



Memorandum

Date **MAR 10 1992**
Richard P. Kusserow
From Inspector General

Subject Audit of Equipment Acquisitions through Capital Leases
and Other Financing Agreements at the Ohio Department of
Administrative Services (A-05-91-00066)

To Arnold R. Tompkins
Assistant Secretary for
Management and Budget

This memorandum alerts you to the issuance on March 12, 1992, of our final report. A copy is attached.

The Ohio Department of Administrative Services (ODAS) had the responsibility for the procurement of data processing equipment used by various State departments and agencies. The equipment was acquired from suppliers through direct purchases, rentals, leases and other types of financing agreements. The ODAS, in turn, billed the user agencies for the equipment.

The report points out that billings to the agencies during the period July 1, 1982 through June 30, 1989 included about \$8.2 million of interest expense and other unallowable costs related to the acquisitions. We estimate the Federal share of these costs to be about \$4.9 million through June 30, 1989.

Office of Management and Budget Circular A-87 provides that interest expense in any form, as well as charges for equipment in excess of acquisition costs, are unallowable expenditures under Federal programs. A portion of the amounts ODAS billed user agencies for equipment acquired through capital leases and other types of financing agreements represented interest expense. In addition, the ODAS billed users amounts in excess of their costs of acquiring the data processing equipment from suppliers.

The unallowable charges to Federal programs are attributed to a lack of adequate procedures to identify interest expense and account for the cost of the equipment.

We are recommending that ODAS work with the other user agencies in establishing procedures to identify and properly account for the costs of data processing equipment. We are also recommending that ODAS make a financial adjustment of \$4,897,056 (Federal share) for

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costs improperly charged to Federal programs through June 30, 1989.

State officials generally concurred with our findings and recommendations. To expedite resolution of the audit findings, State officials met with representatives of the Department of Health and Human Services, Division of Cost Allocation on December 13, 1991 and negotiated a settlement in the amount of \$4.8 million (Federal share).

If you have any questions, please call me or have your staff contact John A. Ferris, Assistant Inspector General for Human, Family and Departmental Services Audits, at (202) 619-1175.

Attachment

Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

REPORT ON AUDIT OF EQUIPMENT
ACQUISITIONS THROUGH CAPITAL
LEASES AND OTHER FINANCING
AGREEMENTS

STATE OF OHIO



Richard P. Kusserow
INSPECTOR GENERAL

A-05-91-00066



DEPARTMENT OF HEALTH AND HUMAN SERVICES

REGION V
105 W. ADAMS ST.
CHICAGO, ILLINOIS 60603-6201

OFFICE OF
INSPECTOR GENERAL

Common Identification No. A-05-91-00066

Stephen A. Perry, Director
Ohio Department of Administrative Services
30 East Broad Street
Columbus, Ohio 43266-0423

Dear Mr. Perry:

Enclosed for your information and use are two copies of an OIG report titled, "Report on Audit of Equipment Acquisitions Through Capital Leases and Other Financing Agreements." Your attention is invited to the audit findings and recommendations contained in the report. The official named below will be communicating with you regarding resolution of these items.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), HHS/OIG reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act, which the Department chooses to exercise. (See 45 CFR, Part 5.)

To facilitate identification, please refer to the referenced common identification number in all correspondence relating to this report.

Sincerely,

Original signed by

Martin D. Stanton
Regional Inspector General
for Audit Services

Enclosures

HHS Contact: Mr. Kenneth Gibbons, Director
Division of Cost Allocation
U.S. Department of Health and Human Services
1200 Main Tower Building

SUMMARY

This report provides you with the results of our audit of equipment acquisitions by the Ohio Department of Administrative Services (ODAS) through capital leases and other types of financing agreements. The ODAS acquired dedicated data processing equipment for use by various departments and agencies within the State of Ohio. The objective of the audit was to determine whether interest expense and other unallowable costs relating to these acquisitions were charged to Federal programs administered by the State agencies. Our review covered financing agreements active during the period July 1, 1982 through June 30, 1989.

