognizes that reimbursement may be determined without the use of cost analysis or cost finding.
2. Uniform records and reports do not necessarily require identical methods of accounting.

### 2.200

"The American Hospital Association publications, Uniform Chart of Accounts and Definitions for Hospitals and Cost Finding for Hospitals, should be used as guides in compiling financial and statistical data and in allocating and segregating costs.

"COMMENT . . . Official standard definitions, accounting procedures, statistical procedures, and methods of reporting among hospitals are those described in the American Hospital Association publications, Uniform Chart of Accounts and Definitions for Hospitals and Cost Finding for Hospitals. Their uniform use, nationally, will contribute to better accounting by the hospitals and better understanding of costs and cost factors by third-party purchasers."



INTERPRETATION . . . The publications Uniform Chart of Accounts and Definitions for Hospitals and Cost Finding for Hospitals are presently being revised. Certain groups of hospitals have used the publications at the local level as a base and by revision and amplification have developed them into effective accounting tools. The American Hospital Association is of the opinion that these manuals should be used as guides in the development of a reimbursement program.

### 2.300

"It is essential that the principle of reimbursement of hospitals at cost be embodied in a reimbursable cost formula. This may be used to determine the total cost of operations for the purpose of computing a general average cost per inpatient day or other unit of service. Such an average cost figure should be used when applicable to the services which a hospital or hospitals agree to furnish. Under other circumstances the average may serve as a basis for adjustment, up or down, according to the scope and content of an agreement with respect to cases covered, accommodations used, extent of services, or other major considerations.

"Attention is called to the recommendations indicated in 2.301 to 2.311 with respect to certain items which are sufficiently important to justify special mention for inclusion or exclusion in the computation of reimbursable cost.

"COMMENT . . . An average per diem cost, computed under a reimbursable cost formula, should be used to establish a rate of payment under contractual agreements with third-party agencies when the patients for whom a contracting agency is responsible are average for the hospital concerned.

"Patients paid for by specific third-party agencies may be atypical for a variety of reasons. For example, all patients might be hospitalized for obstetrical care, and reimbursable cost for this group might not be average cost for all patients in the hospital. A third-party agency might wish to have all of its beneficiaries hospitalized in semiprivate rooms which might cost more than average cost, or all beneficiaries of another agency might be chronic patients requiring long periods of hospitalization with relatively small amounts of special services at less than average cost. In such situations, it may be necessary to develop more detailed cost data or other factual information for the purpose of demonstrating the extent to which a reimbursement rate should deviate from the overall average patient day cost."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.301

"Identifiable expenditures made for medical research purposes, over and beyond the usual care of patients, should not be included in determining reimbursable cost of patient care and services.

"COMMENT . . . Research ultimately results in better patient care; its benefits usually are derived over long periods of time and are not always of direct benefit to patients in the hospital at the time the research is being conducted. It is, therefore, reasonable that such desirable pioneering efforts be financed from sources other than the patients being served in a particular hospital. Such other sources might be eleemosynary foundations, philanthropic contributors, and tax-supported agencies.

"Those paying for hospital care should understand that the quality of care in any hospital is improved by research and that any increased cost is reflected in better care because of the incentive provided for better service by those working in such a hospital."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.302

"In determining reimbursable cost, a reasonable amount for medical, nursing and other education not reimbursed through tuition, or through scholarships, grants, and other community sources is a legitimate inclusion in the interest of continuing to upgrade quality of service to the community.

"COMMENT . . . Ideally, the cost of educating and training the technical and professional health services personnel needed for community service, for industry, or for other health activities should be financed by the whole community through a combination of public resources and private contributions, rather than by the sick patient representing a small percentage of the community who is usually in the poorest position to meet such cost. It will be necessary, however, that the cost of such programs be considered as a factor in determining reimbursable cost of hospital service until the community is prepared to assume this educational responsibility. Hospitals and third-party purchasers must seek methods for transferring this cost to the whole community through concerted joint effort. It must be borne in mind that nursing education traditionally has been supported by hospital income and by the service rendered by student nurses in hospitals. While financing from other methods must be developed, nothing must be done to discourage the education of increasing numbers of nurses prior to the time that such cost can be transferred to other sources."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.303

"Income specifically designated for research or education should be deducted from total hospital expenses to the extent that expenditures for such items have been included in the total cost.

"COMMENT . . . It appears justifiable to include the expense of some types of applied research and basic training programs as part of the cost of hospital operation. But in the event special contributions, government subsidies, or foundation grants are made available for financing these activities, in part or in full, such amounts should be recognized in the special purpose budget to which they apply as a reduction in the gross amount of the cost of such research or educational projects. To charge the patient for an expense that was met specifically in another manner would mean that income would be derived from two sources for the same expense."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.304

"Bad debts, the unpaid costs of care of the indigent and medically indigent, and courtesy allowances are deductions from earned income and should not be included in reimbursable cost.

"COMMENT . . . Adequate reimbursement from third-party agencies reduces hospital deficits incurred by reason of bad debts.

"All agencies which assume responsibility for the payment for hospital care of needy patients should be prepared to pay hospitals adequately as defined in Principle 1.200.

"Hospitals and third-party agencies should cooperate in seeking full community support for the hospital care of the indigent and medically indigent.

"It is apparent, however, that net operating deficits resulting from the foregoing factors must somehow be covered if essential services are to be maintained; Therefore, it may be appropriate that a reimbursement formula developed under the terms and provisions of Principle 1.100 give recognition to this fact.

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"Courtesy allowances should not be recovered through patient income."

