



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, 2004**

**Report No. 2006-3-00168**

**July 26, 2006**

**Report Contributors:**

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**Abbreviations**

|                |  |
|----------------|--|
| CFDA           | Catalog of Federal Domestic Assistance   |
| CFR            | Code of Federal Regulations  |
| Consortium     | Alaska Native Tribal Health Consortium   |
| CPA            | Certified Public Accountant  |
| EPA            | U.S. Environmental Protection Agency   |
| IHS            | Indian Health Service  |
| MBE/WBE        | Program for the Utilization of Small, Minority, and Women's Business Enterprises |
| 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                                  |
| USDA           | U.S. Department of Agriculture   |



# At a Glance

*Catalyst for Improving the Environment*

## Why We Did This Review

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

## Background

The Single Audit Act of 1984 established uniform entity-wide audit requirements for State and local governments receiving Federal financial assistance. The State's Division of Legislative Audit performed the single audit for the year ended June 30, 2004. In fulfilling the requirements of the Single Audit Act, the Office of Inspector General reviews and disseminates the results of single audits to responsible U.S. Environmental Protection Agency (EPA) officials. The State identified \$32,976,401 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/2006/20060726-2006-3-00168.pdf](http://www.epa.gov/oig/reports/2006/20060726-2006-3-00168.pdf)

## ***Single Audit Report for the State of Alaska Department of Environmental Conservation for the Year Ended June 30, 2004***

### **What We Found**

The single audit questioned \$1,115,721 in labor costs because State employees did not account for their activities in accordance with Federal requirements. We have questioned the balance of the EPA grant amounts of \$31,860,680 because:

- 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. While the State contracted for a third-party certified public accountant firm to assess a subrecipient's compliance with managing State funds, the State did not follow up with problems identified with this subrecipient. This subrecipient also 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 2004 would be over \$8 million.

The State had not corrected findings from the prior year single audit. In particular, disbursements made by the State were advances and not actual costs. The State also had not correctly reported assets and expenditures.

### **What We Recommend**

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

- Implement the single audit recommendations and disallow \$1,115,721 of labor costs.
- Require the State to prepare and submit an indirect cost rate proposal for indirect costs related to direct labor costs.
- Disallow the remaining \$31,860,680 of costs associated with EPA funds until the State can provide actual cost data.
- Require the subrecipient to remit dividend and interest earned on EPA funds.
- Require the State to enter into an agreement with the Consortium to recognize and support (1) the direct transfer of EPA grant funds from the State to the Consortium, and (2) the Consortium's responsibility to comply with all EPA grant requirements.
- Place the State on a reimbursable payment basis until EPA determines the State's cash management, labor, and financial reporting systems meet Federal requirements, and the recommendations of this report are 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, 2004  
Report No. 2006-3-00168

**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, 2004. 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](mailto: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,

A handwritten signature in black ink, appearing to read "Bill A. Roderick". The signature is written in a cursive style with a horizontal line underneath it.

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, 2004, 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 managing 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 overseeing and monitoring 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 requirements under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the EPA OIG reviews and disseminates 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) developing and constructing 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 operating and maintaining sanitation services in rural Native villages. EPA awards these grant funds to Alaska to support the Village Safe Water program. Since 1995, EPA has awarded \$259,535,500 to the State to fund these various projects. For the year ended June 30, 2004, the State expended \$32,976,401 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.<sup>1</sup> 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 single audit disclosed four findings and related recommendations (recommendations nos. 22-25) that pertain to EPA assistance agreements, per the Catalogue 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 \$1,115,721.

Additionally, the EPA OIG has questioned the balance of the grant amounts of \$31,860,680 (total questioned costs of \$32,976,401) 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, labor accounting, and procurement systems fully meet Federal requirements, and the recommendations in this report have been fully satisfied.

A summary of the single auditor's recommendations (nos. 22-25) and the OIG comments are presented below. The full text of the single auditor's results and recommendations (nos. 22-25), along with the Schedule of Federal Expenditures, are included in Exhibit 1 of this report. The entire single audit report is available upon request.

### **Timekeeping Not Compliant with OMB Circular A-87** ***(Single Audit Report Recommendation No. 22)***

This a continuing issue from the June 30, 2003, single audit. The single auditor questioned labor costs of \$1,115,721 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 seven 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.

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<sup>1</sup> Recipients expending more than \$50 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.



Second, 17 employees charged 100 percent of their time to the Village Safe Water reimbursable service agreement; we question whether the employees worked solely on projects funded by EPA Grant No. XP97056901. The single auditor noted that:

- The State used EPA infrastructure grant number XP97056901 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 that program for the period certified.

However, since the Village Safe Water program had 10 active EPA grants, and also receives funds from other Federal agencies and the State, we question whether the employees actually worked solely on EPA infrastructure grant number XP97056901 during the year ended June 30, 2004. Further, if the employees worked on more than one Federal award or cost objective, using 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 appears 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. We found that the State drew funds from the 10 active EPA infrastructure grants in FY 2004 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 charge 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 it had 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 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. 23)***

This is a continuing issue from the June 30, 2003 single audit. The single auditor reported that the State did not consistently follow procurement procedures. The single auditor reviewed 25 procurement transactions from the Village Safe Water program and found that 6 transactions did not follow program procedures, as follows:

- One transaction failed to document a rent/purchase analysis or receive Federal agency approval for an equipment purchase, as required by State policy.
- Three transactions failed to maintain all copies of vendor bids and quotations in the procurement files.
- A project onsite manager verbally agreed to pay for \$172,673 in rental services and materials without following procurement procedures.
- One transaction failed to use a necessary Village Safe Water purchase order.

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 single auditor corroborated this single audit finding. That report<sup>2</sup> 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 Federal requirements and are allowable. As a result of the procurement weaknesses noted, procurements under EPA grants are unsupported and unallowable.

**State Not Compliant with MBE/WBE Requirements**  
***(Single Audit Report Recommendation No. 24)***

The single auditor reported that the State is not in compliance with EPA grant conditions pertaining to EPA's Program for the Utilization of Small, Minority, and Women's Business Enterprises (MBE/WBE). The State did not include in its bid documents the required MBE/WBE percentage and did not require subrecipients and prime contractors to report to the State the actual amount of expenditures from MBE/WBE procurements. The single auditor recommended that the State finance officer and Division of Water facility programs manager modify EPA-related bid and grant documents and establish reporting procedures with subrecipients and prime contractors to ensure compliance with EPA MBE/WBE requirements.

