



Disallowed Costs

(Accounting Issue #7)

Background:

In performing reviews of PHA Financial Data Schedules (FDS) submitted to HUD's Real Estate Assessment Center (REAC), instances of large balances in the category of **Undistributed Debits** were identified within a number of submissions. After inquiries were made as to what was being recorded within this line item, we found that these amounts often represented items classified under account 1620- Ineligible Expenditures. While recording of these transactions was proper under the old HUD basis of accounting, such treatment is not proper under Generally Accepted Accounting Principles (GAAP). The following analysis was performed in order to document the nature of disallowed costs and proper accounting treatment under GAAP.

Issues:

- What constitutes disallowed costs?
- What entries should be made to properly account for disallowed costs in accordance with GAAP?

Analysis:

“Questioned costs are defined by OMB Circular A-133 to include costs that are questioned by the auditor because of an audit finding: (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (b) for which the costs, at the time of the audit, are not supported by adequate documentation, or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances” [SOP 98-3, Appendix M, paragraph 6.54]. Generally, identification of questioned costs following an audit does not determine whether these costs will be disallowed. HUD, following an examination by the HUD Office of the Inspector General (IG) makes a determination as to the disallowance of these costs. Upon such determination, HUD's policy has been to require the PHA to record a journal entry in the applicable HUD program to reverse the expenses incurred by debiting former HUD account # 1620 – Ineligible Expenditures (a balance sheet account), and crediting the

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expenses which have been disallowed. This process is followed under the assumption that these disallowed costs will be reimbursed to the program, by the PHA, through non-HUD funds.

However, PHAs are now required to report their financial results to HUD REAC annually using (GAAP). Consequently, accounting for these disallowed costs in the manner referred to above would not be appropriate under (GAAP). Assets, as defined by (GAAP) are “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” [FASB Concepts Statement No. 6 paragraph 25]. Expenses are defined by (GAAP) as “outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out of other activities that constitute the entity's ongoing major or central operations.” [FASB Concepts Statement No. 6 paragraph 80]

Accordingly, the removal of these disallowed costs can not be accounted for as an asset of the entity as they have no economic value. In addition, the disallowance of these costs does not change the nature of what they are. As these costs have resulted in the consumption of economic benefits of the PHA, they must be accounted for within the entity's financial statements.

In order to properly segregate and account for these costs, REAC has proposed either (1) in cases where unrestricted resources are determined to be available, these costs will be allocated to the program which has these available unrestricted resources, or (2) where unrestricted resources are not available, these costs will be allocated to a temporary program with offsetting interprogram receivables and payables.

If PHA management determines that such disallowed costs were a result of an accounting “error”, as defined by APB20, ¶13, and such disallowed costs are considered to be material to the PHA's financial statements, then the PHA should modify its adjustments such that those entries affecting income statement accounts would need to be made to its opening retained earnings/fund balance. However, we believe that in most cases these adjustments will not be the result of an accounting error, but will be included in determination of net income in the current period [FAS16, ¶3]. PHA management should consult with their Fee Accountants and or auditors to determine the proper accounting treatment for these items. Should a determination be made that these amounts will be accounted for prospectively, a credit should be recorded as Other Revenue within the HUD program and a debit as Other Administrative Expenses within the unrestricted program. The offset to these entries will still flow through the Due From/ Due To accounts. In addition, if the PHA has available resources, these monies must be paid back to the HUD program that these disallowed costs were identified within. Upon such repayment, there will be an actual movement of cash with a corresponding removal of the Interprogram receivable/payable account balances.

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Based upon the IG's current position, these amounts will remain on the PHA's books until reimbursed with non-HUD resources or written documentation has been received, in a future period, relieving the PHA of its obligation of reimbursement of these monies. Also, note that in some cases, available resources may constitute Section 8 Administrative Fees earned by the PHA. However, determination must still be made by the representative Action Office as to whether these monies will be allowed to be used for reimbursement of the disallowed costs.

Conclusion:

By definition, disallowed costs represent items, which should not have been charged to the applicable program. Accordingly, in order to properly reflect available resources under the program, previous HUD accounting took into consideration amounts improperly charged against the program and restated equity balances to reflect available resources. While accounting for these transactions may have been proper under the HUD basis of accounting, it is not proper treatment under GAAP. The documentation herein was developed in order to first provide an explanation of what disallowed costs are and second to provide guidance on accounting for these costs in accordance with GAAP. Based on such, GAAP dictates that the activity be accounted for within the statement of operations rather than be eliminated. In addition, proper classification of assets should be accounted for in a manner consistent with GAAP reporting.

The following entries summarize HUD REAC's preferred accounting treatment for disallowed costs.

Entry to record disallowed costs recognized in the current period**Entry in HUD program**

DR:	Interprogram Due From ⁱ	XXX	
CR:	Operating Expenses		XXX

Entry in unrestricted program or temporary program

DR:	Operating Expenses	XXX	
CR:	Interprogram Due To ⁱⁱ		XXX

Entry to record disallowed costs recognized as prior period adjustments

Entry in HUD program

DR:	Interprogram Due From	XXX	
CR:	Retained earnings/fund balance		XXX

Entry in unrestricted program or temporary program

DR:	Retained earnings/fund balance	XXX	
CR:	Interprogram Due To		XXX

Entry to record prior period and current period disallowed costs recognized in the current period
(prior year disallowed costs are deemed to be immaterial and or not considered to be prior period adjustments)

Entry in HUD program

DR:	Interprogram Due From	XXX	
CR:	Operating Expenses		XXX
CR:	Other Revenue		XXX

Entry in unrestricted program or temporary program

DR:	Operating Expenses	XXX	
DR:	Other Administrative Expenses	XXX	
CR:	Interprogram Due To		XXX

ⁱ Represents amounts to be funded from unrestricted resources or temporary programs.

ⁱⁱ Represents amounts to be refunded to HUD program