We determined that ODAS billed the other departments approximately \$8.2 million of interest expense and excess costs related to the data processing equipment. Contrary to Federal regulations, the departments charged these costs to Federal programs. Based on our audit, we estimate the Federal share of these costs to be about \$4.9 million through June 30, 1989. An additional \$337,301 of interest expenses, applicable to agreements that extend beyond June 30, 1989, has been or may be charged to Federal programs.

Office of Management and Budget Circular A-87 provides that interest expense in any form, and charges for equipment in excess of acquisition costs, are unallowable expenditures under federally-funded programs. A portion of the amounts ODAS billed user agencies for equipment acquired through capital leases and other financing agreements represented interest expense. The amounts billed to users in excess of the amounts paid to suppliers represent excessive costs. In determining whether an agreement constituted a capital lease, we used definitions included in generally accepted accounting principles published by various accounting boards that set standards for the accounting profession and in the Department of Health and Human Services' Grants Administration Manual. The capital leases we identified generally provided for title to pass to the State at the end of the lease term or provided an option to purchase the equipment at a reduced price.

The unallowable charges to Federal grants is attributed to a lack of adequate procedures to identify interest expense and properly account for the cost of equipment acquired through capital leases and other financing agreements.

We are recommending ODAS work with the other user agencies in establishing procedures to identify and properly account for the cost of equipment acquired through financing agreements. These procedures should preclude unallowable interest expenses being charged to Federal programs. We are also recommending ODAS make a financial adjustment of \$4,897,056 for costs improperly charged to

Federal programs through June 30, 1989, and identify and refund the Federal share of any additional interest expenses charged up to the time that corrective actions are taken to preclude such charges to Federal programs.

State officials generally agreed with our findings and recommendations. They subsequently negotiated with action officials a settlement of \$4.8 million for the amounts we recommended for financial adjustment.

INTRODUCTION

State and local Governments have used various types of financing arrangements to acquire capital equipment. In Ohio, the Ohio Department of Administrative Services (ODAS) acquired data processing equipment through various financing agreements, including capital leases. A portion of the payments that ODAS made under these agreements represented interest expense. We performed an audit to determine whether any interest expenses or other unallowable costs related to these acquisitions were charged to federally-funded programs.

BACKGROUND

The ODAS was responsible for procuring all data processing equipment and services utilized by the various State departments and agencies until June 30, 1988, at which time the responsibility was transferred to the user agency. The data processing equipment ODAS acquired for the other State agencies included computer hardware and software, related computer peripherals and word processors. These items were acquired through direct purchases, rentals, installment purchases, leases and other types of financing agreements. The ODAS billed the user agencies for the equipment. Financing agreements in effect on June 30, 1988 continued to be billed by ODAS through October 31, 1992.

The allowability of a particular cost item charged to a Federal Program by a State or local governmental agency is determined by the requirements of Office of Management and Budget Circular A-87 (Circular), Cost Principles for State and local Governments. One of the cost principles included in this Circular provides that interest on borrowing (however represented) is unallowable. Another provides that compensation for use of equipment will be through use allowances or depreciation, computed based on acquisition cost.

Equipment leasing agreements, which provide for title to pass to the lessee, are often referred to as lease-purchase agreements. generally accepted accounting principles, published by the Government Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB), refer to these arrangements as capital leases. The Department of Health and Human Services (HHS), in its Grants Administration Manual, refers to this type of arrangement as a material equity lease. For purposes of this report, we will use the term "financing agreements" to refer to this type of lease as well as other types of financing arrangements.

SCOPE

Our audit was conducted in accordance with generally accepted government auditing standards. The objective of the audit was limited to determining the amount of unallowable interest expenses and other excessive costs charged to Federal programs for dedicated data processing equipment acquired by ODAS for use by various State departments. The audit covered financing agreements active during the period July 1, 1982 through June 30, 1989. For equipment items billed during this period, we computed unallowable charges from the inception to the end of the billing periods--in some cases, prior to July 1, 1982 and/or after June 30, 1989.

