

payment of interest charges for the lease-purchase of computer equipment. The parties further agreed to waive a hearing and submit these matters on a record which, on January 31, 1992, they jointly stipulated.

Finding of Fact
Rental Costs
90-UIA-2

1. In September 1986, the Iowa Department of Employment Services, Division of Job Service ("Iowa") entered into a rental contract for a computer security software system. The annual cost of \$13,992.00 for the system was to be paid monthly. 90-UIA-2, Administrative File ("AF") at 92, 113-129.

2. Under the contract's terms, either party could terminate the agreement upon 30 days notice to the other party. Id.

3. In fiscal year 1987, Iowa made an entry in its fund ledger recognizing \$71,500.00 as an expenditure for the contract and set up a payable account for this amount. The expenditures were charged to the employment insurance grant fund ledger #92155. Id.

4. The \$71,500.00 expended for the contract in 1987 was fiscal year 1985 grant money and the system under the rental contract was listed as "resources on order" when the 1985 grant was closed out. Id. at 13.

5. Iowa actually planned to purchase the system. However, in 1987 when the actual acquisition was made the transaction was changed from a purchase to a rental agreement. Id.

6. The auditors questioned the \$71,500.00 for rental costs, because the contract contained a provision that it could be terminated by either party with 30 days notice. Consequently, the auditors concluded that the contract should not have been recognized on the books as a financial obligation, but rather as a monthly expense each time an installment was to be paid. Id.

7. On November 17, 1989, the Grant Officer issued his Initial Determination disallowing the rental costs of \$71,500.00 under OMB Circular A-87 and Employment Training Administration Handbook 336, 2nd Edition, dated June 4, 1984 (FY '85 Planning Guidelines). Id. at 18.

8. On January 26, 1990, the Grant Officer issued his Final Determination based on all comments and documents submitted by Iowa, and again disallowing the rental costs of \$71,500.00. Id. at 10.

9. On February 13, 1990, Iowa appealed the Grant Officer's disallowance of the rental costs pursuant to 20 CFR §658.707 and ETO No. 5-85. See, Letter from Cynthia Eisenhower, Director of Iowa Department of Employment Services; AF at 4.

10. On February 21, 1990, Grant Officer received a warrant drawn on the Iowa State Treasury in the amount of \$52,998.00, thereby reducing the disallowance to \$18,502.00.

II.

Interest Charges

90-UIA-1

11. On January 24, 1985, Iowa issued a bid to acquire a computer system. 90-UIA-1, AF at 79. The bid provided that "[b]ecause of federal government cost policies that forbid the payment of interest, the [Iowa Department of Job Service] IDJS is seeking methods of leasing to ownership that would not include interest." Id. at 79. Bid No. 6063.

12. The bid process involved two steps: selection of a supplier for the system and selection of a financial plan. IBM was selected to provide the system and finance the plan. Id. at 79.

13. Iowa entered into a lease-purchase agreement No. 1728 with IBM, called a Federal Lease to Ownership Plan, or FLTOP, for acquisition of the computer system. The agreement provided alternative methods of purchase. It set forth a cash price if the purchase was a cash sale. If the purchase was paid for in increments, the agreement provided for a "lease increment." Id. at 80.

14. The cash sale price was \$2,584,158.00. The 60 month lease payment option would have totalled \$2,999,820.00 or \$469,110 more than the cash sale price. Id. at 80. With 30 days prior notice to IBM, Iowa was permitted "to repay its entire principal obligation without penalty" Partial "principal payments" were permitted once every calendar year. Id. at 101. Iowa elected the "lease increment" option, made payments with federal funds, and included the cost in the job service cost allocation pool. Id. at 79.

15. The "lease increment" through September 30, 1986, totalled \$176,494.00. This amount was questioned in the fiscal year 1986 audit. Id. at 79-81. .

B.

90-UIA-2

16. In fiscal year 1987, Iowa incurred an additional lease increment of \$8,339.00 under the 1985 lease purchase agreement. 90-UIA-2, AF 13.

17. During fiscal year 1987, Iowa entered into two other lease purchases and incurred "lease increments" totalling \$2,392.00. Id.

