



DEPARTMENT OF HEALTH & HUMAN SERVICES

Ah

Program Support Center
Financial Management Service
Division of Cost Allocation

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(See Attachment 3, Addressee List):

The U.S. Dept. of Health & Human Services, Division of Cost Allocation (DCA) is the cognizant Federal agency for the cost negotiation of the Statewide Cost Allocation Plans (SWCAPs), including allocated and billed central service costs. During recent SWCAP reviews, we have observed that many state governments are currently engaging in large information technology (IT) projects and reorganizations, such as data center consolidations, outsourcing of data centers, and large software projects. These IT initiatives are often very costly and may result in significant billed or allocated costs being charged to Federal programs. Unfortunately, we are finding that some state governments are not adequately considering Federal regulations prior to charging Federal programs for these costs. This can result in Federal billings being disallowed or the state government being required to make a significant refund to the Federal government for prior unallowable charges. We want to alert state governments to the requirements that should be complied with prior to allocating or billing these types of costs to Federal programs, either as direct or indirect costs.

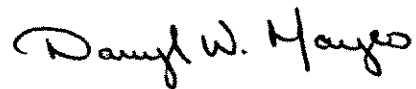
All SWCAPs must comply with Title 2 of the Code of Federal Regulations (2 CFR), Subtitle A, Chapter II, part 225 - Cost Principles for State, Local and Indian Tribal Governments (OMB Circular A-87) (hereinafter referred to as "the Circular") and the implementation guide entitled, "A Guide for State, Local and Indian Tribal Governments" (ASMB C-10). State governments should submit the planned allocation or billing methodologies for significant new central services, including information technology projects and data centers, well in advance of implementing the new methodologies. This advance notification will allow the Federal government to evaluate the state's plans and identify obvious potentially unallowable costs or unallowable allocation methodologies prior to implementation.

We have attached two guidance documents to this letter. Attachment 1 discusses data center consolidations and outsourcing, and Attachment 2 discusses software projects. Each document discusses the requirements that the state should comply with, if Federal programs are going to be billed for these services.

We are providing the state governments with these guidance documents in order to lessen the likelihood of subsequent unexpected Federal disallowances or refund determinations.

If you have any questions, please contact your cognizant DCA Regional Office.

Sincerely,

A handwritten signature in black ink that reads "Darryl W. Mayes". The signature is written in a cursive style with a large initial "D" and "M".

Darryl W. Mayes
National Director

Attachments

ATTACHMENT 1
GUIDANCE FOR DATA CENTER CONSOLIDATIONS AND OUTSOURCING

1. Data Center Consolidations

A number of states are consolidating their multiple state data centers. However, some states are not adequately considering the Federal requirements before billing the costs of the newly consolidated data center to Federal programs. In addition, not all of the affected states are providing advance notice to or coordinating with their cognizant agency prior to the consolidations. States should comply with the following requirements for consolidated data centers:

a. Billing Rates/Allocation Methodologies

The Circular, Appendix A, Section C.3 states "A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received." Therefore, the consolidated state data center should have separate billing rates or allocation methodologies for each individual service it provides. In addition, the state must ensure that systems are in place to measure usage by state department or program, as applicable. This is necessary to ensure that charges to Federal programs are based upon their actual usage or benefit received for each individual data center service.

The Circular, Appendix C, Section G.4 states "Billing rates used to charge Federal awards shall be based on the estimated costs of providing the services, including an estimate of the allocable central service costs." Therefore, for billed services, each billing rate must be based upon the budgeted costs for each service with subsequent adjustments to actual costs. A lump sum billing based upon budgetary needs for the entire data center is not an acceptable method for charging Federal programs.

In addition, services for public assistance programs must be accounted for and billed in accordance with the applicable requirements of the various Federal public assistance programs and the approved Public Assistance Cost Allocation Plan. Prior to the consolidation, the state data center should fully coordinate with the state agencies that have primary responsibility for public assistance programs to ensure that the Federal requirements will be met.

b. Accounting for and Reporting Revenues and Expenses by Service

The Circular, Appendix C, Section G.1 states "Each billed central service activity must separately account for all revenues (including imputed revenues) generated by the service, expenses incurred to furnish the service, and profit/loss." Therefore, the state data center must separately account for each individual service's revenues and expenses. This information should be readily available for review by the cognizant DCA Regional Office.

The Circular, Appendix C, Section G.4 states "A comparison of the revenue generated by each billed service (including total revenues whether or not billed or collected) to the actual allowable costs of the service will be made at least annually, and an adjustment will be made for the difference between the revenue and the allowable costs." Therefore, the state must monitor the variance for each individual data center service. The state should consult with its cognizant DCA Regional Office in order to determine the appropriate adjustment method.

c. Timeliness of Billings

The Circular, Appendix A, Section C.3 states "A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received." Therefore, the state data center must ensure that services are not billed to any Federal program before being implemented and used by the Federal program(s). Some states have billed Federal programs in order to create a source of funds to set up the consolidated state data center. This is unallowable, and may result in the state having to pay a refund to the Federal government.

2. Data Center Outsourcing

The state must comply with the Circular requirements discussed above for out-sourced state data centers. Specifically, the state must ensure that its vendors provide itemized billings, based upon usage, for each individual data center service. The state is also responsible for ensuring that Federal programs are charged on an equitable basis for the services that the programs use. Furthermore, the state must maintain adequate accounting records of the state's revenues and expenditures (including vendor payments) for each individual data center service. The state should monitor the variance for each individual service and consult with its cognizant DCA Regional Office in order to determine the appropriate adjustment method.

ATTACHMENT 2 GUIDANCE FOR SOFTWARE PROJECTS

Many states are initiating large software projects, including new Enterprise Resource Planning systems and Human Resources Management Systems. The large expenses associated with these projects usually result in significant allocations or billings to Federal programs. However, these projects can be high-risk, since we have observed instances of state software project failures and terminations even after significant funds were expended.

In June 2007, the Governmental Accounting Standards Board (GASB) issued Statement No. 51, Accounting and Financial Reporting for Intangible Assets. However, even prior to implementation of the new GASB statement, the general principles contained therein should be complied with for charging Federal programs. Intangible assets were previously referred to in the description of capital assets in Statement No. 34, Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments. The GASB Statement No. 51 sets forth detailed guidance for capitalization of computer software projects.

It is not acceptable to expense all of the costs of significant software projects and charge Federal programs based upon budgetary needs to finance the projects or as costs are incurred. For the costs that should be capitalized, Federal programs in the current period do not benefit from those expenditures. These projects are clearly intended to produce systems that will be used longer than the year(s) in which the costs are expended, and, similar to equipment and other capital expenditures, should be amortized over their estimated useful lives. Federal programs only benefit and should only be charged for amortization of the capitalized costs once the software programs are implemented and in use by Federal programs.

States that have initiated or are planning software projects that will be allocated or billed to Federal programs, whether as a direct or an indirect cost, should submit their planned accounting and billing or allocation methodology to their cognizant DCA Regional Office for review.