OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Audit Report

Single Audit Report for the State of Alaska Department of Environmental Conservation for the Year Ended June 30, 2003

Report No. 2006-3-00167

July 26, 2006

Report Contributors:	Leah Nikaidoh Robert Adachi Janet Lister Eileen Collins

Abbreviations

CFDA	Catalog of Federal Domestic Assistance
CFR	Code of Federal Regulations
Consortium	Alaska Native Tribal Health Consortium
EPA	U.S. Environmental Protection Agency
IHS	Indian Health Service
OIG	Office of Inspector General
OMB	Office of Management and Budget
Single Auditor	State of Alaska Division of Legislative Audit
State	Alaska Department of Environmental Conservation
Treasury	U.S. Department of the Treasury
USDA	U.S. Department of Agriculture

U.S. Environmental Protection Agency
Office of Inspector General

2006-3-00167
July 26, 2006

At a Glance

Catalyst for Improving the Environment

Why We Did This Review

During our review of a single audit of the State of Alaska, we noted that the single auditor raised issues regarding the State's Department of Environmental Conservation (State) that potentially impact the allowability of expenditures incurred by the State.

Background

The Single Audit Act of 1984 established uniform entity-wide audit requirements for State and local governments receiving Federal financial assistance. The single audit for Alaska for the year ended June 30, 2003, was performed by the State's Division of Legislative Audit. The Office of Inspector General is required to review and disseminate the results of single audits to responsible U.S. Environmental Protection Agency (EPA) officials. The State identified $33,887,200 in Federal expenditures for EPA grants under the Alaska Village Safe Water program.

For further information, contact our Office of Congressional and Public Liaison at (202) 566-2391.

To view the full report, click on the following link:
www.epa.gov/oig/reports/2006/20060726-2006-3-00167.pdf

Single Audit Report for the State of Alaska Department of Environmental Conservation for the Year Ended June 30, 2003

What We Found

The single audit questioned $1,166,051 in labor costs because State employees did not account for their activities in accordance with Federal requirements. In addition, we have questioned the balance of the EPA grant amounts of $32,721,149 due to the following single audit results:

- The State claimed disbursements that were advances and not actual costs.
- The State did not correctly report assets and expenditures.
- The State did not follow procurement procedures.

We also found that the State did not adequately monitor its subrecipients. As a result, one subrecipient earned interest and dividend income, contrary to EPA regulations. We estimate that the potential amount of Federal interest earned on the over $100 million in investments from 2001 to 2003 would be over $7 million.

What We Recommend

We recommend that the Acting Regional Administrator, EPA Region 10:

- Implement the single audit recommendations and disallow $1,166,051 of personnel services costs;
- Require the State to prepare and submit an indirect cost rate proposal for indirect costs related to direct labor costs under the Village Safe Water program;
- Disallow the remaining $32,721,149 of costs associated with EPA funds until the State can provide actual cost data, which includes the proper application of the 4 percent administrative costs under each grant;
- Require remittance of dividend and interest earned on EPA funds by its subrecipient; and,
- Formally place the State on a reimbursable payment basis until EPA determines the State's cash management, labor, and financial reporting systems fully meet Federal requirements, and the recommendations of this report have been fully satisfied.

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

OFFICE OF
INSPECTOR GENERAL

July 26, 2006

MEMORANDUM

SUBJECT: Single Audit Report for the State of Alaska Department of Environmental Conservation for the Year Ended June 30, 2003
Report No. 2006-3-00167

TO: Ronald Kreizenbeck
Acting Regional Administrator
EPA Region 10

This is the final report on the State of Alaska Department of Environmental Conservation's single audit for the fiscal year ended June 30, 2003. This report contains findings that describe issues the Office of Inspector General (OIG) and the single auditor have identified and the actions necessary to correct the deficiencies. We discussed these findings with representatives from the State of Alaska Department of Environmental Conservation and U.S. Environmental Protection Agency (EPA) Region 10, and issued a draft report to the State for its comments. We have summarized the State comments in this final report and included the complete response in Appendix A. This report represents the opinion of the OIG and the findings do not necessarily represent the final EPA position. Final determinations on matters in this report will be made by EPA managers in accordance with established audit resolution procedures.

The estimated cost of this report – calculated by multiplying the project's staff days by the applicable daily full cost billing rates in effect at the time – is $60,882.

Action Required

In accordance with EPA Manual 2750, Chapter 3, Section 6(f), you are required to provide us your proposed management decision for resolution of the findings contained in this report before any formal resolution can be completed with the State of Alaska Department of Environmental Conservation. Your proposed decision is due on November 13, 2006**.** To expedite the resolution process, please email an electronic version of your proposed management decision to nikaidoh.leah@epa.gov.

We have no objections to the further release of this report to the public. For your convenience, this report will be available at http://www.epa.gov/oig.

We want to express our appreciation for the cooperation and support from your staff and the State of Alaska Department of Environmental Conservation during our review. If you have any questions about this report, please contact me at (202) 566-0847, or Melissa Heist at (202) 566-0899.

Sincerely,

Bill A. Roderick
Acting Inspector General

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Purpose of Audit

During our review of the single audit of the State of Alaska, the single auditor identified issues that potentially impact the allowability of expenditures incurred by the State's Department of Environmental Conservation (State). We are issuing the single audit for the fiscal year ended June 30, 2003, and have provided our comments on specific areas noted in prior audit reports issued by the U.S. Environmental Protection Agency (EPA) Office of Inspector General (OIG) and other Governmental agencies. Based on our review of the single audit, we identified additional issues relating to the State's timekeeping process and subrecipient monitoring that impact the State's management of grants funded by EPA.

Background

The Single Audit Act of 1984 established uniform entity-wide audit requirements for State and local governments receiving Federal financial assistance. Single audits are a key control for the oversight and monitoring of recipient use of Federal awards. Federal agency actions to ensure that award recipients address audit findings in single audit reports are a critical element in the Federal Government's ability to efficiently and effectively administer its awards. These findings can include internal control weaknesses; material noncompliance with the provisions of laws, regulations, or grant agreements; and fraud affecting a Federal award. In fulfilling its responsibilities under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the EPA OIG is required to review and disseminate the results of single audits to responsible EPA officials. The State of Alaska Division of Legislative Audit performed the single audit for Alaska.

The State of Alaska recognized the need for adequate water and sewer systems through passage of the Village Safe Water Act in 1970. The purpose of the Village Safe Water program was to "establish a program designed to provide safe water and hygienic disposal facilities in the state." The program receives funds from three primary sources: EPA, the U.S. Department of Agriculture (USDA), and the State of Alaska.

In 1996, Congress amended Section 303 of the Safe Drinking Water Act to authorize grants to the State of Alaska for the benefit of rural (non-Native) and Native villages for: (1) the development and construction of public water systems and wastewater systems to improve the health and sanitation conditions in the villages; and (2) training, technical assistance, and educational programs relating to the operation and maintenance of sanitation services in rural Native villages. Since 1995, EPA has awarded $224,980,200 to the State to fund these various projects. For the year ended June 30, 2003, the State expended EPA funds of $33,887,200 under its Village Safe Water program.

Results of Single Audit

The State of Alaska Division of Legislative Audit (single auditor) performed the single audit pursuant to the provisions of OMB Circular A-133. The U.S. Department of Health and Human Services, as the cognizant agency for the audit, was required to review the work of the single auditor.[1] The single auditor issued an unqualified opinion on the financial statement report for the entire State of Alaska and a qualified report on major program compliance. The qualification referred to the Military Construction Program and did not impact EPA grant expenditures.

The single audit disclosed four findings and related recommendations (nos. 32-35) that pertain to EPA assistance agreements, per the Catalog of Federal Domestic Assistance (CFDA) 66.606, *Surveys, Studies, Investigations and Special Purpose Grants*. These findings pertain to grants awarded to the State to fund construction projects, training, and technical assistance, as part of the State's Village Safe Water program. The four findings represent internal control and noncompliance areas. The single auditor questioned labor costs of $1,166,051.

Additionally, the EPA OIG has questioned the remaining grant amounts of $32,721,149 (total questioned costs of $33,887,200) listed under CFDA 66.606 due to the magnitude of the findings presented in the single audit, in conjunction with findings and recommendations made by our office in prior reports.

In accordance with 40 Code of Federal Regulations (CFR) 31.12, EPA can institute special conditions or restrictions in grant awards, including payment on a reimbursable basis. Because of the magnitude of the findings noted, we have recommended that EPA place the State on a reimbursable payment basis until the cash management, financial reporting, and labor accounting systems fully meet Federal requirements, and the recommendations of this report have been fully satisfied.

A summary of the single auditor's recommendations (nos. 32-35) and the OIG comments are presented below. The full text of the single auditor's results and recommendations nos. 32-35, along with the Schedule of Federal Expenditures, are included in Exhibit 1 of this report. The entire single audit report is available upon request.

State Cash Management Procedures Need Improvement
(Single Audit Report Recommendation No. 32)

The single auditor reported that the State's cash draws and subsequent disbursements for the Village Safe Water program are not conducted in the best interest of the State. The program's procedures call for the advance of funds to communities to cover the needs of the project during the construction season (April to October of each year). Payments for the projects are either sent to an accounting firm that handles payments for Village Safe Water projects for deposit into separate bank accounts for each project, or are provided to the Alaska Native Tribal Health Consortium (Consortium) for the projects it administers. The Consortium is responsible for administering the majority of Village Safe Water projects. These advances individually may be small, but in aggregate represent a significant amount of funds outside of the State's control at any given time.

[1] Recipients expending more than $25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding.

As of June 30, 2003, during the construction season, the program's accounting firm held $11.5 million ($8.4 million in Federal funds and $3.1 million in State general funds). Using 5 percent as a long-term interest rate average, the State is losing approximately $8,000 to $13,000 in interest each month by having these funds drawn down too early.