To accomplish our objective, we obtained a copy of ODAS's dedicated equipment file and gathered detailed information on capital leases, installment payments, and other financing agreements for the equipment. We reviewed accounting records and related documentation at ODAS and selected user agencies. The information was used to calculate interest expenses applicable to the agreements, and to determine the amount of interest expenses and excessive costs ODAS billed the user agencies for the equipment. At the Ohio Department of Human Services (ODHS) and the Ohio Department of Health (ODH), we reviewed the systems in place to identify and account for the costs of equipment acquired through financing agreements, including the interest expenses and excessive costs they paid ODAS. We determined the Federal share of the unallowable expenses based on composite Federal share rates negotiated between the HHS Division of Cost Allocation and the State's Office of Budget and Management.

Due to the limited objectives of the audit, we did not evaluate the overall internal accounting and administrative controls of ODAS and the user agencies. Our review was limited to the accounting controls that related to our review of equipment capital leases and other financing agreements. We performed a limited review of ODAS's billing and accounts receivable systems for dedicated equipment, and of the ODHS's and ODH's payment, recording and financial reporting of these transactions.

Our review was performed at the ODAS, Human Services, and Health during the period April 1991 through August 1991.

FINDINGS AND RECOMMENDATIONS

CHARGES FOR DEDICATED EQUIPMENT INCLUDE UNALLOWABLE COSTS

In Ohio, State departments administering Federal programs charged the programs with unallowable interest expenses and other excessive costs applicable to capital leases and other types of financing

agreements. These agreements were entered into by the ODAS for acquisition of dedicated data processing equipment utilized by the various departments and agencies. For agreements active during the period July 1, 1982 through June 30, 1989, these agencies charged Federal programs with about \$4.9 million (Federal share) of costs that are unallowable under cost principles contained in the Circular. The overcharges occurred because of the lack of adequate procedures to account for the acquisition costs of the equipment and to exclude unallowable interest and other excess costs from allocations to Federal programs.

Criteria

Specific guidance to State agencies as to the allowability and unallowability of certain items of costs is contained in the Circular. Although the Circular does not specifically address interest on capital leases, it does make it clear that interest on borrowing is an unallowable charge to Federal programs. Attachment B, paragraph D.7. of the Circular states:

"Interest on borrowings (however represented), bond discounts, cost of financing and refinancing operations, and legal and professional fees paid in connection therewith, are unallowable..."

The substance of the transaction, rather than form of the contract, determines whether or not the applicable lease payments contain interest expense. Generally, payments made on rental agreements do not contain interest expense, while payments applicable to lease purchase agreements or capital leases do contain interest expense. The terms and conditions existing at the inception of each lease must be considered in order to determine whether it should be classified as a rental agreement or a capital lease. To distinguish between capital leases and basic rental agreements, we used criteria contained in generally accepted accounting principles published by GASB and FASB and in the HHS Grants Administration Manual. In general, these guidelines require that a lease be classified as a capital lease if (i) the ownership of the property is transferred to the lessee by the end of the lease term, (ii) the lease contains a bargain purchase option, or (iii) certain other conditions are met.

Once a determination is made that a particular lease agreement meets the definition of a capital lease, the costs of the lease are allowable up to the amount that would be allowed if the lessee had purchased the property for cash on the date the lease agreement was executed.

With respect to compensation for the use of purchased equipment, Attachment B, paragraph B. 11. of the Circular states:

"Grantees may be compensated for the use of...equipment through use allowances or depreciation....The computation of depreciation or use allowance will be based on acquisition cost...."

The financing agreements we identified in ODAS records generally contained the information necessary to determine the amount of interest expense applicable to each agreement. One of the essential items of information needed to calculate the interest portion of each payment was the cash price that ODAS would have paid for the equipment at the time the financing agreement was executed. Any cost above the price of the equipment, other than specifically identifiable costs such as maintenance, is considered to be an unallowable cost.

