Department of Health and Human Services
DEPARTMENTAL APPEALS BOARD
Appellate Division

Campesinos Unidos, Inc.
Docket No. A-15-77
Decision No. 2720
July 7, 2016

DECISION

Campesinos Unidos, Inc. (CUI) timely appealed the May 14, 2015 disallowance by the Administration for Children and Families (ACF) of $111,930 for expenditures by CUI from December 1, 2008, through November 30, 2013. The disallowance was based on an audit which found that CUI charged unallowable mortgage interest costs to its Head Start grant during those years in the amount of $72,272 and that CUI overstated other expenditures by a total of $39,658. CUI Ex. I, at 1-2.

CUI asserted that the audit process was flawed and did not provide CUI with adequate information or opportunity to provide documentation. CUI further argued that its mortgage interest was allowable because it did not use federal funds to purchase the building in question and that, in any case, it did not charge the Head Start program mortgage interest, but only reasonable rent for its use of space that did not exceed CUI's actual costs for the building. CUI Br. at (unnumbered) 1-3. As for the other disallowed expenditures, CUI conceded that discrepancies existed between its Federal Financial Reports (FFRs, also known as SF-425s) and its audited records, but asserted that the amount to be repaid was only $10,078, partly based on its claim to have already repaid $10,072.29. *Id*. at 7-8.

For the reasons explained below, we find CUI's arguments unsupported on the record. Therefore, we uphold the disallowance in full except as to $11,021.34 in expenditures which ACF determined were adequately documented in CUI's submissions.

Factual and Case Background

CUI, a non-profit organization based in Brawley, California, received Head Start grant award 09CH0247 for a project period covering five program years (PYs) from December 1, 2008

through November 30, 2013.[1] CUI Ex. I, at 1; ACF Ex. 3 passim; ACF Br. at 2. It is not disputed that, in 2008, before the grant's project period began, CUI acquired a building and land at 1535 Main Street in Brawley (also referred to in the record as the "Las Palmas Building"). CUI financed the purchase and later renovations with a private construction loan and with a first and second mortgage on the facility. CUI asserts that it did not begin to occupy the building until March 2011 and that only a small amount of the building's space was occupied by Head Start personnel. CUI Br. at 1-2.

In connection with the purchase, refinancing and renovation of 1535 Main Street, CUI's accounting firm prepared an "agreed-upon procedures" (AUP) report. CUI Ex. III. The report documented a five-year schedule for allocating CUI's capitalized acquisition and renovation costs (*i.e.,* mortgage principal and interest) among CUI's federal and state-funded programs, including Head Start. *Id.* (schedule H). According to the AUP report, the costs were to be assigned to CUI's programs in two ways, as depreciation and interest expense and as indirect costs. *Id.*

ACF engaged Rubino & Company (Rubino) to conduct an audit of CUI which included a site visit on January 26-28, 2015. ACF Ex. 1. The focus of the audit was to determine whether building-related costs had been borne by CUI's Head Start program and whether the costs were allowable. Rubino reported its findings to ACF in memoranda dated February 25, 2015 and May 1, 2015. ACF Exs. 1 and 2.[2] In its reports, Rubino explained that it extracted the information on the building-related charges to Head Start from the AUP report and reviewed underlying agreements and accounting documents. *Id.* Rubino pointed to Head Start requirements for prior approval to charge costs of previously purchased facilities or for costs of renovating facilities used in Head Start. ACF Ex. 1, at 2-3. Rubino reported that CUI officials stated that they did not seek approval because the purchase was made with corporate funds, but Rubino rejected that position as inconsistent with the Head Start Act and regulations. *Id.* Rubino determined that the amount of mortgage interest that was improperly charged to Head Start (through the indirect cost rate and through direct charges)[3] in PYs 23, 24 and 25 totaled $72,272. *Id*. at 5.

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[1] The budget period for PY21 began December 1, 2008 and ran through November 30, 2009. ACF Ex. 3, at 1 (notice of grant award). PYs 22 through 25 covered the succeeding periods ending on November 30, 2013. *Id*. at 4-21.

[2] These memoranda and other underlying documents were produced by ACF in response to a Board order dated August 10, 2015 after CUI requested assistance with obtaining discovery.

[3] The direct charges relate to the space occupied by the Head Start program within the 1535 Main Street building, a space which CUI describes as a single office of about 128 square feet. CUI Ex. VI, at 4; CUI Reply Br. at 4. The indirect cost rate is charged to all programs operated by CUI and is meant to capture the costs of administrative services from which they benefit and included the costs of the building space used for administration which CUI says amounted to 7480 square feet. *Id*.