INTERPRETATION . . . Principle 2.304 is concerned with accounting methodology rather than with reimbursement on a cost basis. The American Hospital Association takes the position that deficits resulting from bad debts and the net losses on care of the indigent and the medically indigent are recoverable items, and provisions should be made in Principle 1.100 for their recognition in a reimbursable cost formula as a "cost of doing business." Employee fringe benefits, including hospitalization and personnel health programs should be recognized as operating expenses of the hospital and not considered courtesy allowances for employees.

### 2.305

"Ordinary remodeling is a charge against maintenance and repairs and should be included in expenses. Remodeling which enhances the capital value should be capitalized and, therefore, not included in reimbursable costs.

"COMMENT . . . Hospitals are expected to make the necessary expenditures required to maintain the original purpose and efficiency of the plant facilities and to do minor remodeling periodically to improve efficiency and economy of hospital operations. Such costs are properly chargeable to current operating expense. It is expected that expenditures for extensive remodeling or replacement of buildings for the purpose of enhancing the value of the hospital should be capitalized. Funds for such capital expenditures should be accumulated by regular depreciation allowances included in costs over a period of years or by some other type of financing, such as public subscription and philanthropic contributions."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 2.306

"Net interest at a reasonable rate incurred on capital or other indebtedness should be included in determining reimbursable cost.

"COMMENT . . . A hospital is a public service agency and, as such, represents a public investment in necessary community health facilities. If the public has not provided a debt-free institution, either through extended purchase of care or through public fund-raising campaigns, it must assume responsibility for the payment of debt service charges added to its bill for hospital care. Net interest is computed by deducting from gross interest paid, the income derived from investing the borrowed funds on which interest is paid."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation. It does wish to note that hospitals that include net interest as a cost factor should be able to demonstrate that the unit or units of capital expense, financed by borrowed capital, meet acceptable criteria of logical planning and sound financing.

### 2.307

"The expense incurred by hospitals in providing services of sisters or other members of religious orders shall be accepted as an operating expense for the determination of reimbursable cost. The amounts included should not exceed those paid other employees for similar work and should be identifiable in the records of the institution as operating expenses.

"COMMENT . . . Inclusion of a comparable value for the services of members of religious orders is a recognition of their contribution to community health and welfare. Equity among hospitals requires that each institution maintain records of the amounts included in the operating expenses for such services, with a list of the individuals for whom the amounts have been calculated. The total amounts may be subdivided in the records according to whether they represent living expenses, special prerequisites or salary allowances."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 2.308

"Income received from governmental agencies, foundations or others to cover special projects or salaries paid to special employees, who ordinarily would not be employed by the hospital, should be deducted from expense in the determination of reimbursable cost.

"COMMENT . . . Under some circumstances a hospital receives income from outside agencies toward the conduct of special projects or for the employment of specially trained personnel required to administer the treatment of specific types of illnesses. Agencies sponsoring such special projects or services should pay the cost of the services sponsored on their behalf, in order that no part of the cost of these extraordinary projects need be paid by other patients, including the beneficiaries of other third-party agencies."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.309

"Reimbursable cost should provide for a separate cost for the nursery care of the newborn.

"COMMENT . . . Present-day standards of specialized care for newborn infants frequently represent a substantial portion of hospital operating expenses. The cost of such care should be computed separately in order that agencies which purchase predominant amounts of maternity care may pay their proportionate share of such hospital operating costs. Such classification of expense would make possible more accurate comparison of adult patient day costs among hospitals, irrespective of the variance in the amount of care provided newborn patients. Such information should also prove useful in determining charges for self-paying patients."

INTERPRETATION . . . From practical experience prepayment agencies have found the most logical approach to the acknowledgment of newborn days in a reimbursement formula is to count these days, apply a predetermined ratio and add the remaining result to the adult patient day count.

2.310

"Depreciation on buildings and equipment, in accordance with recommendations of the American Hospital Association publication, Uniform Chart of Accounts and Definitions for Hospitals, should be included in reimbursable cost, identifiable on the books of the hospital and acceptable for certification, and reimbursement for depreciation should be used for capital purposes.

"COMMENT . . . The rates of depreciation for various capital assets listed in the American Hospital Association publication, Uniform Chart of Accounts and Definitions for Hospitals, have gained widespread acceptance in the hospital field. Funds so provided under this principle should be deposited in a restricted account. Expenditures from these funds for implementation, expansion, or replacement of necessary health facilities should be in harmony with recommendations of area-wide planning groups. It is recognized that the exigencies of financial operation of hospitals may require borrowing from the funded depreciation reserves for purposes other than capital expenditures. If these funds are used for noncapital purposes, they should be charged to the General Fund and identified as a liability on the General Fund balance sheet."

INTERPRETATION . . . The American Hospital Association recognizes that the capital requirement needs of hospitals necessitate a reimbursement allowance based on current replacement costs.

2.311

"Expenses for inpatient and outpatient services should be segregated according to one of the methods advocated by the American Hospital Association in the publication, Cost Finding for Hospitals, or by a comparable method.

"COMMENT . . . The payment of cost for hospital care should be related to the services rendered. When paying for inpatient care, therefore, the rates of payment should not include costs of outpatient services."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.312

"Careful studies should be made of methods for adjusting general average costs to determine rates of payment applicable to particular agreements, having regard for their scope and content with respect to cases covered, accommodations used, extent of service, or other major considerations.

