



OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Attestation Report

Examination of Financial Management Practices of the National Rural Water Association, Duncan, Oklahoma

Report No. 2007-4-00027

November 30, 2006

Report Contributors:

Janet Kasper
Robert Adachi
Eileen Collins

Abbreviations

CFR	Code of Federal Regulations
EPA	U.S. Environmental Protection Agency
MTDC	Modified Total Direct Cost
NRWA	National Rural Water Association
OIG	Office of Inspector General
OMB	Office of Management and Budget
USDA	United States Department of Agriculture



At a Glance

Catalyst for Improving the Environment

Why We Did This Review

In response to a congressional request, the Office of Inspector General examined the execution of U.S. Environmental Protection Agency (EPA) grants awarded to the National Rural Water Association (NRWA) and the financial management practices used by NRWA under EPA grants.

Background

The NRWA is a nonprofit organization that provides technical assistance, training, and legislative representation to water providers serving rural communities. NRWA is a federation consisting of 48 State associations representing 49 States. Since October 2000, NRWA has received over \$70 million from EPA to provide training and technical assistance to rural water systems.

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/2007/20061130-2007-4-00027.pdf

Examination of Financial Management Practices of the National Rural Water Association, Duncan, Oklahoma

What We Found

NRWA's method of allocating indirect costs over total direct costs is contrary to the requirements of the Office of Management and Budget (OMB) Circular A-122. Currently, NRWA does not exclude subcontracts or subawards from its indirect cost allocation base. As a result, the EPA grants are bearing a disproportionate amount of indirect costs. For the period from March 1, 1999, to February 29, 2004, EPA grants may have been over-allocated by \$2,021,821 in indirect costs. The exact amount of the indirect over-allocation will be determined during negotiating the indirect cost rate.

NRWA's procedures do not identify all unallowable costs. Because NRWA does not have written procedures for reviewing costs, its current practice may not comply with OMB Circular A-122. NRWA's practice of charging costs based upon budgets does not comply with OMB's definition of direct costs. NRWA also does not consistently record costs based upon the actual activity performed. As a result, NRWA's direct and indirect costs may include unallowable costs and would conflict with its assertion in the cost allocation plan that only allowable costs are allocated to specific grants and programs.

NRWA's drawdowns for State associations' costs are based upon budgeted amounts and not on actual expenditures. Because NRWA is distributing payments based on budgeted and not actual State associations' costs, it may be providing cash advances in excess of the State associations' immediate needs.

What We Recommend

We recommend that the Director of the Grants Administration Division:

- Obtain final negotiated indirect cost rates for NRWA.
- Require NRWA to develop written procedures to (a) identify unallowable costs in accordance with OMB Circular A-122, and (b) develop written procedures for the preparation of cash draws.



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

OFFICE OF
INSPECTOR GENERAL

November 30, 2006

MEMORANDUM

SUBJECT: Attestation Report: Examination of Financial Management Practices of the National Rural Water Association, Duncan, Oklahoma
Report No. 2007-4-00027

TO: Richard T. Kuhlman
Director, Grants Administration Division

This is our report on the subject attestation conducted by the Office of Inspector General (OIG) of the U.S. Environmental Protection Agency (EPA). We undertook this work as a result of a request by Senator James Jeffords dated August 24, 2005, which asked that the OIG examine the execution of EPA grants awarded to the National Rural Water Association.

This report contains findings that describe the problems the OIG has identified and corrective actions the OIG recommends. This report represents the opinion of the OIG and does not necessarily represent the final EPA position. EPA managers will make final determination on matters in this report 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 \$228,820.

Action Required

In accordance with EPA Manual 2750, you are required to provide a written response to this report within 120 calendar days. You should include a corrective actions plan for agreed upon actions, including milestone dates. We have no objections to the further release of this report to the public. This report will be available at <http://www.epa.gov/oig>.

If you or your staff have any further questions, please contact me at 202-566-0847 or roderick.bill@epa.gov or Janet Kasper, Director, Assistance Agreement Audits at 312-886-3059 or kasper.janet@epa.gov.

Sincerely,

A handwritten signature in black ink, appearing to read "Bill A. Roderick".