In addition to reviewing the capital costs of the 1535 Main Street building, Rubino also attempted to reconcile CUI's FFRs to CUI's accounting records. *Id*. Rubino concluded that the amounts reported on the FFRs were overstated by the following amounts: $18,141 in PY 21; $12,953 in PY 22; and $8,564 in PY 23, for a total of $39,658. *Id.*

The May 1, 2015 Rubino memorandum provided extensive details on how Rubino calculated the amounts to be disallowed and included as attachments documents such as indirect cost rate proposals and CUI's submissions to federal grantors. ACF Ex. 2 passim. Rubino found that for PYs 23, 24, and 25, CUI had charged to its Head Start program direct costs that its accounting records classified as "amortization" relating the Head Start program's use of space in the 1535 Main Street facility. *Id*. at 5; *see also* CUI Ex. III, Sch. H. Rubino determined that a portion of each amortization charge represented mortgage interest, with the balance representing depreciation. ACF Ex. 2, at 5. Rubino estimated that CUI charged its Head Start program a total of $4,438 in mortgage interest as direct costs. *Id.* at 5-6 (tables 6 and 7). In determining the amount improperly charged to Head Start as indirect costs, Rubino removed mortgage interest costs from the indirect cost pools used to calculate CUI's negotiated indirect cost rates for fiscal years 2012 and 2013; recalculated those rates based on the revised indirect cost pools; applied the recalculated (lower) rates to the Head Start cost base to determine allowable indirect costs for those years; and compared those totals to the indirect cost amounts actually charged by CUI to its Head Start grants for the same years. *Id.* at 1-5.

On May 14, 2015, ACF issued the disallowance letter at issue in this appeal adopting the conclusions of the Rubino reports. CUI Ex. I. CUI's timely appeal followed. In addition to providing for a full briefing schedule, the Board conducted an informal conference in this case at CUI's request. CUI Reply Br. (unnumbered) at 6. The Board convened the conference, pursuant to our procedures at 45 C.F.R. § 16.10. CUI's representative appeared in person, while ACF's representative appeared by telephone. Other participants in the conference included Jose M. Lopez and David J. Torres, both from CUI, and Patrick Curtis, an accountant with Rubino & Company.

The Board provided the following questions to be addressed at the conference:

(1) whether, or to what extent, the disallowed mortgage interest expenses are allowable Head Start expenditures and whether a Head Start grantee may claim rent for use of a building that it owns;
(2) whether documentation and argument submitted by CUI are sufficient to establish that CUI's expenditures to upgrade a telephone system are allowable costs of its Head Start program; and
(3) whether the record supports CUI's contention that the portion of the disallowance representing overstated expenditures on its FFR includes $10,078 that CUI returned to ACF as "unexpended funds."

Feb. 25, 2016 Board letter to parties summarizing informal conference (Summary) at 2. After the parties received and had an opportunity to comment on the summary of the informal conference, the record was closed.

Standard of Review

The Board explained the standard of review for Head Start disallowance cases in a recent decision as follows:

> "In an appeal of a federal agency's disallowance determination, the federal agency has the initial burden to provide sufficient detail about the basis for its determination to enable the grantee to respond." *Me. Dep't of Health & Human Servs.*, DAB No. 2292, at 9 (2009), *aff'd*, *Me. Dept. of Human Servs*. v. *U.S. Dept. of Health & Human Servs.*, 766 F. Supp. 2d 288 (D. Me. 2011). If the agency carries this burden, which the Board has called "minimal," then the nonfederal party (the grantee, in this case) must demonstrate that the costs are, in fact, allowable. *Mass. Exec. Office of Health & Human Servs.*, DAB No. 2218, at 11 (2008), *aff'd*, *Mass. v. Sebelius*, 701 F. Supp. 2d 182 (D. Mass. 2010). "When a disallowance is supported by audit findings, the grantee typically has the burden of showing that those findings are legally or factually unjustified." *Id.*

E Center, DAB No. 2657, at 5 (2015).

Analysis

Much of CUI's argument focused on its concerns with the aspects of how the audit was conducted. CUI Br. at 1; CUI Reply Br. at 1. We therefore address first why those concerns cannot justify reversing a disallowance that is supported based on the record before us. We next explain why the amounts claimed by CUI in relation to its carrying costs for 1535 Main Street are unallowable whether characterized as costs of purchase or as charges in lieu of fair market rental. Finally, we discuss the overcharges found by the auditors.

A. <u>The audit process</u>

CUI states that two auditors spent four days at its facilities and left with hundreds of pages of documents. CUI Reply Br. at 1. Thereafter, CUI asserts, no exit conference or audit report was provided to which CUI might have responded or provided responsive documentation. *Id*. Instead, ACF proceeded directly to a disallowance and CUI was unable to discern and reproduce how the amounts disallowed were calculated. *Id*. at 1-2. Absent a report explaining the procedures applied and the calculations made, CUI contends, the process cannot fairly be called an audit. *Id*. at 2.