According to the single auditor, the State does not currently receive sufficient financial information from the Consortium to report actual program expenditures instead of advances for Consortium projects. In the single audit report, the auditor recommended that the State's finance officer and Village Safe Water program manager work with the program's accounting firm and the Consortium to move to a semi-monthly advance of funds for program projects. The State agreed that not all advances were necessary for the entire construction season, but did not agree with the semi-monthly disbursements recommended by the single audit.

The single auditor identified this recommendation as an *Other State Issue*. Based on our review of the finding, we determined this to be a Federal noncompliance issue. Disbursements from the State to the accounting firm and Consortium were advances and did not represent actual EPA grant costs. The State is required under 40 CFR 31.22 and OMB Circular A-87 to claim actual costs under EPA grants. The amounts claimed under CFDA 66.606 of the single audit were advances and not actual costs.

The State has historically drawn funds in advance to meet cash needs for the construction season. The accounting firm had cash balances of $13.2 million and $11.5 million as of June 30, 2002 and 2003, respectively. The amount of cash balance for the Consortium is unknown, but a review of its Federal tax returns showed significant interest and dividend income due to cash and security investments (see "Additional Issue – Dividend and Interest Income" section for details).

In previous OIG audit reports, we identified the same issues regarding excessive/premature draws of cash under the EPA Village Safe Water grants. EPA Region 10 had notified the State that funds must not be drawn in advance of actual immediate cash needs, and the Region also rescinded its prior approval of drawing cash for the construction season.[2] However, Region 10 subsequently awarded a grant that allowed the advance of funds, contrary to the U.S. Department of the Treasury (Treasury) and EPA regulations.[3] Treasury and EPA regulations require that cash draws be close to the immediate needs or within 3 days of cash outlay. Draws should not result in accumulation of funds, and the excess cash balances noted were due to improper draw down procedures.

As discussed in the State's response to the single audit report (see Appendix A for the State's response and our analysis), the State indicated that it has adopted a new financial management system, and is drawing funds on a fully reimbursable basis for requesting grant funds. The State's actions, pending EPA's review and approval of the State's financial management system, should address this matter.

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[2] *EPA Oversight for the Alaska Village Safe Water Program Needs Improvement*, EPA OIG Report No. 2004-P-00029, issued September 21, 2004.
[3] *Region 10's Grant for Alaska Village Safe Water Program Did Not Meet EPA Guidelines*, EPA OIG Report No. 2005-P-00015, issued June 16, 2005.

State Needs to Obtain Actual Expenditures from Consortium
(Single Audit Report Recommendation No. 33)

The single auditor reported that the State's financial statements do not correctly report assets and expenditures for the Consortium. The single audit report said that the State does not have any information on the Consortium's actual expenditures; the only information the State has on expenditures is based on advance draws, as discussed regarding recommendation no. 32 above. The State reported the cash advances as expenditures, which is not in accordance with Generally Accepted Accounting Principles; those principles require that cash advances be reported as an asset until payments for goods and services are made.

In the single audit report, the single auditor recommended that the State's finance officer and Village Safe Water program manager revise the accounting procedures for the program's grants administered by the Consortium to allow proper financial statement presentation in the State's Comprehensive Annual Financial Report. The single auditor also recommended that the State obtain expenditure information for projects administered by the Consortium. To meet the requirements of 40 CFR 31.22, the expenditure information should be reported by EPA grant number and by project.

The single auditor reported that the accounting firm handling Village Safe Water projects does provide the State with actual expenditure information. However, in recommendation no. 32 above, it was noted that the accounting firm had cash balances of $13.2 million and $11.5 million as of June 30, 2002 and 2003, respectively. The fact that the accounting firm had such large cash balances suggests that the State is disbursing excess cash to the accounting firm and may not be reporting actual costs under the EPA grants.

As discussed in the State's response to the single audit report (see Appendix A for the State's response and our analysis), the State indicated that the Consortium performed project reconciliations and would be placed on a reimbursable basis for requesting grant funds. The State also informed us that the Consortium performed its reconciliation internally and that the State did not review the Consortium's reconciliations. Until the Consortium's reconciliations and supporting documentation are reviewed and determined to meet applicable EPA regulations, these funds remain unsupported.

Timekeeping Not Compliant with OMB Circular A-87
(Single Audit Report Recommendation No. 34)

The single auditor questioned labor costs of $1,166,051 because labor charged to EPA's infrastructure grants did not comply with the provisions of OMB Circular A-87. The single auditor specifically questioned labor for two reasons.

First, for nine employees who split-fund their time, the State developed annual estimates at the beginning of the year and used those percentages to allocate labor charges to various grants throughout the year, regardless of the projects on which employees actually worked. OMB Circular A-87 states the use of budget estimates does not qualify as adequate support for labor charging.

Second, 20 employees charged 100 percent of their time to the Village Safe Water reimbursable service agreement, and we question whether the employees worked solely on EPA Grant No. XP97030601. The single auditor noted that:

- The State used EPA infrastructure grant number XP97030601 as a funding source for recovering labor costs charged to the reimbursable service agreement. Although employees prepared time sheets, those time sheets only identified the reimbursable service agreement and not the actual final cost objectives.

- The State did not prepare required certifications. OMB Circular A-87, Attachment B states that where employees work solely on a single Federal award or cost objective, their charges for salaries and wages will be supported by periodic certifications (at least semiannually) that they worked solely on the grant being charged for the period certified.

However, since the Village Safe Water program had at least 10 open and active EPA grants and also receives funds from other Federal agencies and the State, we question whether the employees actually worked solely on EPA grant number XP97030601 during the year ended June 30, 2003. Further, if the employees worked on products or activities funded by more than one Federal award or cost objective, the use of certifications would be inappropriate. When employees work on multiple activities or cost objectives, the Circular provides that a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation that must: (a) reflect an after-the-fact distribution of actual activity, (b) account for the total activity for which each employee is compensated, (c) be prepared at least monthly and coincide with one or more pay periods, and (d) be signed by the employee. Budget estimates or other distribution percentages determined before the services are performed do not qualify as sufficient support.

Through discussions with the single auditor and information from the previous OIG audits, we identified additional problems regarding the acceptability of the State's labor practices:

- The State seems to be treating the Village Safe Water program as a final cost objective without considering which EPA infrastructure grants are funding individual projects, and without considering specific projects as the final cost objective. The purpose of the EPA infrastructure grants is to fund specific projects identified in the grant application, not a continuing environmental program. Therefore, the administrative allocation used by the State to pay personal service costs (i.e., employee labor charges) should coincide with the effort performed by these employees. Currently, there are 10 open EPA infrastructure grants the State is using to fund individual projects, and we found that the State drew funds from these various grants to pay for individual infrastructure projects.

- Some State employees are project engineers and work on specific Village Safe Water projects, and thus should account for their time directly to these projects. However, they charged their time to a single, general account number. OMB Circular A-87 defines a direct cost as any cost that can be identified specifically with a particular final cost objective (in the case of the engineers, the particular project, since each project has a distinct funding source). By charging the one EPA grant that is awarded in the current fiscal year, the engineers are not recording their time to reflect final cost objectives (a variety of EPA grants that fund individual projects).

- The Village Safe Water program also has State employees who do not manage specific projects (non-engineering employees), but instead perform support and oversight duties. The single auditor provided examples of timesheets for a grants administrator, an analyst, and the Division Director. OMB Circular A-87 defines indirect costs as those incurred for a common or joint purpose benefiting more than one cost objective, and not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved. The time spent by these State employees who do not manage specific projects under the Village Safe Water program meet the definition of an indirect cost under OMB Circular A-87 and must be recovered through a federally approved indirect cost rate.

Recently, the State acknowledged that there were deficiencies in its labor charging practices. In response to prior EPA OIG Report No. 2005-P-00015, Region 10 stated that starting with the Fiscal Year 2005 Village Safe Water grant, the State will begin direct billing all Engineering, Management, and Travel expenses to the appropriate projects, and the balance will be included in the State's federally approved indirect cost rate.

As discussed in the State's response to the single audit report, and through subsequent discussions with the State (see Appendix A for the State's response and our analysis), the State has revised its timekeeping system in order to identify labor charges by the engineers to individual projects. The State has proposed to distribute all related charges under the Village Safe Water program to individual projects based upon the engineer's direct time charged to the projects. The State views all of these charges as direct project costs. We have identified two issues with this practice:

1. Any costs not specifically identifiable to a final cost objective are, by definition, an indirect cost. By distributing non-engineering costs using engineering costs as the base, the State has created an indirect cost pool. Therefore, the State will need to prepare an indirect cost rate proposal for approval by EPA.

2. Federal law limits the State's total administrative costs to 4 percent. Until the State correctly allocates all of its direct and indirect costs to the proper grants, there are no assurances that the 4 percent statutory limitation has been met.

Until the State addresses these two issues, all labor charges incurred by the State remain unsupported.

State Procurement Procedures Not Consistently Followed
(Single Audit Report Recommendation No. 35)

The single auditor reported that the State did not consistently follow procurement procedures. The single auditor reviewed 15 procurement transactions from the Village Safe Water program and found that 5 transactions did not follow program procedures, as follows:

- Two transactions failed to use necessary program purchase orders.
- A project superintendent verbally agreed to a 1-year, $12,000 rental without going through the proper procurement procedures or documentation.
- A single source procurement was not properly approved by the program engineering supervisor.
- An existing contract was amended to include work not in the original scope of the contract; while the program manual does not specify when a contract amendment should be used, a State administrative code states a construction contract amendment is only allowable if the amendment is within the scope of the original contract.

The single auditor determined that there is a weakness in the procurement process, and recommended that the Village Safe Water program manager work with the program's engineers to ensure that program procurement procedures are followed.

In a separate report, the State of Alaska Legislative Auditor corroborated this single audit finding. That report[4] questioned the State's spending practices and oversight of construction of water and sewer systems through the program. There is no assurance that the procurements made under the program comply with EPA requirements and are allowable. As a result of the procurement weaknesses noted, procurements under EPA grants are unsupported and unallowable.