In its response, the State concurred with the single auditor's recommendation and has made corrections to comply with the MBE/WBE requirements. The State's actions are acceptable and no additional recommendation or actions are needed.

**State Oversight of Consortium Insufficient**  
***(Single Audit Report Recommendation No. 25)***

The State's oversight of infrastructure funds transferred to Alaska Native Tribal Health Consortium (Consortium) is insufficient to ensure compliance with Federal requirements. The State transfers EPA and USDA funds to the Consortium on behalf of Alaska villages for Village Safe Water projects. In July 2000, the Indian Health Service (IHS) entered into an agreement with the Consortium (a nonprofit organization) to manage IHS projects in Alaska. Because the Consortium works under an agreement with IHS, the State believes that its current oversight of

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<sup>2</sup> *Special Report on the Department of Environmental Conservation, Village Safe Water Program, Selected Projects, Report No. 18-30028-04, issued November 19, 2003.*

funds passed through to the Consortium is sufficient. This oversight includes reviewing quarterly reports and contracting for an annual review by a third-party CPA firm.

The current scope of the third-party CPA review includes (1) examining expenditures to determine if they are supported and in accordance with Village Safe Water requirements; (2) determining if the Consortium is meeting State, EPA, and USDA grant requirements; (3) evaluating Consortium procurement practices; and (4) suggesting recommendations for improving managing the grant funds.

However, for oversight to be complete and effective, it must have three components: collecting information, reviewing information collected, and following up on identified problems. According to the single auditor, the third-party CPA firm reviews – as currently implemented by the State – accomplish the oversight components of collecting and reviewing information, but do not provide for followup on identified problems. The most current review identified duplicate administrative expense billing and a frequent inability to reconcile actual expenditures to reported expenditures. The State does not have an agreement with the Consortium requiring a followup corrective action plan on findings and recommendations.

The single auditor recommended the State finance officer and Division of Water facility programs manager improve oversight of Federal funds. They also recommended that the State sign an agreement with the Consortium to require a followup corrective action plan on findings and recommendations, and require the State to follow up on corrective action in a timely manner.

The State disagreed with the single auditor's finding stating that the IHS, a Federal agency under the U.S. Department of Health and Human Services, had oversight responsibilities for the Consortium, not the State. The State said that IHS contracts with the Consortium to manage IHS projects and is the cognizant Federal agency for the Consortium. The State specifically stated that:

*All agreements related to IHS projects funded by EPA and USDA monies granted to the State are between [the State] and the IHS. The [Consortium] is not a party, and is in no way a subrecipient of the [State] subject to its oversight. As questions frequently arise due to the unique nature of the relationship between the [State], the IHS, and the [Consortium], a legal review is underway to confirm relationships and responsibilities to the satisfaction of all interested parties.*

The single auditor did not accept the State's response to the finding. We also disagree with the State's position that the State is not responsible for overseeing the Consortium. According to 40 CFR 31.40(a), grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function, or activity. Therefore, regardless of how the funds pass through to the Consortium, the funds are EPA funds, and the State is solely responsible for ensuring that the funds are managed in compliance with EPA grant requirements.

## **Unresolved Issues from the 2003 Single Audit**

In addition to the recommendations addressed directly in the June 30, 2004, single audit report, two unresolved recommendations remain from the prior year single audit as of June 30, 2003.

In Recommendation 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. Disbursements from the State to the accounting firm<sup>3</sup> and the Consortium were advances and do not represent actual EPA grant costs. The State has historically drawn funds, in advance, to meet cash needs for the construction season, which runs from April to October of each year. 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 for advances and not actual costs. As a result, there was no assurance that the advances were expended on allowable projects and not accumulated. Therefore, all expenditures claimed under CFDA 66.606 are considered to be unsupported. 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 grant funds on a fully reimbursable basis. The State's actions, pending EPA's review and approval of the State's financial management system, should address this matter.

In Recommendation 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 stated that the State does not have any information on the Consortium's actual expenditures. The State reported the cash advances as expenditures, which is not in accordance with Generally Accepted Accounting Principles. The single auditor recommended that the State obtain expenditure information for projects administered by the Consortium. Since the expenditures claimed by the State represent advances, and not actual costs, these expenditures are unsupported. The single auditor reported that the accounting firm does provide the State with actual expenditure information. However, the accounting firm had cash balances of \$13.2 million and \$11.5 million as of June 30, 2002 and 2003 respectively. That the accounting firm had a cash balance suggests that the State is disbursing excess cash to the accounting firm and may not be reporting actual costs under the EPA grants. Therefore, we recommend that the State provide expenditure information from the accounting firm handling State-led projects by EPA grant and by project and repay the EPA any cash in excess of actual costs. 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.

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<sup>3</sup> The accounting firm handles payments for State-managed Village Safe Water program projects.

## 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 understand how the Consortium treated EPA funds received. When we reviewed the Consortium’s single audit and tax returns, we identified one additional issue involving dividend and interest income.

Specifically, due to the State’s cash draw practices and payment of advances to the Consortium (as described in Unresolved Issues from the 2003 Single Audit section, Recommendation 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:

| <b>Fiscal Year Ended</b> | <b>Dividend and Interest Income</b> | <b>Cash and Security Investments</b> | <b>Percentage of Revenue from Federal Funds</b> | <b>Potential Dividend and Interest Income from Federal Funds</b> |
|--------------------------|-------------------------------------|--------------------------------------|---|--|
| 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  |
| September 30, 2004       | 1,151,593                           | 102,939,359                          | 68%   | 783,083  |
| <b>Total</b>             | <b>\$12,533,403</b>                 |                                      |   | <b>\$8,205,611</b>   |

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) applies. 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 67 percent for the 4 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 \$8,205,611 as of September 30, 2004. Because we were only able to obtain Form 990 tax returns for a 4-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 recommendation nos. 22-25 in the single audit, we recommend that the Acting Regional Administrator, EPA Region 10:

1. Disallow the unsupported personnel service costs of \$1,115,721, 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 \$31,860,680 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. Require the State to enter into an agreement with the Consortium, in accordance with 40 CFR Part 31.37, to recognize and support (1) the direct transfer of EPA grant funds from the State to the Consortium, and (2) the Consortium's responsibility to comply with all EPA grant requirements. This recommendation will address, in part, the single auditor's recommendation to require the State to perform sufficient oversight of the Consortium.
6. 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 April 27, 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 analyzing the laws, regulations, and guidance pertaining to grants awarded to the State for the Village Safe Water program and evaluating 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.