"COMMENT . . . There are some factors in the administration of patient care which can be identified and evaluated clearly. Examples are differences in accommodations, such as single, double, or multiple bedrooms, differences in categories of patients, such as chronic, aged or maternity, and differences in length of stay. When these differences in cost can be identified and evaluated, they form a proper basis for adjustments in rates of contract payment."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.400

"Hospitals should not be required to use income from general endowment funds or unrestricted gifts to reduce third-party payments.

"COMMENT . . . Endowment funds and gifts to hospitals are their property, and it is the responsibility of the hospital governing board to see that such funds are administered in accordance with the wishes of the benefactors or on a basis by which the hospital can best serve the community."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.401

"Income from endowment funds or gifts designated by donors for the care of specific groups of third-party beneficiaries should be used to reduce third-party payments for persons in such groups.

"COMMENT . . . This principle prevents dual payments to hospitals. However, it must be interpreted with care in order that the endowment fund gift be defined specifically for the group who are the responsibility of the third-party agency. Such reductions in reimbursement from community agencies charged with the financial responsibility for general medical care of its indigent beneficiaries should be applied only to the care of the specific groups of patients for whom the gifts or endowment funds are available. It is not intended in this principle that such reductions in payment be used to affect payments from prepayment plans in which the individual has provided protection for himself through a form of insurance. Also, it is not the intent of this principle that unrestricted gifts or general endowment funds be used to reduce payments from third-party purchasers."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

2.402

"Hospitals should not be required to use net income from nonpatient service to reduce third-party payments.

"COMMENT . . . The net income from nonpatient service activities will affect the general revenue of the hospital. This does not relieve third-party agencies of their responsibilities for payment on the basis of reimbursable cost for patient services rendered. This principle does not affect the sale of obsolescent supplies and equipment since this income is a recovery from materials already charged to cost and such income should be credited to expense."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 3.000 OBLIGATIONS IN APPLYING PRINCIPLES OF REIMBURSABLE COST PAYMENT

3.100

"When hospitals are paid reimbursable cost, hospitals and third-party agencies have the following obligations and responsibilities:



3.101

"Hospitals should assume responsibility for the provision of adequate facilities, competent personnel and high standards of service. Third-party agencies should assume responsibility for making payments for comprehensive hospital services.

"COMMENT . . . Hospital responsibility extends beyond the provision of minimum standards of patient care. Hospitals must incorporate in their health care program all essential services which high quality scientific medicine requires. Adequacy of facilities, personnel and standards of service should be judged on the basis of long-term public need rather than on short-term financial considerations. Likewise, third-party purchasers have a responsibility for developing programs by which all such services can be made available to their beneficiaries. Under such programs, third-party agencies must expect to pay the cost of such comprehensive services in order that the hospitals can continue to provide the highest possible quality of service."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

3.102

"Hospitals and organized hospital groups, in cooperation with third-party agencies, have responsibility for making studies which will lead to constant improvement in administrative and professional practices in both hospitals and third-party agencies. Such studies should be conducted for their educational value rather than for the purpose of establishing arbitrary controls.

"COMMENT . . . This principle does not intend that hospitals and third-party agencies shall conduct independent studies of each other's management, but that the two shall make joint studies of subjects of mutual concern and benefit. As the principle states, such studies will have educational value for the entire community as well as for the agencies concerned."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation, and is a logical assignment to the administrative intermediary under Public Law 89-97.

3.103

"Hospitals and third-party agencies should cooperate in the study of such factors as admission, length of stay, extent and amount of services provided, and other factors that affect the cost of services to agencies purchasing care, with a view to economical and efficient use of funds.

"COMMENT . . . The consideration of any factors which would tend to reduce the cost of hospitalization without sacrificing quality of care should be of mutual interest to hospitals and third-party purchasers. Continuous study of statistics and data bearing on hospital cost and third-party purchasers' experience should be carried on to promote all possible operational savings and benefits which will inure to the patient, the hospital and the third-party agency."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation, and is a logical assignment to the administrative intermediary under Public Law 89-97.

### 3.200

"There is a mutual responsibility on the part of hospitals and third-party agencies for making available, upon request, such fiscal and administrative statistics and data as are necessary for a continuing agreement on amount of payment and services provided.

"COMMENT . . . A purchasing agency has responsibility to demonstrate on occasions that its stewardship of funds is defensible. Further, the purchasing agency must have access to data regarding the product for purposes of defending such stewardship. Inasmuch as the third-party agency must secure adequate funds for hospital reimbursement, current and accurate data are required for predicting the amount of funds necessary for the agency to meet its obligations. For these purposes of mutual need, it is necessary that both hospitals and third-party agencies make fiscal and administrative statistics and data available for mutual study and understanding."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation, and is a logical assignment to the administrative intermediary under Public Law 89-97.

### 3.201

"Hospitals receiving payment on the basis of reimbursable cost agreements should provide accurate cost data based on an audit of their financial and statistical records which are capable of verification by those third-party purchasers with whom they have such agreements.

"COMMENT . . . Third-party purchasers must obtain adequate cost information from hospitals to which they are paying reimbursable cost in order to justify the payments they make for hospital care provided their beneficiaries. Such cost information must be kept in a clear and concise form which can be readily analyzed. It is a desirable practice to

have an audit of the accounts of an enterprise by qualified, disinterested auditors. Such practice will ensure the provision of accurate cost information and is evidence of good faith and sound management."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation, and is a logical assignment to the administrative intermediary under Public Law 89-97.

### 3.202

"Hospitals are urged to organize in sectional or regional groups so that they may participate in joint service for uniform accounting, reporting and community planning.