For the purposes of this report, we considered the principal portion of each payment as part of the purchase price. The principal portion represents a recovery of part of the purchase price and is similar to the depreciation expense that is allowed under OMB Circular A-87. We recognize that recovery of equipment costs in this manner results in the reimbursement of the costs sooner than if they were claimed through a depreciation method such as the straight-line method if the financing agreement term is less than the depreciation term. However, the purchase price or cost remains the same whether it is recovered through the principal portion of the payments or through depreciation. The claiming of the principal portion in this manner does not result in a greater reimbursement than under a depreciation method. Therefore, use of this method has no material effect on the charges to Federal programs.

Finding

The ODAS charged user agencies interest expenses and excessive costs for dedicated equipment and the user agencies, in turn, claimed these ineligible costs under their Federal programs. Upon request of the user agencies, ODAS procured data processing equipment and had it delivered directly to the users. The ODAS also procured additional equipment items which it stored until requested by a department or user agency. The ODAS paid the vendors and, in turn, billed user agencies to recover its costs (including interest expense). In some instances, user agencies were billed rental charges by ODAS rather than the cost of the equipment. These rental charges often exceeded ODAS's acquisition costs. In other instances, ODAS billed user agencies for the cost of the equipment and for installation and removal services, it also recovered these same costs by including depreciation and related salary costs in the cost allocation plan for its Division of Computer Information System Services (DCIS).

The ODAS used several different means and various forms of financing to acquire equipment, both for its own department and for other user agencies. The costs, including financing, that ODAS incurred to acquire the equipment were billed to the users. These billings itemized the charges for each equipment item, but did not identify the amount of interest expense included. User agencies charged the amounts billed to various accounts including those for federally-funded activities. Since interest expenses were not specifically identified on ODAS's invoices and the user agencies we visited had no procedures in place to identify and exclude interest expense from the amounts charged to Federal programs, unallowable interest expenses were included in their claims for Federal reimbursement.

A significant portion of dedicated data processing equipment was acquired by ODAS through rental agreements with suppliers. In some cases, it was subsequently determined more advantageous to purchase or lease-purchase the equipment and arrangements were made to buy equipment that was being rented. The ODAS generally entered into some type of financing agreement with the suppliers and the amounts they billed ODAS were reduced. However, since some of the user agencies chose to continue to rent the equipment from ODAS rather than purchase it, billings to users remained at the rental rates. These rental arrangements often continued for as long as several years past the end of the financing agreements between ODAS and the suppliers. Consequently, the amounts charged to the user agencies included not only the interest expense but also amounts in excess of ODAS's acquisition costs for the equipment. These unallowable interest expenses and excessive costs were, in turn, charged to Federal programs.

Equipment items acquired for use in the DCIS were included in its inventory at the purchase price, excluding interest. The depreciation expense was included in DCIS's cost allocation plan. Once an item of equipment was recorded in the DCIS inventory, depreciation was generally taken for the entire 5 year useful life even though some of the equipment was subsequently transferred to other user agencies. We found items of equipment in the DCIS inventory being depreciated at the same time a user agency was being billed for the use of the equipment. The inclusion of the depreciation in the DCIS cost allocation plan for the same periods other agencies were billed for using the equipment resulted in excessive charges to various Federal programs.

In addition to charging users for the equipment, ODAS sometimes billed them a flat service charge for installation or for subsequent transfer of the equipment to another location. A duplication of charges to Federal programs occurred because neither the salary expenses for the ODAS personnel performing these tasks nor the revenues collected for the services performed were offset against costs included in the DCIS cost allocation pools.

To determine the amount of unallowable interest expenses and excessive costs charged to user agencies, we obtained a copy of the ODAS dedicated equipment file, copies of leases, installment payments, other financing agreements, and other pertinent documents. We reviewed the terms and conditions of the agreements to determine whether financing was involved and whether they met the criteria for classification as a capital lease. In most cases, the agreements and supporting documentation clearly indicated an installment purchase or some other type of financing arrangement. Generally, the purchase price, payment terms, interest rates, and asset ownership at the termination of the agreements were clearly established.