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

- Single Audit of the State of Alaska for the Fiscal Year Ended June 30, 2004, issued on May 5, 2005, performed by the State of Alaska Division of Legislative Audit.
- 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, 2004.
- Single Audit Report for the Alaska Native Tribal Health Consortium for the fiscal years ending 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<br>BENEFITS (in \$000s) |                     |
|-----------------|-------------|--|---------------------|---|-------------------------------|--|---------------------|
| Rec.<br>No.     | Page<br>No. | Subject  | Status <sup>1</sup> | Action Official                             | Planned<br>Completion<br>Date | Claimed<br>Amount                          | Agreed To<br>Amount |
| 1               | 9           | Disallow the unsupported personnel service costs of \$1,115,721, until the State provides sufficient documentation to support labor charges in accordance with Federal requirements.   | U                   | Acting Regional Administrator for Region 10 |                               | \$1,116                                    |                     |
| 2               | 9           | 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               | 9           | Disallow costs of \$31,860,680, 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 |                               | \$31,861                                   |                     |
| 4               | 9           | 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           | Require the State to enter into an agreement with the Consortium, in accordance with 40 CFR Part 31.37, to recognize and support (1) the direct transfer of EPA grant funds from the State to the Consortium, and (2) the Consortium's responsibility to comply with all EPA grant requirements. This recommendation will address, in part, the single auditor's recommendation to require the State to perform sufficient oversight of the Consortium.  | U                   | Acting Regional Administrator for Region 10 |                               |  |                     |
| 6               | 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 |                               |  |                     |

<sup>1</sup> 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

## ***Single Audit Report Findings and Recommendations and Schedule of Federal Expenditures***

### DEPARTMENT OF ENVIRONMENTAL CONSERVATION

Four recommendations were made to the Department of Environmental Conservation (DEC) in the *State of Alaska, Single Audit for the Fiscal Year Ended June 30, 2003*. Prior year Recommendation Nos. 32 and 33 have not been resolved; however, DEC has instigated significant changes which are expected to resolve Recommendation No. 33 in FY 05 and Recommendation No. 32 in FY 06. Therefore, these recommendations are not reiterated in this report. Prior Year Recommendation Nos. 34 and 35 have not been resolved and are reiterated in this report as Recommendation Nos. 22 and 23.

Additionally, two new recommendations have been made and are included as Recommendation Nos. 24 and 25.

#### Recommendation No. 22

The DEC finance officer should implement procedures to ensure personal services expenditures charged to the Environmental Conservation Agency (EPA) infrastructure grants comply with federal cost principles.

#### Prior Finding

DEC did not follow applicable federal guidance for the personal services costs charged to the FY 03 EPA infrastructure grant. Village Safe Water (VSW) personal services costs were 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.

For FY 03, we reviewed time sheets for employees charging time to the EPA infrastructure grant, and found that DEC was 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 timesheets, 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 reimbursable service agreement (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 the U.S. 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 charged to the EPA infrastructure grant, we questioned the federal portion of all personal service costs charged to CFDA 66.606 through the EPA infrastructure grant in FY 03 (\$1,166,051).

#### Legislative Audit's Current Position

In FY 04, DEC's personal services costs charged to EPA infrastructure grants through a RSA are not adequately supported as allowable costs. The DEC finance officer confirmed that personal services costs were charged in the same manner as in FY 03 without certifications or detailed timesheets. Also, all personal services costs were charged to the EPA infrastructure grant even though VSW activities benefit both the EPA and the USDA-RD programs.

A total of 24 DEC employees charged personal services costs to the FY 04 EPA infrastructure grant. Of those who charged time to the EPA infrastructure grant, 17 charged 100% of their time, and the remaining seven charged only a portion of their time. The federal portion of these costs was \$1,115,721.

Given the lack of required OMB Circular A-87 support for the personal services costs charged to the EPA infrastructure grant, we again questioned the federal portion of all personal service costs charged to CFDA 66.606 through the EPA infrastructure grant in FY 04.

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: \$1,115,721

*Agency Response Department of Environmental Conservation*

*The Department supports this recommendation, and has implemented processes to ensure the requirements of OMB Circular A-87 are met. Those employees solely dedicated to a particular federal grant are required to complete bi-annual certifications. Additionally, for those employees whose salaries are chargeable to more than one cost objective, actual hours worked on each cost objective are reflected on the employee timesheet.*

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

### Recommendation No. 23

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

### Prior Finding

In FY 03, 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 transactions reviewed, five did not follow VSW procedures in some manner. While no error was significant on its own, the number of errors indicated a weakness in the internal controls over the VSW procurement process.

### Legislative Audit's Current Position

In FY 04, DEC again did not consistently follow procurement procedures for VSW projects. We reviewed 25 procurement-related transactions from 11 projects which were funded by either EPA infrastructure or USDA Rural Development grants. Of the 25 transactions reviewed, six did not follow VSW procedures in some manner:

- One transaction failed to document a rent/purchase analysis or receive federal agency approval for an equipment purchase as required by DEC internal policy.
- Three transactions failed to maintain all copies of vendor bids and quotations in the procurement files.
- A project onsite manager verbally agreed to pay for \$172,673 in rental services and materials without following procurement procedures.
- One transaction failed to use a necessary VSW purchase order.

These errors continue to indicate 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  
Questioned Costs: None

Federal Agency: EPA

CFDA: 10.760  
Questioned Costs: None

Federal Agency: USDA

*Agency Response Department of Environmental Conservation*

*The Department supports this recommendation, and hired a Procurement Specialist III in September 2004 to support the VSW program. This position is solely dedicated to the VSW program, and is supervised by the Division of Information and Administrative Service to ensure appropriate segregation of duties and authorities. The incumbent has been working to strengthen internal controls and to provide appropriate oversight and guidance for VSW procurement practices.*

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

Recommendation No. 24

The DEC finance officer and Division of Water facility programs manager should implement procedures to ensure compliance with EPA grant requirements for small and disadvantaged business utilization.