The Board addressed CUI's concerns about not having received adequate information to understand the reasoning and calculations underlying the disallowance by ordering ACF, over its objections, to produce "any final report resulting from the onsite review . . . as well as any workpapers or other documents embodying the underlying calculations since those are not reflected in the disallowance letter itself." Aug. 10, 2015 Board Ruling on Request for Extension of Time and for Production of Documents at 5. CUI has not asserted that ACF failed to comply with this order to produce. Thereafter, CUI had opportunities both in briefing and in the informal conference to fully respond to the bases for ACF's disallowance. Indeed, CUI conceded at the conference that it had now received sufficient information from ACF to track the relevant calculations underlying the disallowance. Summary at 2.

Thus, while CUI may feel that the audit process itself was not sufficiently transparent or responsive, the proceedings before the Board have been sufficient to cure any potential prejudice. Moreover, the Board's jurisdiction lies in reviewing the disallowance by ACF, not in the evaluating the conduct of audits by an ACF-contracted accountant. Nevertheless, CUI continues to press its position that, while Rubino "performed some types of limited procedures," CUI has still not seen an "audit report or any report of any kind stating the scope of their work or the audit standards followed . . . ." CUI Reply Br. at 2. To some extent, CUI's insistence that the Rubino review was not a proper audit seems to have been driven by the concern that, "when the disallowance is supported by **audit findings**, the grantee typically has the burden of showing that those findings are legally or factually unjustified." *Id.* (emphasis in original).

In the present case, however, whether Rubino's reports are treated as formal audit findings or not makes no difference to the burden borne by CUI. We need not determine if there is any factual or legal error in the reports in order to determine whether the disallowance is merited because our role is to determine, based on the record before us, whether the costs charged by CUI are allowable or not. In order to prevail, CUI needs to demonstrate on the merits that the disallowance is not supported based on documentation in the record before us. *See E Center* at 6-7. Even were we to agree with CUI's criticisms of the auditors, none of the criticisms undermines the validity of the documentation in the record, and, in fact, CUI has not disputed most of the relevant facts about how its funds were spent, focusing mostly on its legal arguments as to why those expenditures should be allowed.

Finally, to the extent that CUI's complaints about the audit process amount to a request that the disallowance be overturned as a consequence of its alleged flaws, we cannot grant such a request. As the Board has repeatedly held, an otherwise well-supported disallowance cannot be overturned based solely on equitable concerns. *See, e.g., Bright Beginnings for Kittitas Cty.*, DAB No. 2623, at 6 (2015) (equitable argument "not a basis for overturning a legally justified disallowance"), *citing Municipality of Santa Isabel*,

DAB No. 2230, at 11 (2009) (Board "has no authority to waive a disallowance based on equitable principles."); *accord Bedford Stuyvesant Restoration Corp.*, DAB No. 1404, at 20 (1993) (citing 45 C.F.R. § 16.14 and stating that the Board is "bound by all applicable laws and regulations" and "cannot provide equitable relief").

We therefore proceed to the merits of the disallowance.

B. Mortgage interest charges

1. *Relevant legal authorities*

Section 644(f)(2) of the Head Start Act (Act) provides, in relevant part, that "[f]inancial assistance provided under this subchapter may not be used by a Head Start agency to purchase a facility (including paying the cost of amortizing the principal, and paying interest on, loans) to be used to carry out a Head Start program unless the Secretary approves a request that is submitted by such agency." 42 U.S.C. § 9839(f)(2). Section 644(g) states, in relevant part, that "[u]pon a determination by the Secretary" that certain criteria are met regarding cost-effectiveness and other project attributes, "the Secretary, in the discretion of the Secretary may authorize the use of financial assistance under this subchapter to make payments for capital expenditures [including payments for "the cost of amortizing the principal, and paying interest on, loans"] related to facilities that will be used to carry out [Head Start] programs." *Id.* § 9839(g)(1).

ACF issued regulations implementing these provisions. Section 1309.10 of those regulations states that a –

> grantee which proposes to use grant funds to purchase a facility, or a grantee found eligible under §1309.4 to apply for funds to construct a facility, or §1309.5 to undertake major renovation of a facility, including facilities purchased for that purpose, must submit a written application to the responsible HHS official. . . .[4]

45 C.F.R. § 1309.10. The application must include "[t]he terms of any proposed or existing loan(s) related to acquisition or major renovation of facility and the repayment plans (detailing balloon payments or other unconventional terms, if any), and information on all other sources of funding of the acquisition or major renovations, including any restrictions or conditions imposed by other funding sources." *Id.* § 1309.10(g).

[4] The eligibility requirements for construction under section 1309.4 and those for renovation under section 1309.5 state that the grantee's Head Start program must serve a rural or low income community and demonstrate the lack of available alternative facilities. Neither party has contended that CUI was "found eligible" under either provision.