18. The auditor's questioned \$10,731.00 as representing interest costs under generally accepted accounting principles. Id.

19. On November 17, 1989, the Grant Officer issued his Initial Determination disallowing \$10,731.00 as interest costs under OMB Circular A-87, Attachment B, Section (D)(7) and the regulations applying costs principles. Id. at 18.

20. On January 26, 1990, the Grant Officer issued his Final Determination, based on all comments and documents submitted by Iowa, and again disallowed the \$10,731.00. The Grant Officer rejected Iowa's arguments that the costs were allowable based on an efficient procurement and as a prudent business decision. Id. at 10.

21. On February 13, 1990, Iowa appealed the Grant Officer's disallowance of the interest costs pursuant to 20 CFR 5658.707 and ETO No. 5-85. See, Letter from Cynthia Eisenhower, Director of Iowa Department of Employment Services.

III. Cash Management

22. The Iowa Department of Employment Services has developed effective procedures to prevent federal cash surpluses in its General Fund.

23. The Iowa Department of Employment Services' Tax and Trust Fund Department has developed a detailed accounting manual for its specific operations.

24. Iowa has implemented an adequate monitoring and oversight system for its Trade Adjustment Assistance subrecipients.

IV. Audit Report

25. The parties have stipulated that, for purposes of this litigation, the relevant portions of Audit Report No. 05-89-07950-598, section B of the Administrative File ("AF"), are: AF at 56-58 (delineating Employment and Training Administration Funds); AF at 79-82 (questioning \$10,731.00 in costs for interest expenses); AF at 92 (questioning \$71,500.00 in costs for accounting for rental costs). The parties also agree that other portions of the file, including attachments, may also be relevant to this litigation.

26. The parties further stipulated that, for purposes of this litigation, the relevant portions of Audit Report No. 05-89078-03-325, section B of the Administrative File ("AF"), are: AF at 61-63 (delineating Employment and Training Administration Funds); AF at 79-81 (questioning \$176,494.00 in costs for interest expenses), and that other portions of the file, including attachments, may also be relevant to this litigation.

C. 91-UIA-1 Interest Charges

27. Findings 11-14 above are incorporated herein by reference.

28. In fiscal year 1988, Iowa incurred an additional lease increment of \$6,597.00 under the 1985 lease purchase agreement. 91-UIA-1, AF 14.

29. The auditor's questioned \$6,597.00 as representing interest costs under generally accepted accounting principles. Id.

30. On August 31, 1990, the Grant Officer issued his Initial Determination disallowing \$6,597.00 as interest costs under OMB Circular A-87, Attachment B, Section (d)(7) and the regulations applying costs principles. Id. at 19. The agency's response is found in the Id. at 26-27.

31. On December 3, 1990, the Grant Officer issued his Final Determination, based on all comments and documents submitted by Iowa, and again disallowed the \$6,597.00. The Grant Officer rejected Iowa's arguments that the costs were allowable based on an efficient procurement and as a prudent business decision. Id. at 9.

32. On December 31, 1990, Iowa appealed the Grant Officer's disallowance of the interest costs pursuant to 20 CFR §658.707 and ETO No. 5-85. Letter from Cynthia Eisenhower, Director of Iowa Department of Employment Services.

B.
Audit Report

33. The parties stipulated that, for purposes of this litigation, the relevant portions of audit Report No. 05-90-05150-598, section C of the Administrative File ("AF"), are: AF at 59-60 (delineating Employment and Training Administration Funds); AF at 79-82 (questioning \$6,597.00 in costs for interest expenses), and that other portions of the file, including any attachments, may also be relevant to this litigation.

Discussion
I.
Rental of Computer Security Software
(90-UIA-2)

In September, 1986, the Job Service Division of the Iowa Department of Employment Services entered into a rental contract for a computer security software system. The contract was recorded in the financial records for fiscal year 1987 as a payable account of \$71,500.00 with an annual cost of \$13,992 payable in monthly installments and was subject to termination by either party upon 30 days notice.

The latter caveat attracted the attention of State auditors who were the first to question this item. They noted that an agreement which could be terminated on 30 days notice was not properly recorded as a financial obligation, but rather was as a monthly expense each time it was paid. 90-UIA-2 at 92. The state agency agreed, and committed properly to account for future expenditures.