DEC is not in compliance with EPA grant conditions pertaining to the U.S. EPA's Program for the Utilization of Small, Minority, and Women's Business Enterprises (MBE/WBE). DEC does not include in its bid documents the required MBE/WBE percentage and does not require that subrecipients and prime contractors report to DEC the actual amount of expenditures from MBE/WBE procurements.

EPA grants contain an administrative condition regarding small and disadvantaged business utilization which requires DEC to accept applicable MBE/WBE "fair share" goals. The grant agreements also state:

- (b) The recipient agrees to ensure, to the fullest extent possible, that at least the applicable 'fair share' objectives of Federal Funds for prime contracts or subcontracts for supplies, construction, equipment or services are made available to organizations owned or controlled by socially and economically disadvantaged individuals, women and Historically Black Colleges and Universities.*
- (c) The recipient agrees to include in its bid documents the applicable 'fair share' objectives and require all of its prime contractors to include in their bid documents for subcontracts the negotiated 'fair share' percentages.*

- (d) *The recipient agrees to follow the six affirmative steps or positive efforts stated in 40 CFR 30.44(b), 40 CFR 31.36(e), or 40 CFR 35.6580, as appropriate, and retain records documenting compliance.*

In addition, the grant agreements require DEC to report, on a quarterly basis, the dollar amount of actual MBE/WBE procurements by DEC or its subrecipients and prime contractors.

DEC's current position regarding MBE/WBE procurements for EPA infrastructure grants is that all cash advances to the Alaska Native Tribal Health Consortium (ANTHC) are MBE procurements due to ANTHC's status as an Alaska Native organization. The cash advances to ANTHC, however, are on behalf of the Native communities and may not go directly to Native communities or may not be used to procure products and services from Native companies. Thus, DEC is required to obtain information from ANTHC regarding actual procurements rather than reporting 100% of the cash advances as MBE.

DEC does not include the MBE/WBE objectives in any of its bid or grant documents. In order to be in compliance, DEC must include the MBE/WBE "fair share" objectives in their bid documents for procurements related to projects managed by VSW engineers, grant documents to municipalities under the Municipal Grants program, and grant documents for projects managed by ANTHC. Additionally, DEC must establish reporting procedures to require all subrecipients and prime contractors to report actual expenditures from MBE/WBE procurements to DEC.

We recommend the DEC finance officer and Division of Water facility programs manager modify EPA-related bid and grant documents and establish reporting procedures with subrecipients and prime contractors to ensure compliance with EPA MBE/WBE requirements.

CFDA: 66.606  
Questioned Costs: None

Federal Agency: EPA

*Agency Response Department of Environmental Conservation*

*The Department supports this recommendation. The VSW Procurement Specialist is working to update bid documents and agreements to include Minority Business Enterprise/Women 's Business Enterprise (MBE/WBE) 'fair share' objectives, and to require reporting of actual MBE/WBE procurements.*

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

#### Recommendation No. 25

The DEC finance officer and Division of Water facility programs manager should improve oversight of funds passed through to ANTHC.

DEC's oversight of infrastructure funds transferred to ANTHC is insufficient to ensure compliance with federal requirements. DEC transfers federal EPA and USDA Rural Development funds to the ANTHC on behalf of Alaska villages for VSW projects. In July 2000, the Indian Health Service (IHS) contracted with ANTHC (a nonprofit organization) to manage IHS projects in Alaska. Because ANTHC is acting on behalf of a federal agency, DEC believes that their current oversight of funds passed through to ANTHC is sufficient. This oversight includes reviewing quarterly reports and contracting for an annual review by a third-party CPA firm. DEC confirmed their position with EPA and USDA officials in FY 03.

The current scope of the third-party CPA review includes: (1) examining expenditures to determine if they are supported and in accordance with VSW requirements; (2) determining if ANTHC is meeting VSW, EPA, and USDA grant requirements; (3) evaluating ANTHC procurement practices; and, (4) suggesting recommendations for improvement of the management of VSW grant funds.

However, for oversight to be complete and effective, it must have three components: collecting information; reviewing information collected; and following up on identified problems. The third-party CPA firm reviews—as currently implemented by DEC—accomplish the oversight components of collecting and reviewing information, but do not provide for follow-up on identified problems. The most current review (FY 03) identified duplicate administrative expense billings and a frequent inability to reconcile actual expenditures to reported expenditures. DEC does not have an agreement with ANTHC requiring the development of a follow-up corrective action plan on findings and recommendations. Without such an agreement, the value of these reviews is questionable.

We recommend the DEC finance officer and Division of Water facility programs manager improve oversight of federal funds. DEC should sign an agreement with ANTHC requiring a follow-up corrective action plan on findings and recommendations and DEC following up on corrective action in a timely manner.

CFDA: 66.606  
Questioned Costs: None

Federal Agency: EPA

CFDA: 10.760  
Questioned Costs: None

Federal Agency: USDA

*Agency Response Department of Environmental Conservation*

*The Department disagrees with this recommendation, in that the Indian Health Service (IHS), a federal agency, not the Department, is responsible for oversight of the Alaska Native Tribal Health Consortium (ANTHC). The INS contracts with the ANTHC to manage INS projects, and is the cognizant federal agency for the ANTHC. All agreements related to IHS projects funded by EPA and USDA monies granted to the state are between the Department and the IHS. The ANTHC is not a party, and is in no way a subrecipient of the Department subject to its oversight. As questions frequently arise due to the unique nature of the relationship between*

*the Department, the IHS, and the ANTHC, a legal review is underway to confirm relationships and responsibilities to the satisfaction of all interested parties, and put the matter to rest.*

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

Legislative Audit's Additional Comments

We have reviewed 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. We agree that the relationship between DEC, ANTHC, and the federal agencies is confusing and expect a complete legal review should clearly identify the responsibilities of each party.