Section 1309.2 provides that grantees with previously purchased facilities "which are continuing to pay costs of purchasing those facilities, may apply to receive Head Start funds to meet those costs by submitting" similar applications. *Id.* § 1309.2. Such a grantee "may only use grant funds to pay facility purchase costs incurred after the responsible HHS official approves its application." *Id.*

Furthermore, an application for acquisition or major renovation must show the "intended use of the facility . . ., including information showing the percentage of floor space that will be used as a Head Start center or a direct support facility for a Head Start program." *Id.* § 1309.10(d). And, where the funding is sought "for the continuing purchase of a facility," the application must show "that the facility will be used principally as a Head Start center, or a direct support facility for a Head Start program." *Id.*, citing § 644(f)(2)(D) of the Act.

Office of Management and Budget (OMB) Circular A-122 (codified in 2 C.F.R. Part 230) provides cost principles for non-profit grantees, including Head Start grantees, governing whether or to what extent their "costs" are "allowable" under (that is, may be charged to) a federal grant award. *E Center* at 2, *citing* 2 C.F.R. § 230.20(a). In order to be "allowable," a grantee's costs must meet various general criteria set forth in Appendix A to OMB Circular A-122. 2 C.F.R. Part 230, App. A, ¶ A.2. Costs must also "[c]onform to any limitations or exclusions set forth in [the cost] principles or in the award as to types or amount of cost items," and be "adequately documented." *Id.*, App. A, ¶¶ A.2.b., A.2.g. Appendix B of OMB Circular A-122 addresses the allowability of specific types of costs and includes the following provisions relevant here:

- Paragraph 11.a. states that "[c]ompensation for the use of buildings, other capital improvements, and equipment on hand may be made through use allowance or depreciation."
- Paragraphs 15.b.(1) and b.(3) state that "capital expenditures" for buildings and land, or for material improvements to land or building, are "unallowable as direct charges, except with the prior approval of the awarding agency." (Paragraph 15.b.(5) indicates that its rules should be read in harmony with Paragraph 11 (rules allowing depreciation or use allowance for buildings or other capital improvements) and Paragraph 43 (relating to "rental costs" of buildings and equipment).)
- Paragraph 23 states that "[c]osts incurred for interest on borrowed capital, temporary use of endowment funds, or the use of the non-profit organization's own funds, however represented, are unallowable." Paragraph 23 also states, however, that interest on debt incurred after September 29, 1995 to acquire or replace capital assets (including renovations, alterations, equipment, land, and capital assets acquired through capital leases), acquired after September 29, 1995 and used in support of Federal awards is allowable, provided that" various conditions specified in the paragraph are met.

- Paragraph 43.a. states, in relevant part, that "reasonable" rental costs are allowable subject to the limitations in subparagraphs (b) through (d). Subparagraph (c) states that rental costs under "less-than arms-length" leases are "allowable only up to the amount . . . that would be allowed had title vested in the non-profit organization." Subparagraph (b) indicates that allowable costs of ownership include "depreciation or use allowance, maintenance, taxes, and insurance."

2. *Discussion*

CUI offers several theories to justify its use of Head Start grant funds to pay mortgage interest costs associated with its 1535 Main Street property. We address each in turn, as they are, in some respects, mutually inconsistent.

a. Servicing an existing mortgage does constitute "purchase."

The Board has held that the expenditures of Head Start funds for the construction or purchase of buildings and acquisition projects are subject to disallowance if the grantee failed to obtain approval in advance for the expenditure. *See, e.g., Child Development Council of Acadiana, Inc.*, DAB No. 2574, at 7 (2014) (holding that ACF "properly disallowed [the grantee's] construction costs because [the grantee] failed to obtain from a responsible HHS official the necessary prior written approval for the expenditures"); *Marie Detty Youth and Family Servs. Ctr., Inc.*, DAB No. 2024, at 37-38 (2006) (holding that section 644(g) of the Act "anticipates that a grantee will not spend grant funds" for construction "before receiving ACF's approval"). Nevertheless, CUI argues that these rules are not relevant because it acquired the building in 2008 without using federal funds, and did not charge Head Start any costs for the building until 2011.[5] CUI Reply Br. at 3. Hence, CUI reasons that no approval was required. *Id.*

CUI's narrow understanding of the term "purchase" is inconsistent with the definition of that term in the Head Start regulations which reads as follows:

> *Purchase* means to buy an existing facility, either outright or through a mortgage. Purchase also refers to an *approved* use of Head Start funds to *continue paying the cost of purchasing facilities* begun after December 31, 1986 as permitted by the Head Start Act and by § 1309.2.