The problem, however, was not so easily resolved. Further inquiry by the Department of Labor Regional office revealed that the \$71,500.00 recognized as a payable account on the financial records for FY '87 were actually FY '85 federal money which the state had shown as a "resources on order" item when its FY '85 grant was closed out. The Grant Officer concluded, and Iowa does not dispute his conclusion, that "The state had initially planned [in FY '85] to buy the computer software security system, but when the actual acquisition was: made in FY '87, the transaction was changed from a purchase to a rental." *Id.* at 13. Thus, although consummated in FY '87, the purchase was noted as a liquidated obligation on the FY '85 records and charged to the FY '85 grant. Thereafter, the state dispersed \$8,410.00 in FY 187 and \$1092.00 in FY 188.

The record shows that Iowa issued a warrant in the amount of \$52,998.00 to the Grant Officer thereby reducing the disallowed rental costs to \$18,502.00. It then sought to resolve the dispute by reopening the fund ledgers for its FY '87 and FY '88 grants and recording what it considered allowable disbursements in those years. *Id.* at 142. Alternatively, the state asked that the remaining balance of \$10,502.00 be allowed even if the FY '87 and FY '88 ledgers could not be reopened. The Grant Officer rejected both alternatives and disallowed the rental costs. Iowa contends that he abused his discretion in these respects.

The Grant Officer committed no error in disallowing the \$71,500.00 expenditure as a "resources on order" item in the FY '85 grant, and Iowa does not seriously contend otherwise. *See*, Iowa brief at 3. Federal cost principals and planning guidelines applicable to these costs provide that allowable "Obligation must be intended to meet a bona fide need of the fiscal year in which the need arisesTo comply with this rule, purchase orders, requisitions, and contracts recorded as obligations must be firm, complete, and must request prompt delivery of materials or services." *See*, ETA Handbook 336, Chapter II, Section III (B) (1), 2nd Ed. (1984)(*Id.* at 137-38). As the Grant Officer noted, no documentation has been furnished to demonstrate that these requirements have been met. *Id.* at 13.

It is unnecessary to accept the blanket assertion in the Grant Officer's brief that a bona fide need could not have arisen in FY '85, because the transaction was completed in 1987. *See*, Grant Officer's brief at 4-5. It should suffice to note that an obligation to satisfy a need in one fiscal year may be bona fide even though the product or service sought is not delivered until the next fiscal year or later. The bona fide nature of the need and obligation is a question of fact, and depends upon the circumstances and context of each transaction. In this instance, I have combed the record and the State's brief for evidence or argument relating to need for a computer software security system as it existed in FY '85. Yet, the context in which the \$71,500.00 obligation was incurred is not apparent on this record. Accordingly, I find that the State has failed to demonstrate a bona fide need for the security system in FY '85.

Further, the State seems to agree that the contract term which afforded either party the right to terminate the agreement upon 30 days notice tended to vitiate it as an obligation in accordance with generally accepted accounting principles. Iowa Brief at 3; *Id.* at 92. Nor would it be a "firm" or "complete" obligation as described in the ETA Handbook. *Id.* at 138. .To the contrary, such an agreement represented unliquidated obligations and was so designated by the state. As such, it was properly disallowed.

The remaining issue is whether the Grant Officer abused his discretion by refusing to reopen the books, afford the State additional obligational authority for FY '87 and FY'88, and allow the expenditure of \$8,410.00 in FY '87, \$10,092 in FY '88 and crediting the FY '88 fund ledger. Iowa argues that these audit exceptions are simply accounting problems, and it is an abuse of discretion not to resolve them by merely reopening the ledgers for the years in question.

The Grant Officer's response, however, tends to remove the issue from the realm of bureaucratic abuse of discretion. The Grant Officer explains:

In converting the transaction in 1987 from a purchase agreement to a rental agreement, and effectively entering into a "new obligation." IDES (Iowa Department of Employment Services), deobligated the \$71,500.00 in 1985 funds. Contrary to IDES' contention, IDES cannot simply reopen the 1987 and 1988 ledgers to record the \$18,502.00 spent as monthly expenditures. Not only has IDES' 1985 fund lapsed, but its appropriation for 1987 and 1988 have been exhausted. IDES has absolutely no federal monies for attributing these expenditures." Grant Officer's Brief at 6.