STATE OF ALASKA  
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
For the Fiscal Year Ended June 30, 2004  
By State Agency

| Federal Agency  | CFDA Number                       | Grant or Other Identifying Number | Cluster | Federal Program Title   | Federal Expenditures |
|---|-----------------------------------|-----------------------------------|---------|---|----------------------|
| USDOC   | 11.477                            |                                   |         | Fisheries Disaster Relief   | 1,897,031            |
| USDOD   | 12.999                            |                                   |         | Delta Junction Missile Defense Test Bed Facilities Impact   | 6,508,714            |
| HUD   | 14.228                            |                                   |         | Community Development Block Grants/State's Program  | 3,011,443            |
| HUD   | 14.231                            |                                   |         | Emergency Shelter Grants Program  | 112,000              |
| USDOJ   | 15.226                            |                                   |         | Payments to States in Lieu of Real Estate Taxes   | 5,858,416            |
| USTreas   | 21.999                            |                                   |         | Jobs and Growth Tax Relief Reconciliation Act of 2002   | 17,887,994           |
| EPA   | 66.006                            |                                   |         | Surveys, Studies, Investigations and Special Purpose Grants   | 1,110,562            |
| DC  | 90.100                            |                                   |         | Denali Commission Program   | 3,446,744            |
| USDHHS  | 93.569                            |                                   |         | Community Services Block Grant  | 2,227,777            |
| USDHHS  | 93.571                            |                                   |         | Community Services Block Grant Discretionary Awards: Community Food and Nutrition                             | 641                  |
| USCNCs  | 94.003                            |                                   |         | State Commissions   | 139,135              |
| USCNCs  | 94.004                            |                                   |         | Learn & Serve America - School & Community Based Programs   | 10,856               |
| USCNCs  | 94.006                            |                                   |         | AmeriCorps  | 800,124              |
| USCNCs  | 94.007                            |                                   |         | Planning & Program Development Grants   | 16,771               |
| USCNCs  | 94.009                            |                                   |         | Training & Technical Assistance   | 59,597               |
| USCNCs  | 94.013                            |                                   |         | Volunteers in Service to America  | 7,418                |
| USDHS   | 97.023                            |                                   |         | Community Assistance Program: State Support Services Element (CAP-SSSE)                                       | 75,700               |
| USDHS   | 97.029                            |                                   |         | Flood Mitigation Assistance   | 58,915               |
| <b>Total Department of Community and Economic Development</b> |                                   |                                   |         |   | <b>67,591,320</b>    |
| <b>Department of Environmental Conservation</b>               |                                   |                                   |         |   |                      |
| USDA  | 10.03-9702-0322                   |                                   |         | Homeland Security Animal Disease Emergency Response   | 11,766               |
| USDA  | 10.103-9702-1093                  |                                   |         | John's Disease  | 29,255               |
| USDA  | 10.12-25-A-40251                  |                                   |         | Cooperative Pesticide Recordkeeping Program   | 8,148                |
| USDA  | 10.43-0109-3-0325                 |                                   |         | Regulatory oversight of Contaminated Sites cleanup  | 31,913               |
| USDA  | 10.760                            |                                   |         | Water and Waste Disposal Systems for Rural Communities  | 2,991,777            |
| USDOC   | 11.45ABNA0N0252                   |                                   |         | Miscellaneous Inspection Service  | 20,891               |
| USDOC   | 11.56ABNC100055                   |                                   |         | Regulatory Oversight, Pribilof Islands, Alaska  | 37,779               |
| USDOC   | 11.NA16AB2392                     |                                   |         | DEC VSW Grants to St. Paul and St. George Islands for construction  | 950,000              |
| USDOD   | 12.113                            |                                   |         | State Memorandum of Agreement Program for the Reimbursement of Technical Services                             | 1,923,762            |
| USDOD   | 12.113AF - Elmendorf Site cleanup |                                   |         | LISAF - Elmendorf Site Cleanup  | 19,448               |
| USDOT   | 20.DTFAAL-04-X-0000               |                                   |         | Clean up contaminated Sites in Alaska   | 3,068                |
| EPA   | 66.001                            |                                   |         | Air Pollution Control Program Support   | 1,130,243            |
| EPA   | 66.034                            |                                   |         | Surveys Studies, Investigations, Demonstrations and special purpose activities relating to the Clean Air Act. | 264,019              |
| EPA   | 66.419                            |                                   |         | Water Pollution Control: State and Interstate Program support   | 263,043              |
| EPA   | 66.432                            |                                   |         | State Public Water System Supervision   | 2,109,982            |
| EPA   | 66.454                            |                                   |         | Water Quality Management Planning   | 112,597              |
| EPA   | 66.458                            |                                   |         | Capitalization Grants for Water State Revolving Funds   | 17,535,004           |
| EPA   | 66.463                            |                                   |         | Water Quality Cooperative Agreements  | 130,300              |
| EPA   | 66.467                            |                                   |         | Wastewater Operator Training Grant Program (Technical Assistance)   | 20,118               |
| EPA   | 66.468                            |                                   |         | Capitalization Grants for Drinking Water State Revolving Fund   | 11,567,604           |
| EPA   | 66.471                            |                                   |         | State Grants to Reimburse Operators of Small Water for Training & Certification Costs                         | 128,867              |
| EPA   | 66.472                            |                                   |         | Beach Monitoring and Notification Program Implementation Grants   | 71,963               |
| EPA   | 66.474                            |                                   |         | Water Protection Grants to the States   | 121,959              |
| EPA   | 66.500                            |                                   |         | Environmental Protection Consolidated Research  | 86,212               |
| EPA   | 66.511                            |                                   |         | Office of Research and Development, Consolidated Research   | 242                  |
| EPA   | 66.605                            |                                   |         | Performance Partnership Grants  | 3,514,760            |
| EPA   | 66.606                            |                                   |         | Surveys, Studies, Investigations and Special Purpose Grants   | 32,976,401           |
| EPA   | 66.608                            |                                   |         | State Information Grants  | 139,657              |