Additional Issue – Dividend and Interest Income

The recommendations made by the single auditor raised questions concerning the role of the Consortium in the Village Safe Water program and whether the Consortium was complying with EPA regulations. We reviewed the Consortium's single audits and Form 990 tax returns to gain an understanding of how the Consortium treated EPA funds received. During the review of the Consortium's single audit and tax returns, we identified one additional issue involving dividend and interest income.

Specifically, due to the State's drawdown practices and payment of advances to the Consortium (as described in single audit report recommendation no. 32), the Consortium earned dividend and interest income on Federal funds and accumulated cash and security investments. In its Form 990 Federal tax return, the Consortium reported the following:

[4] *Special Report on the Department of Environmental Conservation, Village Safe Water Program, Selected Projects*, Report No. 18-30028-04, issued November 19, 2003.

Fiscal Year Ended	Dividend and Interest Income	Cash and Security Investments	Percentage of Revenue from Federal Funds	Potential Dividend and Interest Income from Federal Funds
September 30, 2001	$6,339,965	$101,599,947	63%	$3,994,178
September 30, 2002	2,522,234	115,882,148	64%	1,614,230
September 30, 2003	2,519,611	105,586,530	72%	1,814,120
Total	$11,381,810			$7,422,528

On June 29, 2005, Region 10 determined that the Consortium, as a subrecipient of Federal funds, is not subject to the Cash Management Improvement Act. Thus, the provisions of 40 CFR 30.22(l) apply. The CFR requires that nonprofits not subject to the Act must repay interest income earned on Federal funds. As a result, the Consortium is required to repay any dividend and interest income earned on EPA funds. Because the majority of the reported revenues are from Federal sources (averaging 66 percent for the 3 years in the table above), it is reasonable to conclude that the majority of the cash and security investment accumulated and the resulting dividend and interest income come from Federal funds.

Based on our review of the Consortium's single audit report, the Consortium did not report in its single audits the amount of EPA funds expended. Therefore, we cannot reasonably estimate the amount of dividend and interest income earned on EPA funds versus other Federal sources of revenue. Based on the percentage of the Consortium's revenue from Federal funds, the potential dividend and interest income to be repaid on EPA funds would be a portion of the calculated $7,422,528 as of September 30, 2003. Because we were only able to obtain the Federal tax forms for a 3-year period, we were unable to determine how much interest the Consortium earned on its investments prior to year ended 2001. However, any interest income earned on EPA funds awarded for Village Safe Water projects since 1995 should be recovered by EPA.

Recommendations

Along with recommendations nos. 32-35 in the single audit, we recommend that the Regional Administrator, EPA Region 10:

1. Disallow the unsupported personnel service costs of $1,166,051, until the State provides sufficient documentation to support labor charges in accordance with Federal requirements.

2. Require the State to prepare and submit an indirect cost rate proposal for indirect costs related to direct labor costs under the Village Safe Water program. The indirect cost rate proposal should be submitted to EPA's Office of Acquisition Management, Financial Analysis and Rate Negotiation Service Center.

3. Disallow costs of $32,721,149 representing the remaining balance of CFDA 66.606 funds as unsupported until the State provides actual cost data by EPA grant, for all EPA grants supporting the Village Safe Water program; any costs that remain unsupported should be recovered. As part of its reconciliation process, the State will need to review and approve the reconciliations and supporting documentation

prepared by the Consortium. As part of its actual cost data, the State will need to properly apply and account for the 4 percent administrative cost limitation on a grant-by-grant basis.

4. Require the State to have the Consortium remit the portion of interest, representing dividends from EPA-invested funds from the inception of the Village Safe Water program, through year ended 2003, to the U.S. Department of Health and Human Services, Payment Management System, Rockville, Maryland 20852.

5. Formally place the State on a reimbursable payment basis under the authority of 40 CFR 31.12 until the cash management, financial reporting, labor accounting, and procurement systems fully meet Federal requirements, and the recommendations of this report have been fully satisfied.

Summary of State Response and OIG Comment

We issued our draft report to the State on March 29, 2006. Based upon the State's response, we deleted the draft's recommendation three, due to the State's steps to improve its procurement process. The State's full response is provided in Appendix A of this report. Appendix A also includes our comments on the State's response in shaded areas.

Scope and Methodology

The single auditor conducted the audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that the auditor obtain an understanding of the program to be audited. The understanding of the program was obtained through analysis of the laws, regulations, and guidance pertaining to grants awarded to the State for the Village Safe Water program and an evaluation of internal controls over the grants. Internal controls include the processes for planning, organizing, directing, and controlling program operations. Internal controls also include the systems for measuring, reporting, and monitoring program performance.

In addition to the single auditor's assessment, our understanding of the internal controls was gained through the performance of the procedures outlined below. The OIG performed its field work from August 1 to September 30, 2005. To meet the audit objective, we reviewed the following documents:

- Single Audit of the State of Alaska for the Fiscal Year Ended June 30, 2003, issued on July 6, 2004, performed by the State of Alaska Division of Legislative Audit.
- *EPA Oversight for the Alaska Village Safe Water Program Needs Improvement*, EPA OIG Report No. 2004-P-00029, issued September 21, 2004.
- *Region 10's Grant for Alaska Village Safe Water Program Did Not Meet EPA Guidelines*, EPA OIG Report No. 2005-P-00015, issued June 16, 2005.
- *Special Report on the Department of Environmental Conservation, Village Safe Water Program, Selected Projects*, Report No. 18-30028-04, issued November 19, 2003, performed by the State of Alaska Division of Legislative Audit.

- Federal Form 990 for the Alaska Native Tribal Health Consortium for the fiscal year ended June 30, 2003.
- Single Audit Report for the Alaska Native Tribal Health Consortium for the fiscal years ended June 30, 2002, 2003, and 2004.
- Project Funding Agreements between Indian Health Service and Alaska Native Tribal Health Consortium for funds received from the Village Safe Water program.
- EPA Region 10 Determinations concerning the applicability of the Cash Management Improvement Act to the Alaska Native Tribal Health Consortium.

Instances of noncompliance with laws, regulations, and guidance, and deficiencies in the State's internal control system have been identified and included in this report. Recommendations have been made to correct the deficiencies.

Status of Recommendations and Potential Monetary Benefits

		RECOMMENDATIONS				POTENTIAL MONETARY BENEFITS (in $000s)	
Rec. No.	Page No.	Subject	Status[1]	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
1	8	Disallow the unsupported personnel service costs of $1,166,051, until the State provides sufficient documentation to support labor charges in accordance with Federal requirements.	U	Acting Regional Administrator for Region 10		$1,166	
2	8	Require the State to prepare and submit an indirect cost rate proposal for indirect costs related to direct labor costs under the Village Safe Water program. The indirect cost rate proposal should be submitted to EPA's Office of Acquisition Management, Financial Analysis and Rate Negotiation Service Center.	U	Acting Regional Administrator for Region 10			
3	8	Disallow costs of $32,721,149 representing the remaining balance of CFDA 66.606 funds as unsupported until the State provides actual cost data by EPA grant, for all EPA grants supporting the Village Safe Water program; any costs that remain unsupported should be recovered. As part of its reconciliation process, the State will need to review and approve the reconciliations and supporting documentation prepared by the Consortium. As part of its actual cost data, the State will need to properly apply and account for the 4 percent administrative cost limitation on a grant-by-grant basis.	U	Acting Regional Administrator for Region 10		$32,721	
4	8	Require the State to have the Consortium remit the portion of interest, representing dividends from EPA-invested funds from the inception of the Village Safe Water program, through year ended 2003, to the U.S. Department of Health and Human Services, Payment Management System, Rockville, Maryland 20852.	U	Acting Regional Administrator for Region 10			
5	9	Place the State on a reimbursable payment basis under the authority of 40 CFR 31.12 until the cash management, financial reporting, labor accounting, and procurement systems fully meet Federal requirements, and the recommendations of this report have been fully satisfied.	U	Acting Regional Administrator for Region 10			

[1] O = recommendation is open with agreed-to corrective actions pending;
C = recommendation is closed with all agreed-to actions completed;
U = recommendation is undecided with resolution efforts in progress

Exhibit 1

Single Audit Report Recommendations and Schedule of Federal Expenditures

DEPARTMENT OF ENVIRONMENTAL CONSERVATION

One recommendation was made to the Department of Environmental Conservation (DEC) in the *State of Alaska, Single Audit for the Fiscal Year Ended June 30, 2002.* Prior year Recommendation No. 43 has been resolved.

Additionally, four new recommendations have been made and are included as Recommendation Nos. 32 through 35.

Recommendation No. 32

The Department of Environmental Conservation (DEC) finance officer and Village Safe Water (VSW) program manager should work with the State's cash manager to establish VSW disbursement procedures which maximize conservation of the State's general fund (GF).

The way in which VSW grants are currently distributed is not in the best financial interest of the State. VSW grants are for the construction of water and sewer facilities in the smallest of Alaska's communities. DEC's procedures call for the advance of funds to communities to cover the needs of the project during the construction season. Payments for the construction projects are either sent to an accounting firm for deposit into separate bank accounts for each project or provided to the Alaska Native Tribal Health Consortium (ANTHC) for the projects they administer.

Procedures for advances were initially established over a decade ago to address the difficulties related to rural Alaska's isolation and short intense construction seasons. Communication technology has greatly reduced this handicap for the bush community today. Funds can now be received much more timely from the State, making large advances no longer needed to balance the fiscal responsibilities of administering projects and the financial interests of the State.

These advances individually may be small, but in aggregate they amount to a significant amount of funds outside of the State's control at any given time. In March of 2003 the VSW accounting firm held approximately $8.1 million in cash from the State, of which approximately $2 million was State general funds. At June 30, 2003, during the construction season, the VSW accounting firm held $11.5 million. The $11.5 million is comprised of $8.4 million in federal funds passed through the State, and $3.1 million in state general funds. Using 5% as a long-term interest rate average, the State is losing approximately $8,000 - $13,000 in interest each month.