"COMMENT . . . Uniformity in accounting, reporting and planning can be achieved through joint efforts and formally established lines of communication among hospitals. The promotion and development of uniform accounting and statistics, as outlined in the American Hospital Association publications, Uniform Chart of Accounts and Definitions for Hospitals, and Cost Finding for Hospitals, as well as many other projects, have been conducted successfully by metropolitan hospital councils, and by state or regional hospital associations."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

### 3.300

"Assumption of initiative in cooperation with appropriate agencies to develop objective criteria for evaluation of scope and quality of services of hospitals and third-party agencies is the logical responsibility of the American Hospital Association.

"COMMENT . . . The mutual interest of hospitals and third-party purchasers in the production and distribution of high quality hospital care suggests the need for a continuing program of self-analysis to ensure progress toward common objectives. The American Hospital Association is the logical agency to assume this undertaking, since it follows the established policy of the Association, as evidenced by its sponsorship and participation in a program of hospital accreditation and standardization."

INTERPRETATION . . . The American Hospital Association is of the opinion that this principle is applicable to all third-party agencies without further interpretation.

3.400

"The method and amount of reimbursement to contracting hospitals by third-party agencies should be established by mutual agreement of the parties concerned and should be based on the Principles of Payment for Hospital Care.

"COMMENT . . . If a hospital's costs depart substantially from other hospitals of similar size, scope of services and utilization, maximum reimbursement may be established through agreement reached between third-party purchasers and hospitals."

INTERPRETATION . . . It should be recognized that variation in hospital cost may be attributed to a variety of circumstances and, therefore, decisions as to whether a cost is unreasonable or not become a matter of judgment. To assure a maximum degree of equity, hospitals subjected to such judgments should be provided an opportunity to have their situation reviewed and evaluated by some appropriate agency.

## REFERENCES

1. Uniform Chart of Accounts and Definitions for Hospitals. The Association. 1959. 173 pp. \$2.25.
2. Cost Finding for Hospitals. The Association. 1957. 131 pp. \$3.
3. Guiding Policy for Hospitals in Pricing Their Services to the Public. HOSPITALS, J.A.H.A., 34:55 Aug. 16, 1960.

## CONCLUSION

With respect to the determination of payment rates, under contractual arrangements, the goal of the American Hospital Association is the development of a reimbursement formula that recognizes fully the cost of services received by beneficiaries of various third-party purchasers of hospital care. Methods of arriving at such determinations should be made the subject of careful study and the findings incorporated in a special manual or in a revised edition of the American Hospital Association's manual, Cost Finding for Hospitals.

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X  
October 12, 1967

Mr. Nathaniel A. Karol  
Director  
Division of Grant Administration  
Policy  
Office of the Secretary  
Department of Health, Education  
and Welfare  
Washington, D.C. 20201

Dear Mr. Karol:

First, thank you for the copy of the response of September 21 from Assistant Secretary James F. Kelly to my previous correspondence. Subsequent to receipt of your letter of October 9 we received the original of the September 21 reply from Mr. Kelly. Through a courtesy copy of this letter, I am expressing to Mr. Kelly our appreciation for the information outlined in his letter of September 21.

As soon as we became aware of the existence of the "Guide for Hospitals" and concurrently notified that the American Hospital Association had concurred with the content of the publication, we promptly contacted Ed (Edwin L. Crosby, M.D., Executive Vice-President and Director, AHA). We learned from Ed's office that in fact the AHA had reviewed a draft of the "Guide" in the summer of 1966 but had specifically requested that the material not be published until there was an opportunity of further evaluation, a discussion and resolution of any differences that developed from a series of recommendations that were apparently submitted by the AHA. At that time, of course, this Council was not formally in existence, although as the AHA indicates they did place on the review committee for the draft material of the "Guide" individuals whose primary orientation was teaching hospitals.

It is disappointing to learn that the purpose of the committee concerning the "Guide For Hospitals" is not that of considering recommendations for prompt revision of the "Guide". I am disappointed, also, that the membership on the committee does not include more than one chief executive officer of a major

university teaching hospital. However, I do understand the dynamics of committee operation and the detracting impact of too large a membership. I would only urge an understanding that the "Guide" will have its major application and major impact on those hospitals within this Council where such organization was established to deal essentially with contributions to the thinking of the federal agencies, the Congress, other voluntary agencies and society in general concerning the opportunities, the needs and the abilities of teaching hospitals as existing for the benefit of the public.

It is my understanding that you have contacted directly to serve as a member of your committee Charles R. Goulet, Superintendent, University of Chicago Hospitals and Clinics. As I indicated to you in my letter of October 6, I shall remain in Washington on Monday, October 23 so as to have the privilege of attending your meeting at 10 a.m. in Room 3265, North Building, Department of Health, Education and Welfare.

It is my understanding, further, that Mr. Goulet will submit to you some observations concerning the rules and regulations described in the "Guide". In order to be helpful to the formulation of your meeting, I am outlining hereafter some additional suggestions:

1. The pages and item references in the report to you of last summer from the AHA are difficult to trace. Were they included in the final "Guide?" For example, page 5 of the committee report, in referring to page 25, J.9, recommends replacement cost depreciation rates. Page 27, item 9.a. of the "Guide" says that "Depreciation is a charge to current operations which distributes the cost of a tangible capital asset..." Page 7 of the committee report refers to Page 41, J.47 and argues for use allowances of 2% for buildings and 10% for usable equipment. However, page 29 of the "Guide" specifies rates of 2% and 6 2/3%.
2. On page 1, under Statutory and Administrative Limitations, the second paragraph says "... that Federal grant funds not be used to pay all of the costs of any research project at an institution." Does this mean that the new federal research cost sharing principle that applies to educational institutions also applies to hospitals? If so, what are the implications of this policy? Where does a hospital get the money for its share of the research costs?