STATE OF ALASKA  
 SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
 For the Fiscal Year Ended June 30, 2004  
 By State Agency

| Federal Agency  | CFDA Number          | Grant or Other Identifying Number | Cluster | Federal Program Title  | Federal Expenditures |
|---|----------------------|-----------------------------------|---------|--|----------------------|
| EPA   | 66.700               |                                   |         | Consolidated Pesticide Enforcement Cooperative Agreements            | 275,510              |
| EPA   | 66.708               |                                   |         | Pollution Prevention Grants Program                                  | 1,266                |
| EPA   | 66.804               |                                   |         | State and Tribal Underground Storage Tanks Program                   | 181,885              |
| EPA   | 66.805               |                                   |         | Leaking Underground Storage Tank Trust Fund Program                  | 509,417              |
| EPA   | 66.809               |                                   |         |  |                      |
| EPA   | 66.817               |                                   |         | Superfund State and Indian Tribe Core Program Cooperative Agreements | 226,856              |
| EPA   | 66.LUST              | Trust Cost Recovery               |         | State and Tribal Response Program Grants                             | 263,404              |
| EPA   | 66.LUST              | Trust Cost Recovery               |         | LUST Trust Cost Recovery   | 15,951               |
| ENERGY  | 81.DE-FC03-02EH02039 |                                   |         | Amchitka Medical Screening Program                                   | 501,048              |
| ENERGY  | 81.DE-FG08-99NV13763 |                                   |         | Amchitka Oversight/NEUNET  | 47,541               |
| USDHHS  | 93.223-02-4037       |                                   |         | Food Sanitation Inspections  | (472)                |
| USDHHS  | 93.223-03-4037       |                                   |         | Food Sanitation Inspections  | 287,074              |
| USDHHS  | 93.FD-R-0022425-01   |                                   |         | Food Safety Systems  | 4,064                |
| USDHHS  | 93.FD-R-002475-01    |                                   |         | Food Safety Systems  | 24,940               |
| <b>Total Department of Environmental Conservation</b> |                      |                                   |         |  | <b>78,637,321</b>    |

## **Auditee Response**

STATE OF ALASKA

DEPT. OF ENVIRONMENTAL CONSERVATION  
OFFICE OF THE COMMISSIONER

FRANK H. MURKOWSKI, GOVERNOR

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May 26, 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, 2004

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, 2004, 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 fiscal year 2003 Single Audit Report in July 2004, the department determined that it was necessary to do a full evaluation of the Village Safe Water program. As a result of this evaluation, extensive changes were made to the policy and procedures that govern this program. After your review of the information we provide here, we think that you will find all of the procedural concerns raised in this report have been addressed.

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 supports a conclusion that all necessary corrective action has been completed.

In the enclosed document each issue raised in the OIG audit report is restated and followed by our comments. Thank you for providing this opportunity to comment on

Michael A. Rickey

2

May 26, 2006

your findings and recommendations. If you have 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 April 27, 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.]*

### **Timekeeping Not Compliant with OMB Circular A-87 (Single Audit Report Recommendation No. 22)**

#### **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.” A full copy of this memorandum is included as Attachment #1.

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 administrative function benefits the Village Safe Water as a whole, the administrative functions 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 as a final cost objective.

The single auditor's finding was that the State was not 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 Village Safe Water is responsible for projects funded through various sources, including EPA, USDA, and State of Alaska funds. The project represents the particular final cost objective, not the Village Safe Water program. If the Village Safe Water was the final cost objective, the State should have, at a minimum, been allocating administrative costs to all the various funding sources. Instead, the single auditor found that only the EPA grant was being charged.

The non-engineering costs meet OMB Circular A-87's definition of indirect costs, which are defined as costs:

*(a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefitted, 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 #2, 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. Also attached is an outline of the procedure followed to appropriately allocate these costs. See Attachment #3.

**OIG Comment:** The State's response conflicts with OMB requirements. The State's adopted 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 identify that 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, indirect costs are 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 as an indirect cost, described in OMB Circular A-87, Attachment A, Paragraph F(1) as:

*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. Paragraph 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 Paragraph 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 Alaska Department of Environmental Conservation, 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 EPA Region 10 staff that from the time the administrative funding was added to this program, that this funding (if any was requested by DEC) 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 the 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,<sup>4</sup> 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,<sup>5</sup> 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 State 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:**

We acknowledge that our labor charging practices during this fiscal year did not meet the requirements outlined in OMB Circular A-87. After a thorough review of the alternative allocation processes outlined in OMB Circular A-87 Section 8, we have developed several alternative allocation methods to address this issue. These alternative methods are outline below:

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<sup>4</sup> Pursuant to 40 CFR Part 31.22, ADEC 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.”

<sup>5</sup> “Direct costs are those that can be identified specifically with a particular final cost objective.” OMB Circular 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.” Ibid., Section F (1).

1. Over the course of this program the State of Alaska has contributed much more than the required match necessary to expend these federal funds. Attachment #4 is a report that shows the amount of administrative funding expended on this particular federal program over the years. As you can see, the state contribution is 123% of the amount contributed by EPA. In addition to the extra contributions of administrative funding there have been significant amounts of state funding contributed for direct project costs above and beyond the match requirement. Attachment #5 is an example of just one grant, XP-990561-01, which shows an excess state match amount of \$1,799,951. Other grant years will exhibit a similar over match situation.

With this proposal we would like to simply suggest recognition of the extra administrative funding contribution and/or a reclassification of the questioned administrative expenditures to a state funding source and excess direct state project costs as federal. What this results in is that we would be claiming no reimbursement of administrative costs for FY04 but only direct project costs.

2. Base the distribution of administrative costs for FY04 on the actual administrative distribution of costs in FY06. This would result in a pay back of funding to EPA.
3. Allocation of the FY04 administrative costs on actual direct project expenditures for FY04. This again would result in a pay back of funding to EPA.

With the significant excess state contributions to this program we feel that the proposal outlined in number 1 above is more than equitable for both DEC and EPA and ask your concurrence with this proposal.

**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. 23)**

#### **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 optimal oversight.

To address this need the VSW program created a new Procurement Specialist position to provide additional 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 June 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 our 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.