As mentioned earlier, funds are also advanced to ANTHC for the VSW projects they administer. During FY 03, 44% of funds advanced for VSW projects (federal pass-through and State GF matching funds), went to ANTHC. As discussed in Recommendation No. 33, DEC does not currently receive sufficient financial information from ANTHC to report actual VSW expenditures instead of advances for ANTHC projects. As a result, VSW project cash balance amounts at June 30, 2003 are not readily available.

Given the speed at which funds can be transferred, it is no longer necessary to provide advances for an entire construction season. Currently, the accounting firm pays payroll for VSW projects once every two weeks. The nonpayroll invoices for VSW projects are accumulated for two weeks and paid at once on the week between payrolls. DEC engineers approve payroll and all invoices before the accounting firm makes the payments. Therefore, there is abundant information available to allow for advances of grant funds which more closely approximate the timing of disbursements. DEC should provide funds based on semimonthly billings from ANTHC and the accounting firm. These semimonthly billings can be based primarily on invoices received and not yet paid for VSW projects. Advancing grant funds using electronic funds transfers on a semimonthly, or even monthly, basis would greatly reduce the excessive cash balances currently maintained for VSW grantees. Working with the State's cash manager could maximize establishing procedures that are the most effective and efficient in meeting the VSW administrative needs and financial interests of the State.

The U.S. Treasury Financial Manual states: "*The timing and amount of cash advances will be as close as is administratively feasible to the actual disbursements by the recipient organization for direct program costs.*" DEC should be aware that the Environmental Protection Agency (EPA) could enforce a more stringent interpretation of this federal requirement at any time.

We recommend that DEC's finance officer and VSW program manager work with the VSW accounting firm and ANTHC to move to a semimonthly advance for funding VSW projects.

Agency Response – Department of Environmental Conservation

This recommendation centers on the prescribed practice of advancing project funding to either the VSW accounting firm or the Alaska Native Tribal Health Consortium (ANTHC). We will review our policies and procedures and look at ways to improve our cash management practices regarding the advancement of funding for VSW projects.

While it is true that VSW procedures for advances were originally established over a decade ago, it is not accurate to say that communication technology has significantly reduced the handicap of construction activities and associated requests for project funding in rural Alaska. If anything, the handicap has grown larger because of the complexities entailed with managing multiple state and federal sources of project funding, which was not the case a decade ago.

Contrary to your recommendation, there is a great deal more required in making an advance than the transfer and receipt of funding, which admittedly requires little time. In particular, each *request for a transfer of funds requires that the VSW Program Manager and Grant Manager each confirm that a number of grant requirements are being met. These grant requirements have been established to ensure program compliance with the multiple federal funding sources, and to promote continued safe, sustainable operation of rural sanitation facilities. For example, the VSW Program Manager works closely with the Manager for the Department of Community and Economic Development's Rural Utility Business Advisor (RUBA) program in reviewing requests for most advances. The RUBA program provides information about Essential Capacity Indicators (ECIs) for every community that receives a VSW grant, and notifies VSW about concerns. Requests for funding advances may be denied if ECIs are not being adequately addressed by the grantee.*

Because of the attention and time required to adequately review each request for a funding advance, and the continuing demands of rural construction management in Alaska, we do not agree with your recommendation to advance funds on a semimonthly basis. This is because of the increased risk associated with the advancement of funds for projects where sustainability is in question.

We acknowledge that in most cases there is no need to provide advances for an entire construction season, and that the VSW procedures need to be reviewed, and revised to reflect a consistent process entailing more frequent advances. It is our intent at this time to review this process in attempt to identify ways to that may reduce the period of time for which advances are now issued.

Contact Person: *Gary Zepp, Financial Officer*
Telephone: 907-465-5289

<u>Legislative Audit's Additional Comments</u>

We have read DEC's response to this recommendation and nothing contained in the response has provided sufficient information to persuade us to remove or revise this recommendation.

DEC acknowledges that some improvements can be made on the cash management aspect of the Village Safe Water program. We encourage DEC to minimize the dollar amount and duration for any cash advances while maintaining the necessary internal controls for both cash advances and expenditures.

<u>Recommendation No. 33</u>

<u>The DEC finance officer and the VSW program manager should revise the accounting procedures for VSW grants administered by ANTHC to allow proper financial statement presentation in the State's Comprehensive Annual Financial Report</u>.

DEC's accounting for VSW grant disbursements to ANTHC is inappropriate for purposes of financial reporting per generally accepted accounting principles (GAAP). VSW grant disbursements to ANTHC are reported as expenditures for the ANTHC-administered projects. In accordance with GAAP, these payments represent advances, not expenditures.

Expenditures occur when the State incurs a financial liability. The signed project agreement in itself does not create a financial liability. The point at which the State is financially liable and expenditures should be recorded for VSW grants administered by ANTHC is at the receipt of goods or services for authorized construction projects. Payments made prior to this remain assets of the State and should be classified as advances to the community.

DEC should require ANTHC, at the end of the fiscal year, to provide the State with the financial information necessary to report actual VSW expenditures for the projects administered by ANTHC. DEC already requires this information from the accounting firm that handles project payments for VSW grants administered by DEC.

Alternately, in our view, improved cash management procedures, as discussed in Recommendation No. 32, would be a more effective way to promote reporting consistent with GAAP. Better cash management practices would minimize the time between advances and expenditures. This would allow disbursements to ANTHC and the accounting firm to be considered a reasonable approximation of VSW expenditures. This would occur if disbursements to ANTHC and the accounting firm were made on a semimonthly basis.

We recommend that the finance officer and VSW program manager revise their accounting procedures so that DEC can identify and report VSW grant expenditures for projects administered by ANTHC for the State's fiscal year as they do for projects with the accounting firm.

Agency Response – Department of Environmental Conservation

The Department supports this recommendation and will work with ANTHC to develop a yearend report which reflects actual expenditures of VSW funding and actual balances remaining.

Contact Person: *Gary Zepp, Financial Officer*
Telephone: 907-465-5289

<u>Recommendation No. 34</u>

<u>The DEC finance officer should implement procedures to ensure personal services expenditures charged to the EPA infrastructure grants comply with federal cost principles</u>.

DEC is not following applicable federal guidance for the personal services costs charged to the FY 03 EPA infrastructure grant. VSW personal services costs are charged to the EPA infrastructure grant through a yearly reimbursable service agreement (RSA). During FY 03, 29 DEC employees charged personal services costs to the FY 03 EPA infrastructure grant. Of those who charged time to the EPA infrastructure grant, 20 charged 100% of their time, and the remaining nine charged only a portion of their time.

Office of Management and Budget (OMB) Circular A-87 requires that salaries of employees chargeable to more than one federal grant or other cost objective be supported by appropriate time distribution records. State agencies with approval from federal program managers, may utilize an alternative system. OMB Circular A-87 states that budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards. Charges for employees working solely on a program funded by a single federal award will be supported by periodic (at least semiannual) certifications that the employee worked solely on that program for the period covered by the certification.

We reviewed time sheets for employees charging time to the EPA infrastructure grant, and found that DEC is not following OMB Circular A-87 requirements for charging personal services costs to federal programs. Split-funded employees' time was being charged to the EPA infrastructure grant based on annual estimates which are intended to represent the percent of total time devoted to the programs charged. Further, employees charging 100% of their time to the EPA infrastructure grant did not prepare certifications stating the employee worked solely on the program for the period covered by the certification. While the employees charging 100% of their time to the EPA infrastructure grant maintained time sheets, the timesheets did not directly indicate that 100% of the time was being charged to the EPA infrastructure grant, but rather charged to the VSW Administration RSA.

Finally, we found that all VSW personal services costs were being charged to the EPA infrastructure grant, CFDA 66.606. No VSW personal services costs were charged to United States Department of Agriculture – Rural Development (USDA-RD) – CFDA 10.760, even though VSW activities benefit both programs.

Given the lack of required OMB Circular A-87 support for the personal services costs charge to EPA infrastructure grant, we question the federal portion of all personal service costs charged to CFDA 66.606 through the EPA infrastructure grant ($1,166,051).

We recommend the DEC finance officer implement procedures to ensure that VSW personal service costs comply with OMB Circular A-87 requirements.

CFDA: 66.606 Federal Agency: EPA Questioned Costs: $1,166,051

Agency Response – Department of Environmental Conservation

The Department supports this recommendation. Steps are being taken to ensure that those employees funded 100% by a federal grant will complete bi-annual certifications. Additionally, for those funded by multiply [multiple] *funding sources, actual hours worked on a particular project will be reflected on the employee timesheet.*

Contact Person: *Gary Zepp, Financial Officer*
Telephone: 907-465-5289

Recommendation No. 35

The VSW program manager should work with project engineers to strength internal controls over the VSW procurement process.

DEC did not consistently follow procurement procedures for VSW projects. VSW procedures, including procurement, are prescribed in the EPA approved VSW procedures manual. DEC engineers, in addition to onsite managers/superintendents hired by the village, are required to follow the VSW procedures manual.

We reviewed 15 procurement-related transactions from eight projects which were funded by EPA infrastructure grants. Of the 15 projects reviewed, five did not follow VSW procedures in some manner:

- Two transactions failed to use necessary VSW purchase orders.
- A project superintendent verbally agreed to a one year, $12,000 rental without going through the proper procurement procedures or documentation.
- A single source procurement was not properly approved by the VSW engineering supervisor.
- An existing contract was amended to include work not in the original scope of the contract. While the VSW manual does not specify when a contract amendment should be used, the Alaska Administrative Code 12.485(b) is clear that a construction contract amendment is only allowable if the amendment is within the scope of the original contract.

While no error was significant on its own, the number of errors indicates a weakness in the internal controls over the VSW procurement process. We recommend the VSW program manager work with the VSW engineers to ensure VSW procurement procedures are followed.

