DEPARTMENTAL GRANT APPEALS BOARD

The Department of Health, Education, and Welfare

SUBJECT: University of California at San Diego, Proposed Recharge Rates for the Computer Center
Audit Control No. 40101-09
Docket No. 23
Decision No. 13

DATE: January 27, 1976

DECISION

The leasing of equipment has grown enormously. It has been estimated that during the 1960's leasing grew at an annual average rate of 15 to 20% and that by the end of 1975 equipment on lease will total $100 billion (Financial Accounting Standards Board (FASB), Proposed Statement of Financial Accounting Standards, Accounting for Leases, August 26, 1975, Paragraph 43). In its application to grants, this requires the articulation for this rapidly expanding area of principles of prudent decision-making and of proper reporting. These are still in process of articulation and have not yet been fully solved but are evolving through successive refinements in the direction of a reasonably consistent approach. This problem is particularly prominent in the field of computer equipment.

STATEMENT OF THE CASE

An HEW audit determined that grantee's payments for a computer system acquired from Burroughs Corporation contains unallowable interest charges in the amount of $1,050,000, Audit Control No. 40101-09, dated November 13, 1973. One effect of this determination, if sustained, would be a requirement that grantee's computer recharge rates to federally supported research agreements be reduced to compensate. See OMB Circular A-21 J.35.

Grantee and HEW Regional officials exchanged several letters on the factual and legal issues including copies of opinions of their respective counsel. The Regional Comptroller sustained the audit finding. Grantee appealed to the Regional Director, who sustained the ruling. Grantee appealed to this Board.

The Agreement in question does not characterize the transaction as a lease or a sale, but its terms appear on their face to be consistent with those of a lease with option to purchase. They also appear to be consistent with those of an installment sale in which title is retained for security purposes.

Both sides have argued rather fully the characterization of this transaction under the Uniform Commerical Code as adopted in California. Neither side has offered any argument as to why a characterization, intended largely to determine recordation requirements and which set of creditors (lessor/seller's or lessee/buyer's) will be able to levy on the property, should be a guide as to whether the payments are reimbursable as between Government and grantee. The Chief Reporter, Professor Karl N. Llewellyn, particularly sought to avoid in the Code the decision of narrow practical problems by the application out of context of broad general concepts. See Official Comment on Section 2-101 and Section 9-101.

FACT BACKGROUND

The agreement between Burroughs and grantee was several times amended. For convenience we refer principally to the agreement dated April 25, 1972 and ignore differences between the several versions except as relevant to the discussion.

The agreement was for 84 months. This is roughly the expected economic life of the equipment involved. The agreement was terminable however at the unqualified option of the grantee at the beginning of any fiscal period. The non-cancellable period (the "lease term" under the proposed FASB standards) is thus less than a year, very much less than the economic life of the property. The anticipated residual value of the property at the end of the noncancellable portion of the agreement would be substantial. The agreement does not transfer title at the end of the term, unless grantee affirmatively exercises its option to buy a portion or all of the equipment at a price fixed in the agreement. The option coupled with terminability permits acquisition of the property whenever that is economically advantageous without locking the grantee in to an acquisition that is not advantageous. This is particularly a valuable privilege in view of the rapid evolution of computer technology. The equipment is not special purpose to the University. The option price is not a bargain option but is a price roughly equivalent to the expected residual value of the property at the date of exercise, diminishing progressively from the full initial

price (over $1,700,000) to a price equivalent to the depreciated value after seven years ($34,295). Thus, the arrangement, in FASB's terminology, is an operating lease not a capital lease from lessee's point of view (nor a sales-type lease or direct financing lease from lessor's point of view). In the terminology of Securities and Exchange Commission Regulations S-X §3-16(q), it is not a financing lease. In the terminology of HEW Grants Administration Manual Chapter 1-77 (now 6-10) it is not a "Lease Which Creates a Material Equity in Property" but a "Long-Term Lease."

It is agreed that the equipment could have been purchased outright at the inception of the agreement for $1,758,595. The cost of maintenance is agreed to be $1,196,105. The sum of scheduled cash payments is $2,954,700 (after addition of a substitute core memory) which exactly covers the initial cost price and maintenance.

