Looking Behind the Curtain

By Carter T. Froelich, CPA

How are jurisdictions spending your impact fees?

Have you ever wondered if the impact fees your company pays to various jurisdictions are going toward their intended purpose? You may not be shocked to learn that often they're not.

Over the last 20 years, Launch—Development Financial Advisors has worked with the National Association of Home Builders, local NAHB chapters, and various home building companies, to review, critique, and determine the overall fairness and equity of the impact fees proposed by associated jurisdictions. Over the last seven years, Launch conducted a number of in-depth audits of municipalities' fee programs, and we can now conclude greater transparency and oversight are needed related to the expenditure of fees.

How to peek behind the curtain

The purpose of performing a jurisdictional impact fee audit or peer review is not to certify the accuracy of a public company's accounting records related to generally accepted accounting principles, as a public accountant would do. Rather, it is to determine whether the jurisdiction is utilizing fees to fund the construction of public improvements necessitated by new growth as delineated in their fee study.

As part of the peer review, the jurisdiction's fee study, enabling resolutions, detailed general journals by fee account, capital improvement program (CIP), and certified annual financial reports (CAFR) must be obtained. The fee study is thoroughly reviewed to understand the methodologies (e.g., incremental expansion, plan-based, buy-in) used by the associated municipalities' consultant to estimate the impact fee.

Upon completing the review of the fee study, a sampling of large dollar fee expenditures are selected from the jurisdiction's general ledger for detailed analysis of their appropriateness. Additionally, payments that appear out of place based upon the review of the fee study are also selected for further investigation.

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The purpose of the peer review is not to perform an objective evaluation of a jurisdiction's funds and accounts or to determine whether such funds and accounts have been presented fairly. The intent is to determine if the jurisdiction is spending its fees on capital improvements outlined in the fee study.

If the jurisdiction is not utilizing the fees to fund improvements necessitated by new growth, then the basic tenets of rational nexus and rough proportionality are not being met. In such a case, new growth is not receiving any benefit for the payment of fees, which is in direct conflict with case law related to such matters.

Most common misuses of fees

Most jurisdictions attempt to utilize fees for the intended purposes. There does, however, appear to be an almost uniform "disconnection" between the departments that prepare the fee study (e.g., manager, public works and finance departments) and the departments and/or personnel that collect and expend impact fees (accounting and public works departments). This disconnection can lead to the intentional or unintentional expenditure of impact fees outside of the scope of their intended purpose, which may result in new growth receiving no benefit for the impact fees paid.

In states with no fee audit requirement, Launch's audit findings have found the misuse of impact fees in four general areas:

Using fees to correct existing deficiencies. While reviewing a fee study, it was noted that federal and state authorities had cited a jurisdiction for not having sufficient fire stations. The jurisdiction was required by the authorities to use its own non-impact fee funds to build a second fire station to adequately serve its existing population. This fact was clearly outlined by the fee study. During the peer review of the impact fee accounts, we discovered that the jurisdiction spent approximately $935,000 of impact fees it was collecting for fire stations 3, 4, and 5 for the construction of the second fire station. The local home builders' association is suing the jurisdiction to restore the $935,000 inappropriately utilized from the impact fee accounts.

Using specific impact fees to fund non-authorized capital facilities. During a review of a jurisdiction's water impact fee accounts, for which separate impact fees were being collected for water capacity and water distribution, Launch uncovered that the jurisdiction had utilized $4.1 million collected for water distribution to finance water capacity projects. The same jurisdiction also spent approximately $2.2 million in impact fees specifically for sewage collection facilities to fund the wastewater treatment plant, for which it was collecting a separate fee. The fee study determined the costs necessary to fund both water/sewer capacity projects, as well as distribution/collection systems. To the extent that the separate funds were used to fund projects for which they were not intended, the jurisdiction will not be able to fund improvements for which the fee study intended. This instance precluded new growth from obtaining the benefits for which it paid impact fees.

Using fees for the payment of non-capital assets. A jurisdiction funded more than $2.1 million in public works and park department salaries, payroll taxes, health insurance, vacation pay, overtime pay, and even retirement benefits. Fees were used to fund departmental office supplies, cellular service, travel, and meals. The state in which the city is located requires that funds be used for capital facilities that have a useful life of 5 years or more. At present, the parties are negotiating the appropriateness of these expenditures.

Using fees for the repair and maintenance of existing facilities. In another jurisdiction, approximately $218,000 in funds were used to repair and replace existing park facilities rather than to construct new park facilities. The city has agreed to replenish the funds taken from the fee accounts through their general fund.

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What happens in a state that requires a third-party fee review?

In 2011, the home building associations in Arizona successfully passed Senate Bill 1525 (see Appendix C of the National Association of Home Builders' 2016

Impact Fee Handbook). SB1525 enumerated detailed steps jurisdictions must follow as a precursor to their ability to collect fees, further ensuring that new growth is only funding costs associated with the construction of necessary public infrastructure. Additionally, SB1525 required jurisdictions to perform a biennial audit of their impact fee accounts if they don't have an impact fee advisory board of housing industry representatives to help prepare fee studies.

Since the passage of SB1525, Launch has performed numerous peer reviews of Arizona jurisdictions' fee accounts and have found only minor issues constituting nominal dollar amounts. Accordingly, the requirement of a regularly scheduled audit appears to be bringing more discipline to the fee process and keeps fees flowing toward their intended purpose. For this reason, home building associations and their members are wise to keep a watchful eye on the fee process.

Ensuring proper expenditure of fees

Most state impact fee statutes are vague and open to interpretation, which leads to abuses by the public sector.

A possible solution is enacting impact-fee enabling legislation that outlines specific rules and guidelines for the estimation, collection, and expenditure of impact fees. This legislation should also provide a means for independent third parties knowledgeable in impact fees, public infrastructure, accounting. and finance to audit the jurisdiction's expenditure of impact fees. This will allow for the independent opinion on whether the jurisdiction is property utilizing its impact fee to foster the construction of public infrastructure required by new growth.

As a starting point, industry associations may want to consider a broader effort to implement more specific legislation related to the estimation, collection, and expenditure of impact fees. By providing more detailed guidelines and implementing regular peer reviews of fee accounts, both the public and private sectors can feel more confident that jurisdictions are utilizing impact fees for their intended purpose, which is to provide necessary infrastructure for new growth.

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