**State Not Compliant with MBE/WBE Requirements  
(Single Audit Report Recommendation No. 24)**

**STATE OF ALASKA COMMENT #1:**

As stated in our response the department did support this recommendation. The VSW bid documents and agreements have now been updated to include the Minority Business Enterprise/Women's Business Enterprise (MBE/WBE) fair share objectives and also require reporting of actual MBE/WBE procurements. For your information we have included the following documents with this response:

- An example of a Request for Statement of Qualifications – This form is the initial publication of a procurement. Any responding firm that indicates it or its subcontractors are eligible for MBE/WBE is granted this preference. See page 2 of 5 on Attachment #6.
- An example of the contract form that communities are required to use when entering into an agreement with a consultant. See Article 28 on Attachment #7.
- A copy of the format used to quarterly report MBE/WBE procurements. See Attachment #8.

In addition to the procurements performed by the VSW program we have included provisions in the agreements with the Indian Health Service (IHS). These provisions are presented in the following attachments:

- Memorandum of Understanding between the State of Alaska, Department of Environmental Conservation and the United States Indian Health Service. See page 7 on Attachment #9
- Funding Transfer Agreement between the State of Alaska, Department of Environmental Conservation and the United State Indian Health Service. This document contains three attachments please see Section 12 of attachment 1. This section requires the comply with all the requirements outlined in 15 C.F.R. Part 24 which includes the MBE/WBE requirements. See Attachment #10,
- A copy of a recent quarterly report received from IHS/ANTHC listing MBE/WBE procurements. See Attachment #11.

**OIG Comment:** In its response, the State concurred with the single auditor's recommendation and has made corrections to comply with the MBE/WBE requirements. The State's actions are acceptable and no additional recommendation or actions are needed.

**State Oversight of Consortium Insufficient  
(Single Audit Report Recommendation No. 25)**

**STATE OF ALASKA COMMENT #1:**

As a result of the this recommendation and other independent audits, the department implemented a new oversight process for the funds passed through to the Indian Health Service

(IHS) and the Alaska Native Tribal Health Consortium (ANTHC) . The following is an overview of this new process.

Programs to develop sanitation facilities in rural Alaska are jointly administered by the Alaska Department of Environmental Conservation (DEC) and the ANTHC, along with the following federal funding agencies:

- US Environmental Protection Agency (EPA)
- US Department of Agriculture, Rural Development Program (RD)
- Indian Health Service (IHS)

For projects funded by or through the State of Alaska, DEC may elect to transfer sanitation facility improvement grant funds from EPA and RD to IHS as a contribution toward the accomplishment of their common objectives to improve water quality, sanitation and public health for the residents of Alaska Native and rural communities. To avoid duplication of administrative efforts, when IHS has transferred administration of a project to ANTHC, DEC may reimburse ANTHC directly for project expenditures. EPA and RD approval of such transfers will be contingent upon DEC's continued support through programmatic and financial oversight and assistance to ensure successful project performance and completion.

DEC oversees administration of projects in ANTHC-lead communities through a series of policies and procedures, many of which are specifically identified in the Memorandum of Understanding between DEC and IHS (Attachment #9). These policies and procedures begin at the project planning stage and continue through project close out.

A data system of sanitation facility needs in every rural Alaska community is jointly maintained by DEC and ANTHC. This data system is updated annually, and is used for state and federal funding allocation.

Project-specific oversight begins when a funding request is received for a planning project. DEC and its federal funding partners utilize jointly-developed evaluation criteria to score the request. If there are any questions about the request, DEC works with ANTHC to have them addressed. If the funding request scores high enough, the planning project is funded. As work proceeds, draft sanitation plans are submitted to DEC for comments, and the final draft must be approved by DEC before it can be published and used for future funding requests.

Once a community has a sanitation plan approved for funding purposes, ANTHC can assist in preparing a funding request for design and construction. These funding requests are considered in the same way as requests for planning funds as described above. Once a design and construction project is funded, DEC utilizes the following oversight tools:

- Funding Transfer Agreement (Attachment #10) – Projects administered by ANTHC are included in an annual Funding Transfer Agreement (FTA) with IHS, which includes the following information:
  - Total funding transfer amount
  - Project scope and estimated cost for each community

- General conditions and construction funding conditions
  - Cash management procedures
  - Agency Requirements
- Review and approval of Project Cooperative Agreements - A Cooperative Project Agreement (CPA) (Attachment #12) between ANTHC and the community is executed for every sanitation project administered by ANTHC. The CPA details the project schedule, funding contributors, cost estimate table, project schedule, and project methodology. Once executed, the CPA is used to establish the budget for the project in the ANTHC accounting system. DEC reviews and approves CPAs for all projects funded through the State of Alaska.
  - Written financial and progress reports – Project-specific financial and performance reports (Attachment #13) are provided to DEC before and after the construction season. Performance reports include the following:
    - Project development milestones, including design, construction, and closeout;
    - Comparison of current outputs (facilities provided by the project) and outcomes (increased levels of service to homes and essential community buildings) to targeted outputs and outcomes (established in any project work plans included in the federal grant award);
    - Reasons for delays, reduced scope, and cost overruns;
    - An estimation of the percentage of facilities (outputs) completed;
    - Financial information by facility (output), including budgets, expended funds, and remaining funds; and
    - Information regarding problems, delays, or adverse conditions which will materially impair the ability to meet the objective of the award.
  - Project specific presentations and discussions - Three months following each financial and performance report, DEC and Federal funding agencies are provided with the opportunity to request project specific presentation and discussions. These presentations include detailed information about expenditures, progress, challenges, and any significant changes or delays affecting the project.
  - Review of engineering plans and specifications – DEC is provided with the opportunity to review and comment on engineering plans and specifications as they are being developed.
  - Review of Department Operating Guidelines – Policies and operating guidelines must be established and maintained by ANTHC to ensure compliance with state and federal funding requirements. These operating guidelines include, but are not be limited to, procurement, accounting, personnel, the use of force account labor, design and construction processes, and project close-out.

- Joint use of project expense codes for budgeting and reporting – DEC and ANTHC have jointly established a financial expenditure and accounting code structure. This structure is used by both organizations to track project expenses and prepare financial expenditure reports.
- Special Analysis and Review of ANTHC Project Administration - DEC has also used contract services to analyze and review the procedures used by ANTHC to administer projects. Specific procedures reviewed include:
  - Review, approval and payment of invoices for materials and services
  - Bid documents to procure materials and services
  - Project accounting by outside accounting firms
  - Force account, equipment and labor costs
  - Costs associated with administration and indirect administration
  - Accuracy of reporting on financial reports
- Joint development of design and construction standards – ANTHC and DEC work together to jointly establish and maintain design and construction standards for rural sanitation facilities. These standards are used by both agencies to ensure that design details and specifications for standard system components have been thoroughly reviewed and approved for statewide use.
- On-site construction inspections – DEC participates in on-site construction inspections on specific projects on an as-needed basis. These inspections provide the opportunity to verify written reports about progress under specific projects, and talk with community residents and project workers about the project.
- Project close out reports – ANTHC provides a project close out to DEC for each project. The Final Report summarizes the project’s funding sources and expenditures and also describes events throughout the course of the project.