45 C.F.R. § 1309.3 (italics added). Section 1309.2, in turn, expressly requires grantees "continuing to pay costs of purchasing" to obtain prior approval. Other regulatory provisions quoted above reinforce the broader application of the approval requirement beyond initial financing of acquisition costs. For example, grantees must seek approval

[5] On page 2 of its initial brief, CUI spells out the details of the bank loans used for 1535 Main Street.

before charging Head Start regarding "existing loan(s) related to . . . major renovation of facility," and associated "repayment plans" (section 1309.10(g)) and "the continuing purchase of a facility" (as to which the application must show "that the facility will be used principally as a Head Start center, or a direct support facility for a Head Start program.") (section 1309.10(d)). Plainly, these provisions contemplate that, even where a grantee already owns a building, financing costs related to carrying an ongoing mortgage or undertaking refinancing or significant renovations require approval from Head Start in order to obtain federal participation in those costs.

We therefore reject CUI's position that its acquisition of the building several years before initiating charges to Head Start exempted CUI from the requirement to obtain prior approval to use grant funds for mortgage interest costs.

b. Mortgage interest is not an allowable Head Start cost without approval.

Next, CUI relies on the statements in paragraph 23 of Appendix B, OMB Circular A-122, that interest on mortgages for assets acquired after 1995 may be allowable. CUI Br. at 4. CUI has not shown that it met the Circular's requirements for allowability and has further not shown that, even if it had, that it would be entitled to charge the mortgage interest costs to Head Start without first obtaining approval to do so.

Among the requirements in paragraph 23 for such mortgage interest to be allowable is that a lease/purchase analysis be performed "prior to the acquisition or replacement of the facility" to demonstrate that such a purchase "is less costly to the organization than other leasing alternatives, on a net present value basis." 2 C.F.R. Part 230, App. B, ¶ 23.a.(2). The analysis must include specific detailed cost comparisons of upfront costs, as well as operating and maintenance expenses, over the expected period of use of the facility. *Id.*

To attempt to show that it performed a lease/purchase analysis, CUI points to two exhibits. CUI Br. at 4-5, *citing* CUI Exs. VI and VII. CUI Exhibit VI consists of a memorandum to the Rubino accountant apparently responding to questions about the acquisition of 1535 Main Street. An exhibit attached to CUI Exhibit VI is entitled "Comparison Option Lease Cost/Commercial Based on FY 2009." It is not clear when this comparison sheet was prepared or by whom, but it identifies three properties that were not selected, all assessed as requiring renovation to be used by CUI and all alleged to have costs basically the same as or higher than the "monthly payment" for 1535 Main Street. The costs of insurance, utilities and maintenance are referenced for the alternative properties as "triple net cost," but no actual figures or comparison is provided for total cost over expected useful life on a net present value basis. Moreover, the comparison does not appear to have been prepared in anticipation of deciding whether the purchase

option was better than available rental alternatives but rather to "ensure that rent charges charged to Federal programs and to the indirect cost pool were allowable," and in particular to ensure that the rent was in line with what was reasonable in the depressed local leasing market. CUI Br. at 4-5.

Exhibit VII lists annual rent and square footage from 11/1/2001 to 10/31/2015 (resulting costs per square foot) for "HTC Properties, Inc Head Start Administrative Office, El Centro, California." CUI suggests that this rental for another property demonstrates that its charges for the 1535 Main Street property were "reasonable." CUI Br. at 5. The question for paragraph 23 is not whether the costs of the purchased property are reasonable but whether the grantee performed, prior to buying the building, the sort of detailed comparison of total costs over the lifetime use of the building against lease/rent alternatives. CUI has not established that it did so.

Even more significantly, CUI has not shown that grantor agencies are precluded from requiring prior approval of mortgage interest cost charges even when a grantee has met the requirements of paragraph 23 to make such costs allowable. ACF does not deny that mortgage interest costs might be allowable if prior approval is obtained, but contends that CUI failed to seek prior approval as required by 45 C.F.R. § 1309.10. ACF Br. at 8.[6]

CUI does not argue that it actually sought or obtained approval to include mortgage interest costs in its charges to Head Start, and indeed acknowledged at the conference that it had not done so. Summary at 2. To the extent that CUI contends that such approval was not required because it did not use federal funds for the "purchase," we have already explained why that argument lacks merit.

CUI also points out that the indirect cost rate was itself approved, implying that such approval sufficed to make allowable the mortgage interest costs allocated to its Head Start grant as indirect costs. CUI Br. at 3. The Cost Allocation Service (CAS) (formerly Division of Cost Allocation) of the Department of Health and Human Services is the cognizant agency responsible for negotiating indirect cost rates for non-profit grantees (such as CUI), rates which then apply across all federal programs from which the grantee receives funding. Summary at 3. CUI obtained negotiated indirect cost rate approval