3. Regarding page 3, "The Use of Separate Rates," I believe that most universities have a single indirect cost rate that applies to all of its units. Does the "Guide" suggest that an over-all university rate could be applied to a university hospital? If it is not correct or proper to apply a university rate to the medical school, I would wonder even more about doing this for a teaching hospital.
4. Will the paragraph on page 4 regarding Research Performed by Other Institutions on Hospital Premises cause impractical complications for university hospitals? Could a simpler approach such as the adoption of a reasonable space rental charge be used? See also page 21, VII, 3.
5. The last 2 sentences under the "Basic Process in Outline" heading on page 7 is typical of federal policies regarding unexpected financial complications in any relationship with the government. The institution must bear all of the financial risks. The government takes full advantage of every contingency that produces a savings but keeps a legal escape hatch regarding financial responsibility for unforeseen developments. This basic inequity should be spotlighted whenever and wherever it appears. Some system of reciprocity must be developed. The institutions always run financial risk in relations with the federal government. Some institutions must now "repay" to the federal government sums in excess of \$100,000 because a reimbursement formula developed in good faith between teaching hospitals and the federal government for initiation and operating of Clinical Research Centers cannot now be honored by the federal government.
6. Item 4 on page 5 under the Alternative Calculations heading refers to the possibility of establishing an "indirect cost rate based on the relationship between total indirect costs allocated to all organized research within the institution and total direct salaries and wages of persons engaged in research, (or some other appropriate base)". Most universities do use direct salaries and wages as the base for determining their indirect cost rate and for computing indirect costs. However, many hospital research grants include sizable expenditures for expendable research supplies, patient costs, etc. Thus, total expenditures would make a much better base for indirect costs than salary costs alone. This item merits special attention which I trust we can give.

7. Some part of the "Guide", for example, page 12, II. D., E., G., implies that this government directive is specifying the bases that hospitals should use to distribute its indirect costs to activities other than those under federal sponsorship. I can see the government's right to approve or disapprove indirect costs for research or anything else for which it is to be charged, but the apportionment of other indirect costs to other hospital programs should not be prescribed by the government. See page 15, B.2, the first sentence.
8. The reaction to the "Guide" is based on its broad principles and concepts rather than details. It has been my pleasure to serve in previous years in a federal agency. I enjoyed that service and have a deep respect for the "federal know-how." I did learn, however, that federal directives of this kind, even though they may be called a guide, usually turn out to be a control with all the force of law; at times they can be harder to change than a law. Incorporated in "A Guide for Educational Institutions," (a counterpart of "A Guide for Hospitals,") is the Bureau of the Budget A-21 directive which certainly is a control document.
9. This hospital "Guide" has yet to be tested for acceptability or workability. Yet there is a flavor of finality about it that is going to make it difficult for teaching hospitals to understand. It is unfortunate that a "field test" could not have been first accomplished in a half-dozen representative teaching hospitals. I do believe that the request of the AHA expressed by Dr. Crosby for an opportunity to review and comment on the final document before final publication was pertinent and important.
10. I trust that one of the charges to this committee "on the Guide" will be to obtain and examine evidence and determine if the "Guide" is "fair," workable and in the best interest of the taxpayer and hospitals.

Best regards.

MATTHEW F. McNULTY, JR.  
Director, COTH  
Associate Director, AAMC

MFN:jk

cc: James F. Kelly  
Assistant Secretary, Department of HEW





DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE  
WASHINGTON, D.C. 20201

OFFICE OF THE SECRETARY

OCT 9 1967

Mr. Matthew F. McNulty, Jr.  
Director, Council of Teaching Hospitals  
Association of American Medical Colleges  
1346 Connecticut Avenue, N.W.  
Washington, D. C. 20036

Dear Mr. McNulty:

I am responding on behalf of James F. Kelly to your letter of September 28, 1967. I am somewhat surprised that you had not yet received his letter of September 21 by that date. In the event that it got misdirected, I am enclosing a copy.


As is pointed out in Mr. Kelly's letter it is not feasible to delay distribution of the "Guide for Hospitals" since it was distributed before your first letter of July 28. His letter also points out that the effort which I had discussed with you and for which I solicited your participation is directed toward planning and facilitating appropriate implementation of the principles and developing a supplement for training. If you have received the impression that we will be considering recommendations for possible revision to the Guide before we have had the opportunity to accumulate operating experience with it this is an erroneous impression and I am sorry if we have in any way fostered such impression.

I appreciate your suggestions for committee membership. Since we will have representation from the American Hospital Association as well as from the Department we are attempting to hold the group to a manageable size. Accordingly, I would like to limit C.O.T.H. participation to two representatives, one of which would be yourself, and hope that you will feel free to solicit the views of other members of your organization on occasions when this appears necessary or appropriate.

You will have received shortly before this letter a notice of our first meeting which, because of the commitments described in your letter you will be unable to attend. We will advise you of the results of this

initial meeting and hope that we may look forward to your participation on your return.

Sincerely yours,



Nathaniel H. Karol  
Director, Division of Grant  
Administration Policy

Enclosure

cc: Mr. James F. Kelly



DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE

WASHINGTON, D.C. 20201

OFFICE OF THE SECRETARY

SEP 21 1967

Dear Mr. McNulty:

I would like to apologize for the somewhat delayed response to your letter of August 31, which you brought up at our Steering Committee meeting.