Under these circumstances, the State of Iowa has failed to demonstrate that the Grant Officer abused his discretion by refusing to reopen and issue additional obligational authority for FY '87 and FY '88. Accordingly, \$18,502.00 spent on the computer software in FY '87 and FY '88 was properly disallowed.

II

Interest Costs v. Lease/Purchase Payments

(90-UIA-1)

(90-UIA-2)

(91-UIA-1)

A.

On August 12, 1985, the Iowa Department of Job Services and the IBM Corporation entered into Lease-Purchase agreement No. 1728. The agreement states that Iowa sought to purchase computer equipment from IBM and was offered a "cash price" or "lease-purchase price" to consummate the deal. The leasepurchase option contemplated 60 monthly payments and cost \$469,110 more than the cash method of purchase.

Under the terms of the agreement, Iowa made a \$500,000 "down payment" and was afforded the right "at any time (to) pay in advance the full amount due ... and the lease increment will be adjusted by IBM to reflect the shorter payment period." 90-UIA-1 at 98-99. In the event of "prepayment;" IBM agreed to "release its security interest in said property." *Id.* In the event the machines were irreparably damaged, "prior to the payment in full of the total Lease-Purchase price," Iowa was obligated to pay IBM a sum equal to the aggregate casualty value of the machines. The casualty value was defined as "the sum of the balances of Lease-Purchase Price and Lease Increment unpaid at the time of such Casualty Occurrence and attributed to such machine, such Lease Increment being adjusted by IBM to reflect the shorter payment period." *Id.*

at 101. Upon their installation, title to the machines passed to the Iowa Department of Job Services. Id. at 103.

B.

Section 1-15.713-9 of Title 41 of the CFR provides in part that "interest on borrowings (however represented), ... are unallowable", and Iowa was aware that DOL grant funds could not properly be expended on interest payments in any form. Id. at 80. Iowa argues, however, that the agreement required it to pay rent not interest, and accordingly each payment was allowable in its entirety.

Now I have carefully considered Iowa's contentions that the down payment may be regarded as a "lease bonus;" that the difference between the cash price and the lease-purchase price could be predicated on an increase in the market value of the used computers over the rental period; that the parties intended the agreement to be construed as a lease not a conditional sale; that other federal agencies in different circumstances permit these types of arrangements; and that state auditors erred in applying Generally Accepted Principles of Accounting when they treated the excess of the lease-purchase price over the cash price as interest. I find, however, I am unable to accept these contentions.

While the agreement between Iowa and IBM uses lease and rental terminology, the reality of the relationship between them is more in the nature of vendor and purchaser. Unlike a customary lease agreement in which title to the property remains with the lessor, in this instance title passed to Iowa "upon installation of the machines," and IBM retained a "security interest said property." Risk of loss also passed to Iowa which was required to pay the Casualty value of the machines in the event of irreparable damage. The Casualty value moreover was the lease-purchase price with an adjustment for the shorter payment period. A similar adjustment was contemplated to reflect the shorter payment period if the prepayment option were implemented. Further, prepayment of the lease did not merely entitle Iowa to continue to use the leased property for the remaining term of the lease, as may be customary under usual lease arrangements. Prepayment resulted in the removal of IBM's security interest and title, which had passed to Iowa upon installation of the machines, was rendered clear. Consequently, under the terms of this agreement Iowa owned the equipment from the date of installation, subject IBM's "purchase money security interest" which permitted, inter alia, repossession by IBM in the event of a default or circumstances which could potentially jeopardize the security interest.

While the elements of a sale appear fairly strong here, whether the transaction is viewed as a lease or a sale, the Grant Officer appropriately accepted the state auditor's conclusion that the state incurred interest costs as a consequence of this arrangement. The auditor explained that the present value of the lease term, assuming the transaction is viewed as a lease, is the "cash price." The amount of interest implicit in the lease, according to Generally Accepted Principles of Accounting, is the amount identified as the "Lease Increment" in the agreement.