Calculation of Interest Expenses and Excessive Costs

Using data in the dedicated equipment file and the information gathered on the financing agreements, we computed the amount of unallowable interest and excessive costs the user agencies paid for the equipment. The amounts were computed by subtracting the allowable purchase price and rental charges, if applicable, from the total amounts billed for a particular piece of equipment. The purchase prices or principal components used in our computations were determined or verified by

1. Examining the terms of the financing agreements;
2. Using information contained in DCIS's Fixed Asset Management System;
3. Computing the present value of the lease payments using a known term and Moody's state and local government bond rates.

For the period covered by our audit, user agencies incurred interest expenses and excessive costs of approximately \$8.2 million as a result of the financing agreements and continuation of rental arrangements after ODAS bought selected items of equipment.

To compute the Federal share of unallowable costs, we averaged for each department the Federal share rates negotiated between the State's Office of Budget and Management and the HHS Division of Cost Allocation. Based on these rates, the estimated Federal share of the unallowable interest expenses and excessive costs was \$4,897,056.

The total amount and estimated Federal share identified for each department are presented in Appendix A to this report.

Interest Expenses Subsequent to Audit Period

We identified additional interest expenses of \$489,619 that has been or will be incurred from July 1, 1989 through October 31, 1992 for those financing arrangements that were active, but did not expire, during the audit period. The estimated Federal share of these interest expenses is \$337,301. This amount will be charged unless procedures are established to identify and exclude the interest from charges to Federal programs. The total amount and estimated Federal share, by department, are presented in Appendix B.

Conclusions

Interest expenses and excessive costs for equipment acquired through financing agreements were included in Federal claims for reimbursement because adequate procedures were not implemented to identify these costs and exclude them from charges to Federal programs. We estimate that unallowable costs of \$4,897,056 (Federal share) were charged to various Federal programs for financing agreements active during the period July 1, 1982 through June 30, 1989. An additional \$337,301 (Federal share) in interest expenses may be charged to Federal programs from July 1, 1989 through the end of the financing agreement periods.

RECOMMENDATIONS

We recommend that the ODAS

1. Work with user agencies in establishing procedures to identify and properly account for the costs of equipment acquired through financing agreements. These procedures should provide for identifying and excluding interest expense from charges to Federal programs.
2. Make a financial adjustment of \$4,897,056 (Federal share) for interest expenses and excessive costs charged to Federal programs through June 30, 1989, the end of the audit period.
3. Work with the user agencies to identify interest expenses billed the agencies, and to make a financial adjustment for any interest charged Federal programs after the audit period up until the time that corrective actions are taken.

STATE AGENCY COMMENTS

State officials concurred that ODAS's billings to other State agencies for equipment acquisitions included some costs ineligible for Federal reimbursement. They also concurred with our procedural recommendation and the financial recommendations related to the ODHS and Health. However, they did not fully agree with our financial recommendations with respect to the other State agencies. They proposed discussing with appropriate Federal officials alternatives for closing the audit. The State agency's written response to our draft report is included as Appendix C.

OIG RESPONSE

On December 13, 1991, subsequent to the date of the State's response, State officials met with HHS Division of Cost Allocation action officials and negotiated a settlement of \$4.8 million for the amounts we recommended for financial adjustment. We consider the settlement to be reasonable and acceptable.

APPENDICES

OHIO DEPARTMENT OF ADMINISTRATIVE SERVICES
COLUMBUS, OHIO

SUMMARY OF INTEREST EXPENSES AND EXCESSIVE COSTS
RECOMMENDED FOR FINANCIAL ADJUSTMENT

<u>Department/Agency</u>	<u>Total Interest Expenses and Excessive Costs</u>	<u>Federal Share Percentage</u>	<u>Total Federal Share</u>
Human Services	\$ 3,904,574	53.96%	\$ 2,106,908
Health	232,113	59.82%	138,850
Mental Health	179,773	17.15%	30,831
Education	625,818	21.88%	136,929
Environmental Protection Agency	44,155	47.15%	20,819
Mental Retardation & Developmental Disabilities	19,890	32.24%	6,413
Transportation	535,942	45.92%	246,105
Bureau of Employment Services	2,318,511	90.35%	2,094,775
Development	92,448	57.68%	53,324
Rehabilitation Services Commission	44,540	86.39%	38,478
Natural Resources	83,227	10.23%	8,514
Adjutant General	24,158	30.57%	7,385
Civil Rights Commission	13,339	29.82%	3,978
Public Utilities Commission	<u>69,639</u>	5.38%	<u>3,747</u>
Total	<u>\$ 8,188,127</u>		<u>\$ 4,897,056</u>