[6] ACF characterizes the inclusion of mortgage interest as part of the "rent" charges to Head Start as amounting to a "profit" to CUI. ACF Br. at 8. CUI denies that it received any "profit" and suggests that the reviewers may have erroneously believed that the direct charges and indirect cost rate may have resulted in duplicative charges to Head Start for mortgage interest costs. CUI Br. at 6-7. It is not entirely clear what ACF meant by "profit" in this context, but nothing in the record undercuts CUI's explanation that Head Start was charged directly only for the office space which it used while the indirect cost rate included only the costs of space used by administrative support functions. We uphold the disallowance not because the charges at issue were duplicative or profitable to CUI but because mortgage interest for a purchased building may not be charged to Head Start without prior approval.

during the relevant period. CUI Ex. IX. As a result, at the informal conference, the Presiding Board Member granted a stay to allow the parties to obtain an opinion from CAS about "whether the negotiated rates – to the extent they were based on mortgage interest costs that were identified by CUI during rate negotiations as components of it indirect cost pools – constitute prior approval of the federal government's participation in those costs and whether CUI's negotiated rates are subject to adjustment or renegotiation in these circumstances." Summary at 3, citing *Piedmont Cmty. Actions, Inc.*, DAB No. 2595, at 2, 13-15, 22 (2014).

ACF thereafter reported that CAS did not consider its indirect cost rate process to substitute for the prior approval of the awarding entity, where such approval is required. March 11, 2016 ACF Response to CAS Questions (CAS Response) at 5. ACF also provided a declaration from its counsel (Johnson Declaration) with two attachments (A and B) showing the correspondence with CAS containing CAS's position and also including copies of applicable cost principles. As ACF indicates, CAS noted in its correspondence that "agency program regulations limit what may be charged to agency-administered grants and that 'in general, specific limitations set forth by awarding agencies regarding their programs supersede the cost principles.'" CAS Response at 5, *citing* Johnson Decl., Att. B at 2. Further, says ACF, CAS stated that the Non-Profit Rate Agreement itself contains language recognizing "the precedence of program regulations over the CAS's rate setting procedures." *Id.*, *citing* Johnson Decl., Att. B at 2[7] and 161. In addition, CAS advised ACF that our resolution of this disallowance would not require renegotiation of the overall indirect cost rates. *Id.* at 6, *citing* Johnson Decl., Att. B at 2. CUI did not offer any objection or response to the information from CAS.

We conclude that CAS's approval of CUI's indirect cost rate does not represent an adequate substitute for ACF's prior approval to charge mortgage interest to the Head Start grant. Since we have already determined that such approval was required before such costs could be treated as allowable for Head Start grantees, we further conclude that CUI's mortgage interest costs could not permissibly be charged to its Head Start grant.

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[7] Specifically, CAS's reply to ACF's inquiry on this point reads as follows:

> If mortgage interest is not allowable under a Head Start grant, it does not have any effect on the rate negotiated by CAS. The mortgage interest limitation is specific to Head Start, the rate we negotiated is for All Programs. It is up to ACF/Head Start to make any adjustments based on program limitations. As stated on page three of our rate agreement dated 9/3/15, it states under Section Ill: General A. Limitations, "The rates in this Agreement are subject to any statutory or administrative limitations and apply to a given grant, contract or other agreement . . . ." In general, specific limitations set forth by awarding agencies regarding their programs supersede the cost principles. It would not be possible for CAS to be aware of all program specific limitations for the various Federal funding agencies.

Johnson Decl., Att. B, at 2.

c. CUI is not allowed to charge itself mortgage interest in the form of "rent" but may recover only depreciation or a use allowance.

As we have noted, CUI also argues that it did not, in fact, charge mortgage interest to its Head Start grant. Instead, CUI contends that it charged the grant a reasonable "rent" using its "actual costs" for mortgage interest and depreciation as a ceiling to ensure it did not actually realize any profit. CUI Br. at 3-4 (stating that the "rent amount was limited to actual depreciation and interest as shown on [its] AUP reports"). Furthermore, CUI objects that the amount it could recover for depreciation alone would be only 39 cents per square foot which it calls "ridiculously low." CUI Reply Br. at 3.

This alternative argument fails for two reasons. To begin with, the record does not support that CUI was actually charging its programs rent rather than allocating its ownership costs. Contemporaneous accounting and financial records, including the May 2012 AUP report and CUI's indirect cost rate proposals, indicate that CUI was charging depreciation and mortgage interest, not rent, to its Head Start program. Schedule H of the AUP report (CUI Ex. III) sets out a plan to charge "Depreciation and Interest Expense," as direct and indirect costs, to its Head Start and other programs. Similarly, the schedules of indirect costs included in CUI's 2012 and 2013 indirect cost rate proposals make no mention of building rental costs associated with 1535 Main Street: the 2012 rate proposal specifies $121,287 in "Bldg amortization & interest"; and the schedule for the 2013 rate proposal refers to $127,049 in unspecified "Building charges." ACF Ex. 5, at 1, 2**.** Rubino found that these entries represent depreciation and interest costs associated with 1535 Main Street. ACF Ex. 2, at 3. CUI does not identify any contemporaneous evidence contradicting that finding, such as accounting records showing it recorded the costs in question as rent rather than "amortization."