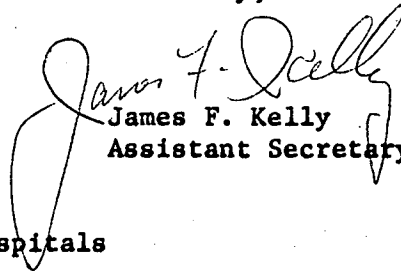
Under separate cover we are sending 15 copies of the "Guide for Hospitals" pursuant to your request. As had been discussed with you by my staff a while ago, we were quite frankly unaware of the existence of your organization and consequently worked exclusively with the American Hospital Association in development of our cost principles. As you may know, this was a collaborative effort which extended over a period in excess of a year and I am most sorry that at sometime during that period you and I were not in touch, since if we had been it would have been relatively simple for us to include representation from your organization in this collaborative effort.

As you are aware, the principles have been published and distributed. However, we tend to view this as somewhat of a trial or pilot effort, in the sense that new principles such as these will inevitably bring to light problems (hopefully not substantial ones) during the course of implementation which were not readily apparent during the development of the principles. Additionally, it is our mutual understanding with the Bureau of the Budget and the General Services Administration that after a suitable trial period, which would suggest the necessity for any possible revisions, we would then present the principles for adoption on a Government-wide basis. Consequently, an analysis and recommendations on the part of your organization can be quite useful in connection with the reassessment of these principles that must take place after a reasonable period of use.

I understand that Nat Karol of my staff has been in touch with you and that you have agreed to participate in a joint effort that will be directed toward planning for and facilitating appropriate implementation of the principles and developing a supplement for training. I am pleased

that you will be participating in this effort not only for the contribution you will make, but because this will insure your continued awareness of and involvement in developments which have an influence on the financial systems of teaching hospitals.

Sincerely,



James F. Kelly  
Assistant Secretary, Comptroller

Mr. Matthew F. McNulty, Jr.  
Director, Council of Teaching Hospitals  
1346 Connecticut Avenue, N. W.  
Washington, D. C. 20036

Separate Cover

X  
October 6, 1967

Nathanáel H. Karol, Director  
Division of Grant Administration Policy  
Office of the Secretary  
Department of Health, Education, and Welfare  
330 Independence Avenue  
Washington, D.C. 20201

Dear Nat:

I am in complete consonance with your letter of October 3rd concerning problems that the Council of Teaching Hospitals believe do exist in connection with the Guide for Hospitals. In fact I have been troubled as well as puzzled concerning three letters on this matter which, at the direction of the Executive Committee of this Council (copy of Committee membership attached), I addressed to Honorable James F. Kelly. We have not received a response to any of these letters. Copies of the letters are attached.

Although the preliminary activities for the Annual Meeting of the Council of Teaching Hospitals and the AAMC begin the week of October 23 at the New York Hilton Hotel, I shall remain in Washington so as to be present at a meeting at 10:00 a.m., October 23, in Room 3265, North Building of the Department of HEW.

Presuming your concurrence, I shall bring with me to the meeting an associate--Fletcher H. Bingham, Ph.D., Assistant Director, COTH. I do this not to burden your meeting, but for the month of November and early December I shall be in Venezuela, Brazil, and Uruguay as a Foundation Visiting Professor and Consultant to the Ministry of Health in those countries. It does seem important to us at COTH that there be a continued approach to the problems related to the Guide. Thus, the participation of Doctor Bingham to provide a contact, continuity and participation in subsequent discussion and/or meetings prior to my return.

Cordially,

MATTHEW F. McNULTY, JR.  
Director, COTH  
Associate Director, AAMC

MM:eab

Attachments: Letters of July 28, August 31, and September 28 from Mr. McNulty to Mr. Kelly.



DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE  
WASHINGTON, D.C. 20201

OFFICE OF THE SECRETARY

OCT 3 1967

Mr. Matthew McNulty  
Executive Secretary  
Council on Teaching Hospitals  
Association of American Medical Colleges  
1346 Connecticut Avenue, N. W.  
Washington, D. C. 20036

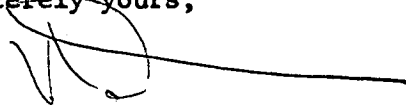
Dear Mr. McNulty:

In June of this year the Department published principles for determining the costs of research conducted at hospitals. It has been brought to our attention that administrative and/or fiscal problems may exist in the application of the principles.

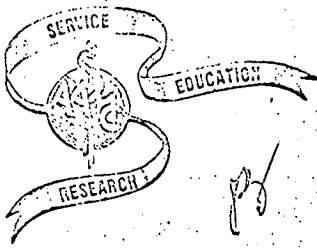
I would like to solicit your participation on a committee to develop workable and mutually satisfactory implementing procedures for the affected programs and to assess the potential budgetary impact of the principles. In addition, the committee will work towards the development of guides for applying the cost principles to work performed by hospitals under Federal grants and contracts for training.

The initial meeting is scheduled for 10:00 a.m., October 23, 1967, in Room 3265, North Building, of DHEW. Your cooperation will be greatly appreciated, and I look forward to hearing from you at your earliest convenience. If you are aware of problem areas which you feel require committee attention, please let me know your ideas prior to the meeting.

