County Monitoring Advisory Bulletin 2008-001
October 24, 2008

To: All CDJFS, CSEA, and PCSA Directors

From: Michelle Horn, Deputy Director
Office of Research, Assessment and Accountability

Subject: **Claiming Costs of Building Space Under "Less-Than-Arm's Length" Transactions**

Background: In recent discussions with county family services agencies, it has been apparent that confusion exists as to the allowable costs for "rent" where the leased building is owned by the board of county commissioners. The purpose of this Advisory Bulletin is to bring to the attention of county agency management the limitations for such costs and to reduce their potential liability.

Issue 1 – Allowable Components of Rental Costs:

The requirements for allocation and allowability of costs to Federal programs by state and local governments are established in OMB Circular A-87, which is codified in Federal regulations at 2 CFR 225. These regulations are available online at:

http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/05-16649.htm

Costs incurred for the acquisition of buildings and land, as "capital expenditures," are unallowable as direct charges, except where approved in advance by the awarding agency. See 2 CFR 225, Appendix B, Section 15 (b) (1). However, rental costs incurred by a county agency are an allowable cost, subject to the limitations of 2 CFR 225, Appendix B, Section 37.

Section 37 (a) states that:

> . . . rental costs are allowable to the extent that the rates are reasonable in light of such factors as: rental costs of comparable property, if any; market conditions in the area; alternatives available; and the type, life expectancy, condition, and value

> of the property leased. Rental arrangements should be reviewed periodically to determine if circumstances have changed and other options are available.

These requirements are also set forth in Ohio Administrative Code Section 5101:9-4-11 (B). Additional limitations are applicable where the rental space is owned by the board of county commissioners. Section 37 (c) of Appendix B provides that where "one party to the lease agreement is able to control or substantially influence the actions of the other," the transaction is considered a "less-than-arms-length" transaction. This includes circumstances where leases are between divisions of a governmental unit, as in a lease between a county agency and a board of county commissioners.

Where a "less-than-arms-length" transaction is in place, Section 37 (b) and (c) indicates that lease costs are allowable only up to the extent that costs would be allowable if title to the property vested in the county agency. This includes expenses such as depreciation or use allowance, maintenance, taxes, insurance and related interest.

These requirements are also set forth in Ohio Administrative Code Section 5101:9-4-11 (C).

Recommendation 1:

Where a county agency is entering into a lease arrangement, we recommend that you review the arrangement in light of the criteria in 2 CFR 225, Appendix B, Section 37 (c), and Ohio Administrative Code Section 5101:9-4-11 (C), and determine whether you are dealing with a "less-than-arms-length" transaction. If this appears to be the case, you should review the guidelines in Section 37 (b) as to allowable costs under such circumstances, as well as the provisions on depreciation and use allowances (2 CFR 225, Appendix B, Section 11), maintenance (2 CFR 225, Appendix B, Section 25), taxes (2 CFR 225, Appendix B, Section 40), insurance (2 CFR 225, Appendix B, Section 22) and interest on related debt (2 CFR 225, Appendix B, Section 23).

Issue 2 – Depreciation and Bond Principle:

As noted in the discussion under Issue 1, above, the components of allowable rental costs under less-than-arms-length transactions are depreciation or use allowance, maintenance, taxes, insurance and interest on related debt. The depreciation is to be based on the acquisition cost of the assets, excluding the cost of land. Calculation of depreciation is to be on a straight-line basis over the expected useful life of the assets. The expected useful life used should be the same as that used for financial reporting purposes by the county auditor.

In many instances where the board of county commissioners issues bonds for the acquisition of building facilities for a county family services agency, the term of the bonds is less than the expected useful life of the buildings. For example, the bonds issued to fund the building may mature in 20 years, but the estimated useful life of the building is 40 years.

Under such circumstances, assuming a useful life of 40 years, an acquisition cost of $3,200,000, and no remaining salvage value at the end of the estimated useful life of the building, the annual depreciation would be $3,200,000/40, or $80,000 per year. Thus, the allowable rental cost for the agency would be $80,000, plus the amount of any maintenance, taxes, insurance and related interest.

A problem arises when, as is sometimes the case, the claim for rental costs is based not on the estimated useful life of the building, but on the term of the bonds issued to fund the acquisition. Under the same assumptions, where the agency incorrectly uses the bond term of 20 years, rather than the estimated useful life of 40 years, the miscalculated "depreciation" is $3,200,000/20, or $160,000 a year.

If this circumstance were to be identified in the course of an A-133 Single Audit, there is a risk that the excessive claim to federal programs, or $80,000, would be a questioned cost. There is also a risk, if the excessive claim has been made over an extended period of time, that the federal awarding agency would seek recovery of the total excessive claims. For example, under the circumstances discussed, if the excessive claim had been made for a 10 year period, the excessive amounts claimed for the entire period, $800,000, might be at risk.

Recommendation 2:

If your agency occupies building facilities owned by the Board of County Commissioners and claims the related cost to federal programs, we recommend that you review the acquisition cost of the building and the appropriate useful life used by the county auditor for financial reporting purposes, and determine whether the correct amount is being claimed to federal programs.

If an excessive amount is being claimed, we recommend you consult with your county auditor and your county prosecuting attorney, as your statutory legal advisor. If they are in agreement with your calculation and this analysis, we recommend that you adjust the claim for the current and subsequent years until the total amount allowable has been claimed for the estimated useful life of the building. The county prosecuting attorney may have additional suggestions as to the potential liability of the county for the excessive claims to that point.

Technical Assistance Requests:

If you have specific questions as to this Bulletin, please contact John Maynard at (614) 466-7933 or by e-mail at john.maynard@jfs.ohio.gov.

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