Moreover, CUI would not be allowed to charge its programs rent for the use of a building which it owns under applicable principles. CUI suggests that Paragraph 43.a. of Appendix B of OMB Circular A-122 makes rental costs "allowable to the extent that the rates are reasonable," and insists that it demonstrated the reasonableness of the rental rates in light of market and available alternatives. CUI Br. at 3, quoting Circular; *see also id.* at 5-6. Other provisions of the cost principles make clear that the rental costs allowable under this paragraph are those rental costs incurred by the grantee, not rent charged by the grantee itself.

ACF has issued guidance, in question-and-answer format, for Head Start grantees on this topic:

> **Rental costs: When is it allowable for a grantee to charge rental costs to its grant for a Head Start facility?**
>
> Many grantees charge their Head Start grants for costs associated with the rental of space in which to operate their Head Start programs either as a federal or a non-federal cost. Generally, under OMB Circular A-122 "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." OMB Circular A-122, Appendix B, ¶ 43.a. The Circular also states that "[r]ental arrangements should be reviewed periodically to determine if circumstances have changed and other options are available." The same standard is applicable to State and local government recipients and Indian Tribes under OMB Circular A-87, Appendix B, ¶ 37.a.
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> *Space "rental costs" are not allowable when the cost is "assessed" by the organization which is the grantee. A grantee cannot "rent" space to itself.* A grantee is limited to charging the grant either depreciation or a use allowance (up to 2% of the acquisition cost per year) for the use of grantee owned space for operations of the Head Start program. Any method, other than the two just mentioned, is not permitted. *Any other factors, for example the estimated market rental costs for similar space are not material and have no bearing on the costs the grantee may charge to the Head Start grant.* OMB Circular A-122, Appendix B, ¶ 11.g(1), OMB Circular A-87, Appendix B, ¶ 11.f(1).

Admin. for Children and Families, ACF-PI-HS-09-10, *Responses to Facility Questions Concerning Acquisition, Rent, and Major Renovations*, available at http://eclkc.ohs.acf.hhs.gov/hslc/standards/pi/2009/resour_pri_010_120809.html (italics added). This guidance was available during the relevant time frame, and the binding cost principles underlying it were also effective throughout.

The Board has long held that the provisions of OMB Circular A-122 that govern the allowability of rental and building-use costs (which are unchanged in any material respect since 1987) "unambiguously prohibit rental charges for grantee-owned facilities in excess of depreciation or use allowances." *Texas Migrant Council*, DAB No. 842, at 3 (1987). In *Texas Migrant*, the Board rejected the grantee's assertion that "rental charges are an alternative to charges based on depreciation or use allowances." *Id.* at 4. Similarly, in *Lorain County Cmty. Action Agency*, the Board upheld the disallowance of claimed "rental costs" of space in a building acquired by the grantee to the extent that those costs "exceeded allowable acquisition costs, *which do not include mortgage interest*[.]" DAB No. 1196, at 1 (1990) (italics added). The Board noted in *Lorain County* that it

"previously rejected the use of 'rental' arrangements to evade regulations prohibiting claims for mortgage interest." *Id.* at 3, *citing Social Science Educ. Consortium*, DAB No. 163 (1981); *see also The Centers for Family Life,* DAB No. 1685, at 5 (1999) (holding that OMB Circular A-122 "clearly barred [the Head Start grantee] from using grant funds to, in effect, pay itself rent for the use of its [own] facilities"); *New Hanover County Cmty. Action, Inc.*, DAB No. 2478, at 11 (2012) (noting that the "applicable cost principles require that a grantee's charges for the use of real property it owns 'be made through use allowance or depreciation'" (quoting paragraph 11.a. of Appendix B of OMB Circular A-122)).

We conclude that CUI may not charge its Head Start program rent for the program's use of space in 1535 Main Street but rather may only charge a use allowance or depreciation.[8]

C. Overcharges not supported by accounting records of allowable expenditures

1. *Relevant legal authorities*

For costs to be allowable under a grant award, they must be "adequately documented." 2 C.F.R. § 230, App. A, ¶ A.2.g. In order to adequately document costs, the grantee must have a financial management system that provides for accurate, current, and complete disclosure of the financial results of each grant in accordance with the reporting requirements set forth in 45 C.F.R. § 74.52. 45 C.F.R. § 74.21(b)(1). To claim a cost as a grant expenditure, the grantee must report the cost on its FFR and must be prepared to document the cost in its financial records. As noted earlier and as the Board has consistently held, "it is a fundamental principle of grants management that a grantee bears the burden of demonstrating the allowability and allocability of costs for which it received federal funding." *Se. Mich. Health Ass'n*, DAB No. 2682, at 3 (2016) (internal quotation marks omitted).