OHIO DEPARTMENT OF ADMINISTRATIVE SERVICES
COLUMBUS, OHIO

SUMMARY OF INTEREST EXPENSES
SUBSEQUENT TO THE AUDIT PERIOD

<u>Department/Agency</u>	<u>Total Interest Expenses</u>	<u>Federal Share Percentage</u>	<u>Total Federal Share</u>
Human Services	\$ 709	53.96%	\$ 383
Health	3,123	59.82%	1,868
Mental Health	14,566	17.15%	2,498
Education	37,937	21.88%	8,301
Environmental Protection Agency	2,068	47.15%	975
Mental Retardation & Developmental Disabilities	5,316	32.24%	1,714
Bureau of Employment Services	350,146	90.35%	316,357
Natural Resources	23,285	10.23%	2,382
Public Utilities Commission	<u>52,469</u>	5.38%	<u>2,823</u>
Total	<u>\$ 489,619</u>		<u>\$ 337,301</u>

STATE AGENCY RESPONSE
TO DRAFT REPORT



Ohio Department of Administrative Services

DIVISION OF COMPUTER SERVICES
30 EAST BROAD STREET
COLUMBUS, OHIO 43266-0409

GEORGE V. VOINOVICH, GOVERNOR

STEPHEN A. PERRY, DIRECTOR

December 12, 1991

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OIG-V-01

Mr. Martin D. Stanton
Regional Inspector General
Department of Health and Human Services
Region V
105 W. Adams Street
Chicago, Illinois 60603-6201

RE: Common Identification No: A-05-91-00066, HHG/OIG Office of
Audit Services Report entitled Audit of Equipment Acquisitions
Through Capital Leases and Other Financing Agreements

Dear Mr. Stanton:

The Ohio Department of Administrative Services (ODAS) has reviewed the above referenced draft report, and concurs that the equipment billings for the reported period did include some Federally ineligible costs to other state agencies. However, we do not agree with certain assumptions used in the determination of the Federal share associated with these charges.

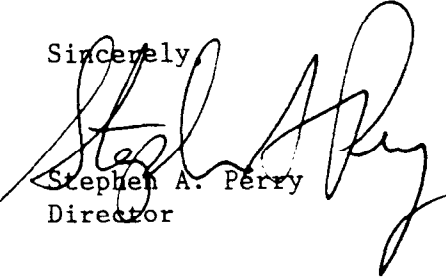
The finding assumes that ineligible costs billed to state agencies were in turn, claimed against these agencies' Federal programs. This assumption is based on a detailed audit review of the payment and financial reporting records for two of the fourteen agencies listed in this report. We have contacted all of the state agencies involved to ascertain the extent to which these costs may have charged to federal programs. Several agencies provided written responses indicating that costs for the questioned equipment acquisitions were charged exclusively to state revenue sources.

Based on the responses we have received from the participating agencies and the limitation in scope represented by the extrapolation technique employed, we concur only with the monetary findings identified to the Ohio Department of Human Services and the Ohio Department of Health. However, we do understand the purpose of an extrapolation approach, and would like to discuss possible alternatives for closing this audit with the appropriate Federal representatives.

Mr. Martin D. Stanton
December 12, 1991
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We agree with the audit recommendation that ODAS work with the user agencies in establishing procedures to properly account for Federally ineligible costs. However, the reporting of these costs is ultimately the responsibility of the agency filing for reimbursement.

Sincerely,



Stephen A. Perry
Director

SAP/dm
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