The agreement also included provision, however, for a right on the part of Burroughs to computing services equivalent at the grantee's regular on-campus users rate of $12,500 a month. The auditors added to the cash payments 84 x $12,500 or $1,050,000, then subtracted the maintenance and initial price and came out with an excess of $1,050,000 which they labelled interest cost and challenged under an interpretation of OMB Circular A-21 §J.16 disallowing interest on borrowed capital "however represented." The coincidence of the equivalence between the Region's computed "interest" figure and the amount of the "service" figure, and the fact that the interest rate thus computed is equivalent to a 14% interest rate while the University was able to borrow money at 5 to 7% should have been tell tales of something amiss with this analysis.

There are indeed many reasons why this approach is untenable.

Every long-term transaction, a simple lease for example, can be analyzed as covering a payment for the use of borrowed funds or for foregoing alternative investment opportunities. In some sense that is equivalent to interest, but such interest charges implicit in every long-term transaction and hidden in the transaction itself are not disallowed. The lessor or seller has interest costs which are obviously passed on to the lessee or buyer. If they are blanketed in within an overall price they are not disallowed If they are passed on in a separately recognizable form they may be. Transactions are thus, often and without impropriety, shaped to meet this peculiarity of federal practice. The University asserts that in good faith it cast the transaction into what it believes and now claims was an acceptable format. There is nothing improper

in the University's frank effort to do this and a comment on the part of one of its employees that the transaction had to be so shaped does not warrant a characterization of "hiding" or "concealing" the interest element in the transaction.

The Region's effort here to extract from this transaction an interest element emphasizes one of the weaknesses inherent in the extreme interpretations sometimes given to §J.16 of A-21. It forces acquisition of major equipment to be made in disregard of sound managerial decision-making and channelled artificially into formats that meet artificial tests. Sounder approaches to this problem than the approach the disallowance here would encourage are shown in Attachment O to OMB Circular A-102, par. 3c(1), (FMC 74-7); 45 CFR 74.154(a); Cf. also Attachment O par. 3(c)(1) to "A-102 1/2" Notice of Proposed Rule-Making, 34 CFR Part 258, 40 FR 6304 (Feb. 10, 1975); Comptroller General's Report B-115369 (July 24, 1975), An Opportunity for Savings of Large Funds in Acquiring Computer Systems Under Federal Grant Programs, esp. at ch. 3; GSA Guidance to Federal Agencies on the...Acquisition of Automatic Data Processing Systems (February 14, 1975) esp. at pp 6-7; FMC 74-5 Management, acquisiton, and utilization of automatic data processing (ADP) 6d and e, and other government studies.

The excess of total payments over the sum of initial cost plus maintenance cannot be equated to an identified interest charge. To attempt to do so overlooks the substantial but not objectively measured value of the option right to cancel at the beginning of a fiscal period or to buy at an agreed price roughly equivalent to expected fair value.

More important, the services agreement cannot be treated as the equivalent of a cash payment. Burrough's right to call for services from the system is not so much an addition to the cost, as a potential diminution of the property made available. Moreover it must be fairly obvious that there never was a realistic expectation that the right would be substantially exercised. In response to specific inquiry, the grantee confirmed that there was no expectation that Burroughs would ever make other than casual use of the privilege, and refers to a letter from Burroughs dated July 12, 1971 allocating 70% of the potential usage to the faculty and students of the University. Burroughs has used in total $77,033 worth of services of which only $64,760.67 was unfunded usage. No further services will be supplied, this provision having been terminated effective December 31, 1974.

Thus, even if we counted Burroughs usage as a payment, the excess of payments over initial price plus maintenance amounts to only $64,760.67. Even if we otherwise accepted the Region's analysis, this amount cannot be identified as interest since there is no showing that it exceeds the fair economic value of the option to cancel and the option to buy in the agreement. Under Chapter 1-77, it might be disallowable under the Long-Term Lease provision without attempting to label it as interest, but that conclusion is not certain, indeed the case seems likely to fall as the University contends, under an exception to the Long Term Lease rule. In any case, both parties have agreed that 1-77 should not be applied.

DECISION

The appeal is allowed. The disallowance of $1,050,000 is set aside. The University is claiming only the cash payments plus $64,760.67 on account of services and that limited amount should be allowed. Recharge rates should be adjusted if necessary to reflect allowance of that amount but not of potential Burroughs use in excess of that amount.

/s/ Bernice L. Bernstein

/s/ Thomas Malone

/s/ Malcolm s. Mason, Panel Chair