2. *Discussion*

Based on Rubino's reports, ACF determined that $39,658 in Head Start expenditures reported on CUI's FFRs for PYs 21, 22, and 23 are subject to disallowance because they are not reflected in expenditures recorded in CUI's General Ledger (GL). CUI Ex. I, at 2. Rubino's May 1, 2015 report provides details of the calculations in the section titled "Program Overcharges." ACF Ex. 2, at 6-7. Specifically, table 8 in that report shows the accounting reconciliation – the comparison of expenditures reported on CUI's FFRs with the expenditures reported in its GL. *Id.* at 6.

[8] At the conference, CUI indicated that it would not pursue a use allowance because the amount would be lower than the depreciation it had charged to its Head Start grants. Summary at 2.

CUI concedes that "there appears to be differences between the amount reported on [its FFRs] and the *final audited* expenditures per our financial statements[.]" CUI Br. at 7 (italics in original). However, CUI submits that Rubino's reconciliation did not account for certain expenditures and transactions. *Id.* If those expenditures and transactions are accounted for, says CUI, the total program overcharge is $10,078, not $39,658. *Id.*

CUI identifies two categories of allegedly unaccounted-for expenditures and transactions: (1) telephone equipment expenditures; and (2) rebates of unexpended grant funds. During the informal conference, ACF agreed that the $11,021.34 in telephone equipment costs have now been adequately documented and thus may be properly charged to CUI's Head Start grant. Summary at 2. We therefore do not discuss the record evidence relating to this aspect of the disallowance.

Since ACF allowed $11,021.34 of the disallowed amount, and CUI admitted an overcharge of $10,078, the amount of the disallowance that remains in dispute is $18,558.66. CUI contends that the amount that ACF is seeking to have returned fails to account for a refund CUI already made of $10,072.29 in "unexpended [grant] funds" associated with PYs 22, 23, and 24. CUI Br. at 7, 8 ("Note 2"); CUI Ex. XIII (CUI letter enclosing check dated March 24, 2015 for that amount designated as reflecting unexpended funds). ACF agrees that the calculation of the overcharge did not reflect any refund of unexpended grant funds, but contends that this was not error because unexpended grant funds are not "expenditures," and should not be reported as such on the FFR or in the grantee's GL. ACF Br. at 14.

CUI counters that a grantee's liability for over-reported expenditures (expenditures recorded on the FFR that exceed booked expenditures) and liability for unexpended funds overlap. CUI Reply Br. at 2, 5-6. More specifically, CUI asserts that the over-charged expenditures identified by Rubino necessarily include the unexpended funds CUI refunded to ACF because the amount of allowable federally-funded "expenditures" reported on the FFR must be reconciled to equal "grant funds received" from HHS's Payment Management System (PMS), with the grantee's liability limited to the amount by which reported expenditures is less than funds received from PMS, whether that difference is called "unexpended funds" or "overreported expenditures." *Id.* The check provided by CUI covered differences between funds received from PMS and expenditures reported on the FFRs, according to CUI.

ACF counters that "unexpended funds" funds are not expenditures that are reported on FFRs or recorded as expenditures in a grantee's general ledger because, by definition, these are grant funds that were drawn down from HHS but never spent for any reported expenditures. ACF Br. at 13. Such excess drawdowns must be returned promptly. *Id*. at 13-14, citing 45 C.F.R. § 74.71(d) (grantee "shall promptly refund any balances of *unobligated cash that HHS has advanced or paid* and that is not authorized to be retained

by the recipient for use in other projects" (italics added)). According to ACF, its calculations were based on the extent to which expenditures reported on the FFR exceeded allowable expenditures recorded in CUI's own ledger, and thus did not include or take into account excess drawdowns of funds. *Id.* at 13-14.

Given the difficulty of tracing and identifying the remaining $18,558.66 in dispute, the Board provided CUI additional time after the conference to submit evidence supporting the claim that the disallowed expenditures included $10,072.29 that it already returned as unexpended funds and for ACF to report whether any further documentation submitted supported a reduction of the disallowance. Summary at 4. No additional evidence was received.

To summarize, with respect to the $39,658 in disallowed expenditures that Rubino found were not reflected in CUI's General Ledger, we reverse (based on ACF's concession) the disallowance of $11,021.34 for CUI's telephone equipment costs and affirm the disallowance of the remaining expenditures totaling $28,636.66 (the difference between $39,658 and $11,021.34).

Conclusion

For the reasons stated above, we sustain ACF's May 14, 2015 disallowance except with respect to $11,021.34 in expenditures for telephone equipment.

/s/
Constance B. Tobias

/s/
Susan S. Yim

/s/
Leslie A. Sussan
Presiding Board Member