Under Generally Accepted Principles of Accounting lease payments are allocated between reduction of obligation and interest expense. The record shows that the Financial Accounting Standard Board (FASB) No. 13 provides that a lessee shall "record a capital lease as

an asset and an obligation at an equal amount to the present value at the beginning of the lease term of minimum lease payments during the lease term" The Statement also requires the lessee to "compute the present value of the minimum lease payments using the interest payment implicit in the lease," and that "during the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation." 90-UIA-1 at 81.

Iowa does not dispute the auditor's interpretation of accounting principles, but it contends that the state does not budget according to such principles. Nevertheless, procurement principles are applicable to the federal grants it receives from the Department of Labor. The Department's Board of Contract Appeals decision in Management & Training Corp. v. U.S. Department of Labor, 86-BCA-26 (May 3, 1988), is thus illuminating. In Management & Training, the Board considered a fixed price, lease-purchase contract for the acquisition of equipment by a government contractor, and concluded that the "imputed interest" on the fixed price of the equipment was not allowable.²

In the context of federal grants to state agencies, the acquisition of equipment under lease-purchase agreements was similarly considered in Wisconsin Department of Industry, Labor, and Human Relations v. Department of Labor, 87-ESA-2; 87-UIA-13 (1988), and U.S. Department of Labor v. Nevada Employment Security Department, 87-UIA-15 (1989). In Nevada, like Kicking Horse, the lease-purchase agreement included specific finance charges which were disallowed. Wisconsin, in contrast, involved imputed interest. Although Wisconsin, unlike Iowa in this proceeding, asserted that interest on the purchase of computer and word processing equipment was permissible, and its purchase order mentioned an interest payment, the final lease purchase agreement referred only to the payment of rent not interest. Nevertheless, the state auditor imputed an interest component to the monthly payments and posted an audit flag on the expenditure. In this respect, the Wisconsin and Iowa final lease-purchase agreements seem to contemplate quite similar treatment of the financial arrangements for the acquisition of computer equipment. Further, the imputation of interest in accordance with accounting principles comports with the economic realities of the relationship between Iowa and IBM.

In this instance, the "lease" includes a "purchase option," identifies a "cash price," conveys title to the equipment upon its installation at the lessee's premises, provides for a "purchase money security interest" retained by the vendor, permits prepayment of the amount due with adjustments for the "shorter payment period," and conveys full unencumbered title to equipment upon prepayment. The indicia of a lessor/lessee relationship under these circumstances, as I have previously noted, appear less compelling than the realities of an agreement between a vendor and purchaser.

²Although the Grant Officer cites Kicking Horse Job Corps Center, 86-BCA-15, (October 15, 1987), Kicking Horse is distinguishable. In that case, the lease-purchase agreement included an option to purchase. The agreement itself then differentiated between the rents paid under the lease and the interest which accrued on the principal balance when the option to purchase was exercised.

For all of the foregoing reasons, whether the transaction is viewed as a sale or a lease, I find and conclude that the Grant Officer properly imputed interest costs to the monthly payments under this agreement. Moreover, while Iowa argues that Grant Officer has failed to account for the residual value or fair market value of the equipment, to the extent this is a challenge to the amount of interest imputed, the Grant Officer adopted the interest amounts imputed by the state auditors, and Iowa has failed to adduce and cite to any evidence which tends to suggest that the amount imputed was not correctly calculated.

Accordingly, the Grant Officer's disallowance of \$193,722 as an improper expenditure on interest costs shall not be disturbed. Therefore;

ORDER

IT IS ORDERED that Iowa's Motion for Summary Decision be, and it hereby is, DENIED.;

IT IS FURTHER ORDERED that Grant Officer's Motion for Summary Decision be, and it hereby is, Granted;

IT IS FURTHER ORDERED that the Iowa Department of Employment Services pay the U.S. Department of Labor, from nonfederal funds, the sum of \$212,224.00, representing \$18,502.00 in rental costs and \$193,722.00 in interest costs.

STUART A. LEVIN
Administrative Law Judge

SAL:jeh