CFDA: 66.606 Federal Agency: EPA Questioned Costs: None

Agency Responses – Department of Environmental Conservation

The Department supports this recommendation. The Division of Water has created a procurement specialist position to support the VSW program to provide the kind of support and guidance needed to strengthen both internal controls and provide training and oversight for project engineers and superintendents. We share your interest in achieving practices which are fully consistent with procurement policies.

Contact Person: Gary Zepp, Financial Officer
Telephone: 907-465-5289

STATE OF ALASKA
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Fiscal Year Ended June 30, 2003
By State Agency

Federal Agency	CFDA Number	Grant or Other Identifying Number	Cluster	Federal Program Title	Federal Expenditures
HUD	14.228			Community Development Block Grants/State's Program	2,571,321
HUD	14.231			Emergency Shelter Grants Program	112,999
EPA	66.606			Surveys, Studies, Investigations and Special Purpose Grants	843,685
FEMA	83.105			Community Assistance Program: State Support Services Element (CAP-SSSE)	89,426
FEMA	83.536			Flood Mitigation Assistance	143,541
DC	90.100			Denali Commission Program	2,543,846
USDHHS	93.569			Community Services Block Grant	2,625,672
USDHHS	93.571			Community Services Block Grant Discretionary Awards: Community Food and Nutrition	7,658
USCNCS	94.013			Volunteers in Service to America	7,500
		Total Department of Community and Economic Development			**28,438,365**
		Department of Environmental Conservation			
USDA	10.025			Plant and Animal Disease, Pest Control, and Animal Care	4,640
USDA	10.12-25-A-4091			Cooperative Pesticide Recordkeeping Program	10,845
USDA	10.43-0109-3-0325			Regulatory oversight of Contaminated Sites cleanup	29,696
USDA	10.760	(Formerly 10.43175712)		Water and Waste Disposal Systems for Rural Communities	16,266,998
USDOC	11.45ABNAON252			Miscellaneous Inspection Service	9,723
USDOC	11.50ABNC100055			Regulatory Oversight, Pribilof Islands, Alaska	48,414
USDOC	11.NA16AB2392			DEC VSW Grants to St. Paul and St. George Islands for construction	800,000
USDOD	12.113			State Memorandum of Agreement Program for the Reimbursement of Technical Services	1,784,671
USDOD	12.USAF Elmendorf Site cleanup			USAF Elmendorf Site Cleanup	26,037
EPA	66.001			Air Pollution Control Program Support	1,080,753
EPA	66.419			Water Pollution Control: State and Interstate Program support	162,622
EPA	66.432			State Public Water System Supervision	2,171,124
EPA	66.454			Water Quality Management Planning	101,265
EPA	66.458			Capitalization Grants for Water State Revolving Funds	8,857,672
EPA	66.463			Water Quality Cooperative Agreements	108,356
EPA	66.467			Wastewater Operator Training Grant Program (Technical Assistance)	36,998
EPA	66.468			Capitalization Grants for Drinking Water State Revolving Fund	3,214,854
EPA	66.470			Hardship Grants Program for Rural Areas	43,348
EPA	66.471			State Grants to Reimburse Operators of Small Water for Training & Certification Costs	175,291
EPA	66.472			Beach Monitoring and Notification Program Implementation Grants	76,537
EPA	66.474			Water Protection Grants to the States	42,317
EPA	66.500			Environmental Protection Consolidated Research	422,471
EPA	66.605			Performance Partnership Grants	3,969,070
EPA	66.606			Surveys, Studies, Investigations and Special Purpose Grants	33,887,200
EPA	66.608			State Information Grants	74,886
EPA	66.609			Children's Health Protection	270,421
EPA	66.700			Consolidated Pesticide Enforcement Cooperative Agreements	279,803
EPA	66.708			Pollution Prevention Grants Program	187,488
EPA	66.804			State and Tribal Underground Storage Tanks Program	188,675

STATE OF ALASKA
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Fiscal Year Ended June 30, 2003
By State Agency

Federal Agency	CFDA Number	Grant or Other Identifying Number	Cluster	Federal Program Title	Federal Expenditures
EPA	66.805			Leaking Underground Storage Tank Trust Fund Program	412,512
EPA	66.809			Superfund State and Indian Tribe Core Program Cooperative Agreements	424,573
EPA	66.	LUST Trust Cost Recovery		LUST Trust Cost Recovery	38,629
ENERGY	81.104			Office of Technology Development and Deployment for Enviromental Management	300
ENERGY	81.	DE-FC03-02EH02039		Amchitka Medical Screening Program	714,505
ENERGY	81.	DE-FG08-99NV13726		Provide Oversight for Conduct of Amchitka Island Workers Health	286,291
ENERGY	81.	DE-FG08-99NV13763		Amchitka Oversight/NEWNET	265,578
USDHHS	93.	223-01-4037		Food Sanitation Inspections	4,356
USDHHS	93.	223-02-4037		Food Sanitation Inspections	230,633
USDHHS	93.	FD-R-002064-01		Food Safety Task Force	2,537
USDHHS	93.	FD-R-18-1-OR		Risk Focused Inspection Training & Evaluation	38,326
		Total Department of Environmental Conservation			**76,748,415**
		Department of Education and Early Development			
USDA	10.550			Food Donation	2,931,477
USDA	10.553		CNC	School Breakfast Program	3,354,105
USDA	10.555		CNC	National School Lunch Program	17,389,195
USDA	10.556		CNC	Special Milk Program for Children	4,743
USDA	10.558			Child and Adult Care Food Program	5,937,963
USDA	10.559		CNC	Summer Food Service Program for Children	161,555
USDA	10.560			State Administrative Expenses for Child Nutrition	720,529
USDA	10.568		EFAC	Emergency Food Assistance Program (Administrative Costs)	69,887
USDA	10.574			Team Nutrition Grants	39,595
USDOC	11.303			Economic Development: Technical Assistance	24,000
USDOC	11.438			Pacific Coast Salmon Recovery: Pacific Salmon Treaty Program	33,443
USDOD	12.999			Troops to Teachers	147,735
HUD	14.246			Community Development Block Grants/Brownfields Economic Development Initiative	30,970
USDOL	17.249			Employment Services and Job Training Pilots: Demonstrations and Research	193,172
NFAH	45.025			Promotion of the Arts: Partnership Agreements	538,055
NFAH	45.310			State Library Program	686,287
NSF	47.076			Education and Human Resources	51,922
USDOE	84.002			Adult Education: State Grant Program	37,000
USDOE	84.010			Title I Grants to Local Educational Agencies	26,053,098
USDOE	84.011			Migrant Education: State Grant Program	6,243,947
USDOE	84.013			Title I Program for Neglected and Delinquent Children	227,709
USDOE	84.027		SEC	Special Education: Grants to States	19,592,871
USDOE	84.041			Impact Aid	25,540,902
USDOE	84.048			Vocational Education: Basic Grants to States	4,058,044
USDOE	84.063		SFAC	Federal Pell Grant Program	206,446
USDOE	84.116			Fund for the Improvement of Postsecondary Education	32,950
USDOE	84.154			Public Library Construction and Technology Enhancement	19,405
USDOE	84.161			Rehabilitation Services: Client Assistance Program	123,668
USDOE	84.173		SEC	Special Education: Preschool Grants	1,378,126
USDOE	84.181			Special Education: Grants for Infants and Families with Disabilities	8,400

Appendix A

Auditee Response

OFFICE OF THE COMMISSIONER

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May 5, 2006

Michael A. Rickey, Director
Assistance Agreement Audits
US Environmental Protection Agency
Washington, D.C. 20460

RE: Single Audit Report for the State of Alaska Department of Environmental Conservation for the Year Ended June 30, 2003

Dear Mr. Rickey:

Enclosed please find the response to the draft report on the results of the State of Alaska Department of Environmental Conservation (DEC) Single Audit Report for the year ended June 30, 2003, as well as the additional findings and recommendations prepared by the Office of the Inspector General (OIG) of the U.S. Environmental Protection Agency.

We have reviewed the findings and recommendations in the above referenced report and appreciate the opportunity to respond. Upon receipt of the original Single Audit Report in July 2004 the department determined that it was necessary to do a full evaluation all of the Village Safe Water program. As a result of this evaluation extensive changes were made to the policy and procedures that governed this program. After your review of the information we are providing here we feel that you will find all of the procedural concerns raised in this report have been addressed in full.

The Single Audit Report for the period ended June 30, 2005 has yet to be released, however, preliminary results indicate that there will be no recommendations for this year. This along with the single auditors agreement with the information contained in the Summary of Prior Audit Findings further support our conclusion that all necessary corrective action has been completed.

In the enclosed document each issue addressed in the OIG audit report is restated and is then followed by our comments related to each. Thank you for providing this opportunity to comment on your findings and recommendations. If you have any questions or need additional information regarding our response, please contact Laura Beason at 907-465-5273.

Sincerely,

Kurt Fredriksson
Commissioner

Enclosures

Cc: Lynn Kent, Director, Division of Water
Mike Maher, Director, Division of Information & Administrative Services
Pat Davidson, Legislative Audit
Nikki Rouget, Legislative Audit

Department of Environmental Conservation Response to the Office of the Inspector General (OIG) Draft Report Dated March 29, 2006

[Note: The State included excerpted portions of the single audit report. We deleted these excerpts from Appendix A because it duplicated information already contained in this report.]

"State Cash Management Procedures Need Improvement
(Single Audit Report Recommendation No. 32)

STATE OF ALASKA COMMENT:

As a result of a complete program review during fiscal year 2005 a new financial management system was identified and implemented. Full implementation of this new system was completed in December 2005. As mentioned above the accounting for this program was previously handled by a contracted accounting firm. The accounting firm was required to maintain individual bank accounts for each project. Under this system advances were needed to ensure cash was available within these bank accounts to pay project invoices. Under the new process all accounting for each project under the Village Safe Water (VSW) program is now handled by State of Alaska employees and all project expenditures are recorded in the state's accounting system.