In addition to these written documents and procedures, DEC works closely with ANTHC on a continuous basis to administer projects throughout the state. This work includes discussion and decision making about the numerous projects that are jointly funded through both DEC and ANTHC in the same communities, and administered by only one agency or the other (depending on lead-agency assignment). These discussions and decisions are another effective means of oversight for both agencies. On many occasions, representatives from both ANTHC and DEC will meet with community representatives or make on-site visits together because of multiple, jointly-funded project oversight concerns.

With the implementation of the above procedures, the department believes that all deficiencies identified have been followed up on and corrected.

**OIG Comments:** It is evident that the State has taken numerous steps to coordinate and formalize how Village Safe Water projects will be administered by IHS and the Consortium. While the efforts taken by the State, in concert with the Consortium and IHS, have helped to define project management, roles, and responsibilities throughout

project planning and execution, we continue to have concerns regarding the defined relationship between the State and the Consortium.

Although the State's response makes reference to the transferring of EPA grant funds to IHS, this does not actually occur. The State sends EPA grant funds directly to the Consortium to support projects authorized under the EPA grants. Consequently, we maintain our position that any EPA grant funds that the Consortium receives from the State remain EPA 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 application of EPA grant requirements (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 recognizes its grant oversight responsibilities in the State Fiscal Year 2006 Funding Transfer Agreement between the State and IHS, which states:

*EPA...consent[s] with such transfers is contingent upon DEC's continued programmatic and financial oversight to ensure successful project performance. Funding transfer does not relieve DEC of responsibility for overall grant management and successful project completion.*

However, the State did not specifically address how its oversight function will ensure that deficiencies that are found at the Consortium are addressed and corrected. Again, it seems that the State plans to rely completely on IHS to address any grant deficiencies at the Consortium. Since the State did not adequately address this recommendation, it will remain in the final report.

## **Unresolved Issues from the 2003 Single Audit**

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

#### **STATE OF ALASKA COMMENT #1:**

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 #2:**

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 #14 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 #15 is a copy of the directive given to IHS/ANTHC on this issue.

The amount of cash on hand at IHS/ANTHC was 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 returned 100% of the funding for those projects in which they could not provide a certified detailed expenditure report. IHS/ANTHC now has no cash balances on hand and will of course be allowed to request reimbursement for the additional project upon completion of the reconciliations.

The final step in both the reconciliation processes outlined above was the repayment of the federal funds to the appropriate federal agency. What this means is that neither the third party accounting firm, IHS/ANTHC nor the State of Alaska have any cash balances on hand for this program.

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 14 showed a reconciliation of expenditures to the funded amount. It is unclear if 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.

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.

## **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 #9 is a copy of this

agreement. 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 #16) and a 1996 letter from the GAO (Attachment #17) 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 purposes. 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

"1. Disallow the \$1,115,721 for personnel services because the State did not maintain the documentation required by Federal regulations to fully support the reported costs, until the State provides sufficient documentation to support labor charges."

### 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. After a thorough review of the alternative allocation processes outlined in OMB Circular A-87 Section 8, we have developed several alternative allocation methods to address this issue. These alternative methods are outline below:

1. Over the course of this program the State of Alaska has contributed much more than the required match necessary to expend these federal funds. Attachment #4 is a report that shows the amount of administrative funding expended on this particular federal program over the years. As you can see the state contribution is 123% of the amount contributed by EPA. In addition to the extra contributions of administrative funding there have been significant amounts of state funding contributed for direct project costs above and beyond

the match requirement. Attachment #5 is an example of just one grant, XP-990561-01, which shows an excess state match amount of \$1,799,951. Other grant years will exhibit a similar over match situation.

With this proposal we would like to simply suggest recognition of the extra administrative funding contribution and/or a reclassification of the questioned administrative expenditures to a state funding source and excess direct state project costs as federal. What this results in is that we would be claiming no reimbursement of administrative costs for FY04 but only direct project costs.

2. Base the distribution of administrative costs for FY04 on the actual administrative distribution of costs in FY06. This would result in a pay back of funding to EPA.
3. Allocation of the FY04 administrative costs on actual direct project expenditures for FY04. This again would result in a pay back of funding to EPA.

With the significant excess state contributions to this program we feel that the proposal outlined in number 1 above is more than equitable for both DEC and EPA and ask your concurrence with this proposal.

**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 to 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 \$31,860,680 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 #13 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 #14 is an example of a report by project by federal award.

The final step in the reconciliation process outlined above was the repayment of the federal funds to the appropriate federal agency. What this means is that neither the third party accounting firm, IHS/ANTHC nor the State of Alaska have any cash balances on hand for this program.

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:** EPA will need to resolve the definition and application of the 4 percent administrative expense 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.

## **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 optimal oversight.

To address this need the VSW program created a new Procurement Specialist position to provide additional 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 June 2006.

**OIG Comment:** As stated previously, the State’s corrective actions have effectively addressed this finding. Therefore, we have deleted our recommendation in the final report. However, 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 2004, to the U.S. Department of Health and Human Services, Payment Management System, Rockville, Maryland 20852.”

### STATE OF ALASKA RESPONSE:

As explained on pages 16 through 19 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. Require the State to perform sufficient oversight of the Consortium, to ensure that deficiencies identified, as part of the third-party CPA reviews, are follow up on and corrected.”

### STATE OF ALASKA RESPONSE:

As explained in detail on pages 8 through 12 of this response the department has determined that all deficiencies identified have been followed up on and corrected.

**OIG Comment:** The State still needs to address, as part of its oversight process, how it will ensure that grant deficiencies identified at the Consortium are addressed and corrected.



## Recommendations

“6. 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.

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