Sincerely yours,

  
Nathaniel H. Karol  
Director, Division of Grant  
Administration Policy

Enclosure



ASSOCIATION OF AMERICAN MEDICAL COLLEGES  
COUNCIL OF TEACHING HOSPITALS  
1346 CONNECTICUT AVENUE, N.W.  
WASHINGTON, D. C. 20036  
202/223-5364

MATTHEW F. McNULTY, JR.  
DIRECTOR

*File*

July 28, 1967

Mr. James F. Kelly  
Assistant Secretary  
Department of Health, Education, and Welfare  
330 Independence Avenue  
Washington, D.C. 20201

Dear Mr. Kelly:

From informal information it is my understanding that there has been issued by the Department of Health, Education, and Welfare a publication titled as follows:

"A Guide for Hospitals--Establishing Indirect Cost Rates for Research Grants and Contracts with HEW"

The Council of Teaching Hospitals (COH), representing the major teaching hospitals of this country, was not aware of any initial discussion, subsequent preparation, and then publication of the aforementioned Guide. As a newly organized activity of the Association of American Medical Colleges, it could well have been that our existence was not known when the Guide was under preparation. This is understandable, though I trust that through the opportunity of this letter our desire and ability to be of assistance in the future is now established. The material suggested by the above title is of direct interest to the major teaching hospitals of this country as represented by this Council.

Any information you can furnish concerning the contemplated dissemination of "A Guide for Hospitals" would be appreciated so that we may be informed as to possible inquiries from teaching hospital member institutions. Also, a copy of the Guide would be appreciated so that we may become knowledgeable as to its content.

Thank you for your assistance in this matter.

Cordially yours,

MATTHEW F. McNULTY, JR.  
Director, COH  
Associate Director, AAMC

Enclosed is one copy of the brochure you requested. For additional copies please contact your Operating Agency.  
August 3, 1967

MM:eab

August 31, 1967

Mr. James F. Kelly  
Assistant Secretary  
Comptroller  
Department of Health, Education, and Welfare  
330 Independence Avenue  
Washington, D.C. 20201

Dear Mr. Kelly:

In response to my letter of July 28th, your office forwarded to me one copy of A Guide For Hospitals: Establishing Indirect Cost Rates for Research Grants and Contracts with the Department of Health, Education, and Welfare. This assistance is appreciated.

As I expressed to you in my letter of July 28th, this recently organized Council of Teaching Hospitals (COTH) is interested and intends to work closely and cooperatively with all Federal agencies and offices, and particularly with those agencies whose activities, in some measure, affect either the medical education process as it is accomplished in the teaching hospital, or the administrative and fiscal framework which supports such educational efforts. With regard to this latter item, a very cursory review of the Guide For Hospitals indicates that the Guide could have an influence on the financial system of teaching hospitals, as well as upon carefully developed and presently prevailing methods of cost allocation and determination.

In the letter of transmittal, which accompanied our copy of the publication, you indicated that you would welcome comments on the substantive content included in the document. On behalf of the officers and Executive Committee of COTH, a committee of senior hospital executives and fiscal management experts is being appointed for certain responsibilities of review and analysis in the area of teaching hospital management with specific observation concerning the Guide. We would, therefore, appreciate the opportunity for careful review, observation, and recommendation, if any, with your office concerning this document, A Guide For Hospitals before it is disseminated to hospitals.



Mr. James F. Kelly

-2-

Aug. 31, 1967

In order that the attention of the COIH Committee mentioned previously may be directed to an early consideration of the Guide, we would appreciate someone in your office, at their convenience, arranging to have fifteen copies of the document sent to this office. If there is any charge for this assistance, we shall arrange for prompt remittance upon advice.

We shall be in contact with your office as soon as it is possible to accomplish review of the Guide. Thank you for your consideration of this matter.

Cordially,

MATTHEW F. McNULTY, JR.  
Director, COIH  
Associate Director, AAMC

**ADMIRAL TO STUDENTS: JOIN THE COAST GUARD AND SEE THE SEA**

An invitation to college students of oceanography to spend some time on Coast Guard vessels early in their academic careers—as guests—was extended by Admiral Willard J. Smith, Coast Guard Commandant, in testimony before the Subcommittee on Oceanography of the House Committee on Merchant Marine and Fisheries.

"A better appreciation of the academic areas of oceanography and ocean engineering would be realized by the student if he were exposed to seagoing operations early in his academic career," Admiral Smith said. "The Coast Guard would be pleased to provide space aboard its ships in order that students may have this early indoctrination."

Health, Education and Welfare of instructional TV and the need for federal aid in this area.

The House then substituted the language of its bill for a similar measure, S. 1160, which has already passed the Senate. The bill will presumably go to conference.

**Obscenity Control Bill to President**

A measure to establish a Commission on Obscenity and Pornography, S. 188, passed the Senate and was then amended and broadened in the House. Now the Senate has concurred in the House amendment by passing an amendment in the nature of a substitute for the House bill and the House has accepted the substitute.

In final form the measure authorizes the Commission to sponsor research on existing laws dealing with obscenity, methods of distribution of obscene materials, and the relationship of obscenity to juvenile delinquency and crime.

**HEW Requires Indirect Cost Proposal from Research Foundations**

Separately established research foundations which are affiliated with educational institutions must submit indirect cost proposals to the Health, Education and Welfare Department by November 1, 1967, in order to be reimbursed for indirect costs. A foundation is allowed to charge only those costs which represent actual charges to itself. See ¶ 14,327.

**... Issues Guidebook on Indirect Cost Rates for Hospitals**

A guidebook for hospitals on the establishment of indirect cost rates for research grants and contracts has been issued by the Department of Health, Education, and Welfare. This guidebook differs from the one recently issued by HEW for educational institutions in the following ways:

1. Hospitals are required to comply with indirect cost principles designed specifically for them, rather than with the provisions of Budget Bureau Circular A-21 (Revised) which educational institutions are required to follow.
2. Hospitals are allowed to use only one type of process in applying indirect cost rates, while educational institutions have a choice of two.
3. Hospitals may use only provisional indirect cost rates, while educational institutions may use either provisional or predetermined rates.