The most significant change in regards to cash management procedures is the method by which we now request federal funds under the VSW program. With the elimination of the contracted accounting firm cash advances are no longer necessary. Requests for federal funds are now made only after the project expenses have been paid with state general funds through the state's accounting system. In other words the VSW program is now operating on a fully reimbursable basis and the cash balance on hand is zero.

> **OIG Comment:** Pending verification of compliance with OMB Circular A 87 and 40 CFR 31.22, the State's actions should address the findings raised in the Single Audit.

"State Needs to Obtain Actual Expenditures from Consortium
(Single Audit Report Recommendation No. 33)

STATE OF ALASKA COMMENT:

As part of the transition from the contracted accounting firm to the state's accounting system a contract was issued that required the reconciliation of all projects being managed by the contracted accounting firm. This was completed in fiscal year 2005. As a result of this reconciliation we can now easily identify actual expenditures by project, by federal grant and by state appropriation. Attachment #1 is a sample of the project reconciliation information available. All project information is available for review.

The review of the VSW program also included an analysis of our relationship with the Indian Health Service (IHS) and their representative in Alaska the Alaska Native Tribal Health Consortium (ANTHC) and in particular the method of advancing project funds. This review resulted in eliminating the practice of advancing funds to IHS/ANTHC. They were notified of this change in fiscal year 2005. As part of the change in process IHS/ANTHC has been required to reconcile each project to determine actual expenditures to date and to return funds not yet spent to the State of Alaska. These funds are then returned to the appropriate federal funding agency.

IHS/ANTHC contracted with an accounting firm to perform this reconciliation, which is now substantially complete. However, there are still eight community accounts in which the reconciliations have not been completed. The last advance payment made to the IHS/ANTHC occurred in October 2005. Since that date only payments for reimbursement of actual expenditures have been made. These payments have been for only those projects in which certified reports detailing expenses by project and by funding source have been received. For the projects managed by IHS/ANTHC, the project reconciliations have taken longer than expected. To ensure a timely completion of this process the VSW discontinued reimbursable payments to IHS/ANTHC for all requests received after March 1, 2006. Attachment #2 is a copy of the directive given to IHS/ANTHC on this issue.

The amount of cash on hand at IHS/ANTHC is far less than the amount of funding actually owed to them for their project expenses already incurred. As a result of their desire to get this resolved and to reinstate the expense reimbursement process they are going to return 100% of the funding for those projects in which they can't provide a certified detailed expenditure report. We expect this payment transaction to occur no later than the middle of May 2006. IHS/ANTHC will of course be allowed to request reimbursement for these project expenditures once the reconciliations are complete.

With the implementation of our new accounting process and the project reconciliation performed, the VSW program has complete documentation to support all project costs under these federal infrastructure grants. Any additional documentation required is available for review.

OIG Comment: The changes made by the State are significant and show a concerted effort to correct longstanding internal control and financial management weaknesses. Given the magnitude of changes made, the State's accounting process will need to be reviewed and approved by EPA. Therefore, the costs will remain questioned until such a review is completed and any related issues are resolved.

The project reconciliation provided by the State in Attachment 1 showed a reconciliation of expenditures to the funded amount. It is unclear whether the funded amount reflects the cash drawn for the project or is just a budgeted figure. In order for the reconciliation to address the finding, the State will need to compare expenditures against the amount of cash drawn for the project to determine whether any excess cash exists. The State will also need to ensure that the expenditures have adequate supporting documentation, and are allowable under applicable Federal regulations.

In connection with the Consortium, the reconciliation performed by the Consortium will need to be reviewed for adequacy and allowability. The State has informed us that it has not reviewed the Consortium's reconciliation process or examined any related supporting documentation. As a result, any costs allocable to the Consortium will remain questioned.

"**Timekeeping Not Compliant with OMB Circular A-87**
(Single Audit Report Recommendation No. 34)

STATE OF ALASKA COMMENT #1:

The statement that employees performing administrative and oversight duties would "normally be considered indirect" is not accurate and we would recommend that this statement be removed or restated. The following are excerpts from A-87 and a clarification memorandum produced by the U.S. Department of Health and Human Services that illustrate this point.

- OMB Circular A-87 Attachment A, D.2 Classification of Costs, "There is no universal rule for classifying certain costs as either direct or indirect under every accounting system."

- Another federal agency has produced a clarification memorandum outlining direct costs versus indirect, or "administrative," costs. Per U.S. Department of Health and Human Services CSBG Memorandum 27 Definition and Allowability of Direct and Administrative Costs, December 10, 1999: "Direct program costs are incurred for the service delivery and management components within a particular program or project. Therefore, direct costs include expenditures on some activities with administrative qualities, including salaries and benefits of program staff and managers, equipment, training, conferences, travel, and contracts, as long as those expenses relate specifically to a particular program or activity, not to the general administration of the organization."

In the Department of Environmental Conservation (DEC), the indirect rate incorporates the costs of providing department-wide centralized general administrative services. Charges for staff performing administrative functions dedicated to a particular program (not department-wide) are not included in the department's indirect rate. DEC fulfills the required test of treating "like costs in like circumstances" the same, and ensures that allowable costs are either direct or are included in the indirect rate – not both.

OIG Comment: In its response, the State disagreed with the EPA OIG's position that costs associated with State employees performing non-engineering functions should be charged indirectly. To support its argument, the State included a portion of OMB Circular A-87 and relied upon a definition from another Federal agency in support of its treatment of administrative functions as direct costs. The State believes that since the staff performing administrative functions benefits the Village Safe Water program as a whole, these labor charges should be treated as direct costs. The State's position is dependent on the premise that the Village Safe Water program is a final cost objective. However, for the purpose of the EPA grants and what they are funding, the State has incorrectly defined the Village Safe Water program as a final cost objective.

The single auditor's finding was that the State was following OMB Circular A-87 for charging costs to Federal programs. OMB Circular A-87 defines direct costs as those that can be identified specifically with a particular final cost objective. The VSW is responsible for projects funded through various sources, including EPA, USDA, and State of Alaska funds. The individual grant(s) and the associated projects represent the final cost objective, not the Village Safe Water program. If the Village Safe Water program was the final cost objective, the State should have, at a minimum, been allocating all of its related costs to all the various funding sources. Instead, the single auditor found that only the current EPA grant was being charged.

The non-engineering costs incurred by the State of Alaska to oversee these grants meet OMB Circular A-87's definition of an indirect cost, which is defined as:

> *(a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically beneffited, without effort disproportionate to the results achieved.*

STATE OF ALASKA COMMENT #2:

The report excerpt above includes the following statement, "…the State will begin direct billing all Engineering, Management and Travel expenses to the appropriate projects and the balance will be included in the State's federally approved indirect cost rate."

To clarify and ensure there is no misunderstanding, engineers charge time directly to projects. Supervisors and staff directly supporting the engineers do the following:

1. Separately identify time spent supporting the Village Safe Water engineering staff each pay period on their activity report (timesheet), and

2. Those charges are then allocated to the projects supported as a direct (not indirect) charge according to the provisions of Circular A-87 Attachment B, 8.h(6)(b).

This process has been reviewed and approved by staff within EPA and is outlined in Attachment #3, Memorandum of Understanding between the State of Alaska, Department of Environmental Conservation, The U.S. Department of Agriculture and the U.S. Environmental Protection Agency.

OIG Comment: The State's response conflicts with the OMB treatment of the costs associated with State personnel supporting the staff that works directly on projects. This process is not a direct allocation, but is in fact the accumulation and allocation of indirect costs.

OMB Circular A-87, Attachment A, E(1) defines a direct cost as "…those that can be identified specifically with a particular final cost objective." It goes on to state typical direct costs chargeable to Federal awards include "Compensation of employees for the time devoted and identified specifically to the performance of those awards."

Conversely, an indirect cost is defined by OMB Circular A-87 as those costs that are "incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objective specifically benefitted, without effort disproportionate to the results achieved."

The process that the State describes is the accumulation of costs into a separate cost pool prior to allocation to projects, which are the final cost centers. The State's process meets the definition of an indirect cost, described in OMB Circular A-87, Attachment A, F(1):

> *To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within a governmental unit department or in other agencies providing services to a governmental unit department. Indirect cost pools should be distributed to benefitted cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.*

The State is also misinterpreting the use of OMB Circular A-87, Attachment B, 8.h(6)(b). Paragraph 8 is entitled "Compensation for personal services," and discusses the composition of personal services, including fringe benefits and pension costs. Paragraph 8.h discusses the standards regarding support for salaries and wages, including time distribution and related documentation. Subparagraph 8.h(6) states the following:

> *(6) Substitute systems for allocating salaries and wages to Federal awards may be used in place of activity reports. These systems are subject to approval if required by the cognizant agency…(6)(b) Allocating charges for the sampled employees' supervisors, clerical and support staffs, based on the results of the sampled employees, will be acceptable.*

This provision does not authorize the allocation of labor charges as a direct cost. This provision simply allows a grant recipient to allocate personnel service compensation when activity reports (i.e., adequate documentation, timesheets, etc.) are not available. This fact is supported by Subparagraph 8.h(4), which states:

> *Where employees work on multiple activities or cost objectives, a distribution of their salaries will be* ***supported*** *[emphasis added] by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system…or other substitute system has been approved by the cognizant Federal agency.*

The State is also incorrect in stating that EPA staff can approve this labor distribution process. Because the allocated labor method proposed creates an indirect cost pool, the new indirect cost pools can only be approved by the cognizant Government agency responsible for negotiating final indirect cost rate for the State. Since EPA is the cognizant agency for the State, then the approval would need to come from EPA's Office of Acquisition Management, Financial Analysis and Rate Negotiation Service Center.

Therefore, in order to properly account for and allocate the non-engineering support staff charges, the State will need to develop and submit an indirect cost rate proposal to EPA for approval.

STATE OF ALASKA COMMENT #3:

The report excerpt above includes the following statement. "The purpose of the EPA infrastructure grants is to fund specific projects identified in the grant application, not a continuing environmental program." It has been clearly understood by DEC staff as well as Region 10 EPA staff that from the incorporation of the administrative funding for this program that the administrative funding provided (if any) would be used to cover the administrative costs for managing all EPA funded infrastructure grants during each state fiscal year regardless of which projects were being worked on during that year.

To further support our position we reviewed P.L. 104-[182], which amended Section 303 of the Safe Drinking Water Act and added the administrative component. Section 303 reads as follows:

> *"(a) IN GENERAL- The Administrator of the Environmental Protection Agency may make grants to the State of Alaska for the benefit of rural and Native villages in Alaska to pay the Federal share of the cost of--*
>
> > *(1) the development and construction of public water systems and wastewater systems to improve the health and sanitation conditions in the villages; and*
> >
> > *(2) training, technical assistance, and educational programs relating to the operation and management of sanitation services in rural and Native villages...*
>
> *(c) ADMINISTRATIVE EXPENSES- The State of Alaska may use an amount not to exceed 4 percent of any grant made available under this subsection for administrative expenses necessary to carry out the activities described in subsection (a)."*

The Administrative component of each grant year was used in accordance with the above - for administrative activities necessary to carry out the activities described above. There is no stipulation that this administrative component may only be used to carry out activities funded under the same particular grant year.

Additionally, this use of Administrative component is consistent with the use of the Drinking Water State Revolving Fund program's administrative set-aside, which is also authorized under the Safe Drinking Water Act. Under this program, up to 4% of an individual grant's funding may be used to administer loans made from the loan fund. Similarly, there is no stipulation that this administrative set-aside only be used to administer loans made from the same grant year's funds.

OIG Comment: We do not agree with the State's response in connection with the allowable period for administrative costs or what constitutes administrative costs subject to the 4 percent limitation. OMB Circular A-87, which establishes applicable cost principles,[5] states that the Circular is intended to assure the "efficient administration of Federal awards." While it uses but does not directly define the term "administrative costs," as it does other cost terms, such as "direct" and "indirect" costs,[6] the most explicit treatment about administrative costs is seen in Attachment D, wherein OMB states "All administrative costs (direct and indirect) are normally charged to Federal awards by implementing the public assistance cost allocation plan." Again, OMB does not say precisely what is or is not included in administrative costs, though it seems clear that there are or can be both direct and indirect cost components to administrative costs.

In addition, while Circular A-87 separately discusses certain categories of cost items, such as advertising and travel, there is no specific category for "administrative." If administrative costs were considered as a specific subset category of costs, it is reasonable to assume that OMB would have treated it in similar fashion.

Based on the above, "administrative costs" is a general term that refers to all of the costs of executing or managing the program, and that it is composed of both direct and indirect costs. Thus, for example, the issue of how the Alaska Department of Environmental Conservation categorizes the cost of its project engineers as either direct or indirect costs is not relevant as far as 33 U.S.C. § 1263a(c) is concerned because both fall under administrative costs.

The statute provides that the administrative percentage cap applies to "any grant" and does not contain further words of limitation, e.g., to fiscal year. Nothing in this language suggests that the cap only applies to the fiscal year in which the grant is awarded. Rather, it seems clear that the percentage cap applies to administrative expenses over the life of the grant. As such, there is no "grant year" that applies to the administrative costs, as argued by the State. Instead, the administrative cost cap of 4 percent is meant to apply to administration of the projects funded under the grant.

STATE OF ALASKA COMMENT #4:

As noted above we do acknowledge that our labor charging practices during this fiscal year did not meet the requirements outlined in OMB Circular A-87. However, we are in the process of developing an alternative allocation process in accordance with OMB Circular A-87 Section 8, Subsection 6(c) for these labor charges. We will be submitting this proposal to EPA for consideration. We will await further instruction from EPA on how this proposal process should proceed.

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[5] Pursuant to 40 CFR Part 31.22, the Alaska Department of Environmental Conservation must follow OMB Circular A-87 cost principles, which "establishes principles and standards for determining costs for Federal awards carried out through grants, cost reimbursement contracts, and other agreements with State and local governments and federally recognized Indian tribal governments."

[6] "Direct costs are those that can be identified specifically with a particular final cost objective." A-87, Section E (1). "Indirect costs are those: (a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved." Id., Section F (1).

OIG Comment: The State acknowledges that its labor charging practices did not comply with OMB Circular A-87. In its response, the State provided alternatives to address historical costs. We have no comment regarding any of the alternatives provided except that the section referred to by the State is only allowable under certain circumstances. OMB Circular A-87, Attachment B, Section 8.h(6)c states:

> *Less than full compliance with the statistical sampling standards noted in subsection (a) may be accepted by the cognizant agency if it concludes that the amounts to be allocated to Federal awards will be minimal, or if it concludes that the system proposed by the governmental unit will result in lower costs to Federal awards than a system which complies with the standards.*

As discussed previously, OMB Circular A-87, 8.h(6) simply allows for a means to allocate personnel service costs, in lieu of activity reports, and does not relate to what alternative systems can be used. The State has not demonstrated that it is unable to prepare activity reports for all personnel; instead, the State is using Section 8.h as its basis for allocating indirect labor costs and treating these costs as direct charges. Again, any cost that is not a direct cost is an indirect cost. Indirect costs needs to be accumulated into pools and allocated as an indirect expense. Until the State correctly treats the allocated labor as indirect costs, we have no opinion or basis for accepting any alternatives proposed by the State to allocate prior labor costs to the various EPA grants. Additionally, the State must treat these costs consistently across all of its projects, including USDA and State-funded projects.

In order for any of the alternatives to be allowable, the State will need to demonstrate that the amount allocated to the grants are minimal or will result in less costs than what would have been allowed had the State's labor charging practices complied with OMB Circular A-87. In order for this to happen, the State, for each grant, will need to provide appropriate documentation that not only supports the direct project costs charged (as discussed in the previous findings), but also correctly identifies and applies the 4 percent administrative charge to the grants. Until this full reconciliation is performed and reviewed, the $1,166,051 in labor charges remain questioned.

"State Procurement Procedures Not Consistently Followed
(Single Audit Report Recommendation No. 35)

STATE OF ALASKA COMMENT #1:

The procurement process in place during this fiscal year was a process that had previously been reviewed and approved by EPA staff. The issue raised in the single audit report was one of insufficient oversight rather than the process being flawed in some way. We do agree that staffing levels at the time simply did not allow for the necessary review or the necessary expertise to provide sufficient oversight.

To address this need the VSW program created a new Procurement Specialist position to provide this needed oversight in September 2004. This position is solely dedicated to the VSW program, and is supervised by the Division of Information and Administrative Services to ensure appropriate segregation of duties and authorities. The incumbent has worked to strengthen internal controls and to provide appropriate oversight and guidance for VSW procurement practices. To further illustrate our commitment to ensure appropriate procurement practices are followed we are creating an additional procurement position. We expect have to this position filled by the end of May 2006.

> **OIG Comment:** The State's actions sufficiently address this finding. The single auditor informed the OIG that under the current single audit being performed (for fiscal year 2005) there were no problems identified with procurement testing. Therefore no further action is required by the State at this time. We will delete the recommendation that Region 10 should review and approve all State solicitations and contracts under EPA grants and cooperative agreements other than small purchases until the State's procurement system is reviewed and determined to comply with EPA requirements. The State's actions do not address historical problems with its procurement process and the contracts issued under the grants prior to 2005. As such we do not accept or approve any procurement costs claimed prior to 2005. Such procurement costs may be unallowable if such costs were not incurred following applicable Federal requirements.

Additional Issue – Dividend and Interest Income

STATE OF ALASKA COMMENT #1:

To address this issue we must first clarify our relationship with the Alaska Native Tribal Health Consortium (ANTHC). In order to prevent duplication of effort and to make the most of the funds available for rural sanitation projects, the State of Alaska, Department of Environmental and the Indian Health Service (IHS) have executed an agreement to transfer the management of certain sanitation project funding between the two agencies. Attachment #5 is a copy of this agreement. This is the most current version of this agreement and is currently being routed through the signature process. As you can see the IHS has stated that ANTHC would manage these projects on their behalf in some situations. DEC does not have any direct relationship with ANTHC.

In attempting to address the interest income issue presented above we asked for IHS/ANTHC to provide documentation supporting their position on this interest income. What follows is their response.

"The Alaska Native Tribal Health Consortium (ANTHC) stands in the shoes of the U.S. Indian Health Service (IHS) and is entitled to receive additional funding on the same terms and conditions as the IHS statewide health programs in Alaska under the terms and conditions of the Compact and Funding Agreement. The ANTHC Compact and Funding Agreement are implemented through the authority of Title V of P.L. 106-260; both the agreements and the statute authorize ANTHC to receive advance payments and earn interest on all funds received through those instruments. All sanitation facilities construction project funding was received as cooperative project agreements through the IHS and are therefore included in ANTHC's funding agreement. Thus, the authorities of P.L. 106-260 apply, including its very specific statutory provisions that supersede any potentially contrary general regulations."

To further support their position IHS/ANTHC provided the following detail information.

"Enclosed is a copy of PL 106-260, Title V, (Attachment #6) and a 1996 letter from the GAO (Attachment #7) that IHS received regarding advance payment of construction funds and the propriety of earning interest on such funds when they are transferred to us through our compact and funding agreement with the IHS.

While Title V needs to be read in its entirety, I see 4 passages as particularly key in establishing the basis for ANTHC receiving advance payments and generating interest from project funds, given the following:

- The program operating environment of rural Alaska which is 90%+ Alaska Native,
- The State being encouraged by the US Gov to work with Indian Tribes as previously cited, and
- All funds provided by the State to IHS were distributed to ANTHC through our Compact and Funding Agreement (FA) as each cooperative project agreement entered into between the IHS and ANTHC is an addendum to our FA

PL 106-260 CITES:

1 - Section 505(b)(2) indicates that Programs, functions, services and activities administered by the IHS may be included in a Compact or FA (Projects are considered an activity). VSW projects have been administered by IHS since the early 1980's – so the State was utilizing an established process of long standing and saved the EPA the expense of creating/expanding the state capacity when the infrastructure grants were first funded.