4. Hospitals should develop a special indirect cost rate for services provided to other institutions performing research on hospital premises. Educational institutions have no such provision.

For details on the guidebook, see ¶ 14,330.

#### Expansion of Juvenile Delinquency Program Proposed

Sen. Thomas J. Dodd, who introduced the Administration bill for extension of federal juvenile delinquency control programs in the Senate, thinks the measure doesn't go far enough.

Appearing as the first witness at hearings on S. 1248 before the Subcommittee on Manpower, Employment and Poverty of the Senate Committee on Labor and Public Welfare, Sen. Dodd proposed increasing authorizations by \$25 to \$35 million a year to add grants for training of personnel for the juvenile correctional field, establishment of a model juvenile correctional system, grants to improve existing judicial machinery, and grants for development of courses and training of teachers to teach delinquency control to high schoolers.

John W. Gardner, Secretary of Health, Education and Welfare, told the Subcommittee that there are areas in which research is vital.

"Several examples come to mind," he said, "—the growing phenomenon of alienation of middle-class youth; causes and treatment of youthful drug abuse; and relative effectiveness of different approaches to prevention and treatment."

#### Committee on Mental Retardation Proposes Priorities

The President's Committee on Mental Retardation has submitted its first report to the President on the nation's progress in the field of mental retardation and stresses 10 areas most urgently in need of attention. They are:

1. Mental retardation services must be available to more of the nation's people;
2. More effective and extensive recruitment and training programs for work with the mentally retarded are needed;
3. Making better use of existing resources is a necessity;
4. More public-private partnerships in program development, services and research are needed;
5. A national mental retardation information and resource center should be established;
6. Basic research, training in application of research, and rapid translation of research results into service program uses need continuing encouragement;
7. Immediate attention should be given to early identification and treatment of the mentally retarded;
8. Social and institutional planning for the future must take into account the special needs of the mentally retarded;
9. The legal status of the mentally retarded individual must be clarified and his rights guaranteed; and

¶ 14,329 FUTURE RESEARCH ACTIVITIES OF MARITIME ADMINISTRATION  
MUST BE REAUTHORIZED

Back reference: ¶ 4016

The Merchant Marine Act of 1936 has been amended to require specific authorizations of funds for, among other activities, research and development work of the Maritime Administration after 1967. Other activities such as acquisition and

construction of vessels, reserve fleet expenses, and financial assistance to state marine schools will also require specific authorizations.

The amendment to Sec. 209 of the Act, H. R. 158, was signed into law as P. L. 90-81 on September 5, 1967.

¶ 14,330 HEW ISSUES GUIDEBOOK ON INDIRECT COST RATES FOR HOSPITALS

Back reference: ¶ 5082

The Department of Health, Education, and Welfare has issued a guidebook for hospitals dealing with the establishment of indirect cost rates for research grants and contracts. This guidebook has the same provisions as the one recently issued for educational institutions (see ¶ 14,156), with the following exceptions.

Indirect cost procedures for hospitals must comply with the "Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Hospitals," which is Section III of the HEW guidebook. Educational institutions are required to follow the provisions of Budget Bureau Circular A-21 (Revised).

Hospitals are allowed to use only provisional indirect cost rates, which are subject to later review and adjustment. Educational institutions may use either

provisional or predetermined indirect cost rates.

Hospitals may apply indirect cost rates only in a two-step process, while educational institutions may use either a one-step or two-step process. Both processes are described at ¶ 14,156 under the heading "Basic Processes in Outline."

The following condition applies only to hospitals: when another institution performs research on hospital premises, the hospital should develop a special indirect cost rate to measure the cost of the services provided and to support a charge to the research grant or contract under which the other institution is performing.

*A Guide for Hospitals, Establishing Indirect Cost Rates for Research Grants and Contracts with the Department of Health, Education, and Welfare*, is available from the Superintendent of Documents, U. S. Government Printing Office, Washington, D. C. 20402, for 40 cents.

¶ 14,331 PHYSICIAN RULED AN EMPLOYEE, ENTITLED TO TAX EXCLUSION ON  
HOSPITAL'S CONTRIBUTION TO ANNUITY CONTRACT

Back reference: ¶ 6563

Vincent M. and Annette K. Ravel v. Commissioner, CCH Dec. 28,599(M), Dkt. 1207-66, September 13, 1967, T. C. Memo. 1967-182, 677 CCH STANDARD FEDERAL TAX REPORTS ¶ 7499(M).

A physician-radiologist was an employee of a tax-exempt hospital rather than an independent contractor and therefore the annuity payments made by the hospital on his behalf could be excluded from his gross income under Sec. 403(b) of the Internal Revenue Code, the Tax Court has ruled.

The court held that the hospital and the physician who was hired to operate

and supervise its X-ray department had an employer-employee relationship as shown by the following factors: (1) the hospital paid him a guarantee of \$500 per month, plus 50% of the patients' fees which the hospital collected; (2) the physician operated the radiology department and performed 95% of the radiology services of the hospital; (3) private patients of the physician could not be treated at the hospital except in emergencies; (4) the hospital had complete control over and paid for personnel, equipment, and supplies; and (5) policies, rules, and regulations were determined by the hospital. The Internal Revenue Service had contended that the physician was an independent contractor

College and University Reports

¶ 14,331