> SEC.505. FUNDING AGREEMENTS.
> (b) CONTENTS.-
> (2) INCLUSION OF CERTAIN PROGRAMS, SERVICES, FUNCTIONS, AND ACTIVITIES.- Such programs, services, functions, or activities (or portions thereof) include all programs, services, functions, activities (portions thereof), including grants (which may be added to a funding agreement after an award of such grants), with respect to which Indian tribes or Indians are primary or significant beneficiaries, administered by the Department of Health and Human Services through the Indian Health Service and all local, field, service unit, area, regional, and central headquarters or national office functions so administered under the authority of–

2 - Section 505(c) indicates that funding may be included in the compact/FA even if it is not specifically designated for Indian programs.

> (c) INCLUSION IN COMPACT OF FUNDING AGREEMENT. – It shall not be a requirement that an Indian tribe or Indians be identified in the authorizing statute for a

program or element of a program to be eligible for inclusion in a compact or funding agreement under this title.

3 - Section 508(a) authorizes annual, semiannual or periodic advance transfer of funding.

SEC.508. TRANSFER OF FUNDS.
(a) IN GENERAL. – Pursuant to the terms of any compact or funding agreement entered into under this title, the Secretary shall transfer to the Indian tribe all funds provided for in the funding agreement, pursuant to subsection (c), and provide funding for periods covered by joint resolution adopted by Congress making continuing appropriations, to the extent permitted by such resolutions. In any instance where a funding agreement requires an annual transfer of funding to be made at the beginning of a fiscal year, or requires semiannual or other periodic transfers of funding to be made commencing at the beginning of a fiscal year, the first such transfer shall be made not later than 10 days after the apportionment of such funds by the Office of Management and Budget to the Department, unless the funding agreement provides otherwise.

4 - Section 508(h) authorizes the collection of interest on all funds received through the Compact or FA.

(h) INTEREST OR OTHER INCOME OF TRANSFERS. – An Indian tribe is entitled to retain interest earned on any funds paid under a compact or funding agreement to carry out governmental or health purposes and such interest shall not diminish the amount of funds the Indian tribe is authorized to receive under its funding agreement in the year the interest is earned or in any subsequent fiscal year. Funds transferred under this title shall be managed using the prudent investment standard.

The GAO letter is of particular interest because it specifically addresses the advance transfer of funds for construction projects and specifically states that treasury regulations do not apply…"

DEC has taken no position on this particular issue as it seems to come down to a difference in the interpretation of law between two federal agencies. We will await further guidance on this from the various agencies involved.

OIG Comment: We maintain our position that any funds that the Consortium obtains from EPA remain EPA funds, regardless of how the Consortium ultimately receives these funds. EPA funds are not subject to any IHS regulations, legislation, opinions, etc. The EPA funds do not become part of an IHS program; therefore, any agreements between IHS and the Consortium regarding IHS-funded programs are not germane.

Agreements among agencies, Federal or State, do not override Federal regulations and a Federal agency cannot override a Federal regulation unless it has the authority to do so. Unless EPA was a party to an agreement between IHS and the State, and waived the treatment of program income (assuming it had the authority to do so), any agreement between Alaska and the IHS does not override the application of EPA's grant regulations to an EPA-funded grant.

The State cites the Title V Tribal Self-Governance law as the basis for allowing the Consortium to keep any interest earned on EPA funds. However, section 505 of this law makes clear that this provision only pertains to grants made by the Indian Health Service, not grants made by other Federal agencies for other purpose. Section 505 provides that the Department of Health and Human Services shall negotiate "written funding agreement[s] with each Indian tribe" to carry out the various programs "administered by the Department of Health and Human Services through the [IHS]." Accordingly, this law does not affect EPA-funded grants and does not provide the authority to retain program income from EPA-funded grants.

Recommendations

"Along with recommendations 32-35 in the single audit, we recommend that the Regional Administrator, EPA Region 10:

1. Disallow the unsupported personnel service costs of $1,166,051, until the State provides sufficient documentation to support labor charges in accordance with Federal requirements."

STATE OF ALASKA RESPONSE:

We acknowledge that our labor charging practices during this fiscal year did not meet the requirements outlined in OMB Circular A-87. We are in the process of developing an alternative allocation process in accordance with OMB Circular A-87 Section 8, Subsection 6(c) for the labor charges. We will be submitting this proposal to EPA for consideration. We will await further instruction from EPA on how this proposal process should proceed.

OIG Comment: The State acknowledges that its labor charging practices did not comply with OMB Circular A-87. However, the State's response deals with correcting future labor charging in order to correct the problem and not how the historical costs will be treated. Two issues need to be addressed regarding the unsupported personnel service charges:

1. EPA will need to determine what is included in the definition of administrative expenses under the Village Safe Water grants. Once this definition is determined, the State will need to apply this definition accordingly, in order to ascertain how labor charges will be treated for reimbursement by EPA.

2. The State will have to develop and submit an indirect cost rate proposal for non-direct personnel costs for EPA's review and approval.

Once these two issues are addressed, the State will need to fully reconcile all costs under the various EPA grants, both direct project costs and administrative project costs, to the best of its ability. As a result, these labor charges remain questioned.

Recommendations

"2. Disallow costs of $32,721,149 representing the remaining balance of CFDA 66.606 funds as unsupported until the State provides actual cost data by EPA grant, by project, for all EPA grants supporting the Village Safe Water Program; any costs that remain unsupported should be recovered."

STATE OF ALASKA RESPONSE:

In January 2005, the VSW program contracted with an independent accounting firm, to provide a detailed project-by-project reconciliation of actual project expenses by funding source. In doing this reconciliation, the contractor compared the actual scope of work completed to the scope of work allowed under the federal award and state appropriation in assigning expenditures to the appropriate funding source. This was done for all expenses through December 31, 2004. VSW's in-house accounting staff then updated the reconciliations provided by the contractor for activity between January 1, 2005 and the transition to the State accounting system. Attachment #1 is an example showing the "Job Report" (expenditures by actual scope of work completed), and the "Funding Report" (expenditures applied to funding sources according to the allowable timeframe and scope of work for the funding source matched to the actual scope of work and timeframe of expenses). Attachment #4 is an example of a report by project by federal award.

With the implementation of our new accounting process outlined on page 2 of this document and the project reconciliation performed, the VSW program has complete documentation to support all project costs under these federal infrastructure grants. Any additional documentation required is available for review.

> **OIG Comment:** EPA will need to resolve the definition and application of the 4 percent administrative expense in order for the State to fully account for all costs under the various EPA grants. Additionally, the State has not reviewed any of the reconciliations prepared by the Consortium; therefore these costs cannot be accepted until the State reviews the reconciliations prepared by the State.

Recommendations

"3. Review and approve all State solicitations and contracts under EPA grants and cooperative agreements, other than small purchases, until the State's procurement system is reviewed and determined to comply with EPA requirements."

STATE OF ALASKA RESPONSE:

The procurement process in place during this fiscal year was a process that had previously been reviewed and approved by EPA staff. The issue raised in the single audit report was one of insufficient oversight rather than the process being flawed in some way. We do agree that staffing levels at the time simply did not allow for the necessary review or the necessary expertise to provide sufficient oversight.

To address this need the VSW program created a new Procurement Specialist position to provide this needed oversight in September 2004. This position is solely dedicated to the VSW program, and is supervised by the Division of Information and Administrative Services to ensure appropriate segregation of duties and authorities. The incumbent has worked to strengthen internal controls and to provide appropriate oversight and guidance for VSW procurement practices. To further illustrate our commitment to ensure appropriate procurement practices are followed we are creating an additional procurement position also dedicated solely to the VSW program. We expect have to this position filled by the end of May 2006.

> **OIG Comment:** As stated previously, the State's corrective actions have effectively addressed this finding. Therefore, we have deleted the recommendation in the final report. However, we want to emphasize that by deleting this recommendation we are not approving any procurement costs incurred prior to 2005. There may be historical procurement costs incurred by the State that do not meet Federal requirements for allowability. As such, these costs could be determined to be unallowable under future grant reviews.

Recommendations

"4. Require the State to have the Consortium remit the portion of interest, representing dividends from EPA-invested funds from the inception of the Village Safe Water Program, through year end 2003, to the U.S. Department of Health and Human Services, Payment Management System, Rockville, Maryland 20852."

STATE OF ALASKA RESPONSE:

As explained on pages 11 through 13 of this response DEC has taken no position on this particular issue as it seems to come down to a difference in the interpretation of law between two federal agencies. We will await further guidance on this from the various agencies involved.

> **OIG Comment:** The State funds passed through IHS to the Consortium are EPA funds. Therefore, the Consortium is required to comply with all EPA regulations and policies in the administration of these funds. As such, the provisions of 40 CFR 30.22(l) apply. The CFR requires that nonprofits not subject to the Cash Management Improvement Act must repay interest income earned on Federal funds. Therefore, we have made no changes to this recommendation.

Recommendations

"5. Place the State on a reimbursable payment basis under the authority of 40 CFR 31.12 until the cash management, financial reporting, labor accounting, and procurement systems fully meet Federal requirements."

STATE OF ALASKA RESPONSE:

The VSW program is now on an entirely reimbursable payment basis and will remain so under our new accounting procedures.

> **OIG Comment:** In order to comply with Federal procedures to draw down funds on a timely basis, the State has chosen to request funds from EPA on a reimbursement type basis. However, Region 10 has not formally placed the State on a reimbursable payment basis, in accordance with 40 CFR 31.12. While the State has made progress in the areas of cash management and procurements, issues regarding financial reporting, labor accounting, and applicable administration expenses still remain unresolved. Until these matters are resolved, we continue to recommend that the State be formally placed upon a reimbursable payment basis.

Appendix B

Distribution

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