Bill A. Roderick
Acting, Inspector General

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Chapter 1

Introduction

Purpose of Examination

In response to a congressional request, the Office of Inspector General examined the financial and program management practices used by the National Rural Water Association (NRWA) under Environmental Protection Agency (EPA) grants. The purpose of the assignment was to address the following objectives:

- Does NRWA's indirect cost rate allocation plan comply with the requirements of Office of Management and Budget (OMB) Circular A-122?
- Is NRWA's procedure for identifying unallowable costs adequate?
- Is NRWA complying with Federal procedures when making cash draws?

Background

Approximately 272 million people receive their drinking water from nearly 53,000 community water systems. These systems range from very small, serving populations of 500 or less, to larger systems, serving over 100,000. A prior EPA Office of Inspector General report noted that although these systems share similar challenges, "...small systems have had great difficulty keeping up with the Safe Drinking Water Act regulations."¹

NRWA is a nonprofit organization that provides technical assistance, training, and legislative representation to water providers serving rural communities. NRWA receives the majority of its funding from EPA and the United States Department of Agriculture (USDA). During the fiscal year ending February 28, 2005, \$37 million of NRWA's total revenues of \$43 million came from EPA (\$13.5 million) and USDA (\$23.5 million).

OMB Circular A-122, *Cost Principles for Non-Profit Organizations*, establishes the Federal requirements for determining allowable and unallowable direct and indirect costs and preparing indirect cost proposals. The purpose of OMB Circular A-122 is (1) to ensure that the Federal government bears its fair share of costs (except where restricted or prohibited by law), (2) to identify allowable and unallowable costs for determining the actual cost of Federal programs, and (3) to

¹ EPA OIG Report No. 2003-P-00018, *Impact of EPA and State Drinking Water Capacity Development Efforts Uncertain*, issued September 30, 2003.

establish policies and procedures for indirect cost allocation plans. OMB Circular A-122, Attachment A describes methods of allocating indirect costs.

Indirect costs are those costs which are not readily identifiable with a particular project or activity but nevertheless are necessary to the general operation of an organization and the conduct of its activities. The costs of operating and maintaining buildings, grounds and equipment, depreciation, general and departmental administrative salaries and expenses are types of expenses usually considered as indirect costs.² They are usually grouped into common pool(s) and distributed to those activities benefited through a cost allocation process. The end product of this allocation process is an indirect cost rate(s) which is then applied to individual grant awards to determine the amount of indirect costs chargeable to the award.

Scope and Methodology

We conducted the examination in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. We performed the field work between April 3 and June 30, 2006, and included visits to NRWA's office in Duncan, Oklahoma. See Appendix B for details on Scope and Methodology.

NRWA's Response and OIG Comment

NRWA's complete response has been included as Appendix C of this report. NRWA's response to the specific recommendations and our comments are included at the end of each chapter. In its letter responding to our draft report, NRWA included hardcopy documentation on the amount of EPA grant funding received by each state association for the period of January 1999 through February 2004. While we did not include the documentation in Appendix C, it is available upon request.

² General and administration expenses are defined under OMB Circular A-122, Attachment A, Section D.3 as *those that have been incurred for the overall general executive and administrative offices of the organization and other expenses of a general nature which do not relate solely to any major function of the organization.* NRWA classifies its general and administrative expenses as indirect costs. For purposes of this report, general and administrative costs and indirect costs will be synonymous.

Chapter 2

NRWA's Indirect Cost Rate Allocation Plan Does Not Comply with Federal Requirements

NRWA's indirect cost rate allocation plan does not comply with Federal requirements. In particular, NRWA's method of allocating indirect costs over total direct costs is contrary to Federal requirements. OMB Circular A-122 requires that indirect costs allocated using the simplified allocation method be distributed over total direct costs, excluding capital expenditures and other distorting items, such as major subcontracts or subgrants. Currently, NRWA does not exclude subcontracts or subawards from its indirect cost allocation base. As a result, the EPA grants are bearing a disproportionate amount of indirect costs. For the period from March 1, 1999, to February 29, 2004, NRWA may have allocated \$2,021,821 of indirect costs to EPA grants in excess of the amounts that would have been allowed. The exact amount of the indirect over-allocation will be determined during the negotiation of the indirect cost rate.

NRWA Is Not Complying with OMB Requirements

By including major subcontracts and subawards in the indirect cost allocation base, NRWA is not complying with OMB requirements. Since 1989, NRWA has used a single indirect cost rate using the Simplified Allocation Method for preparing grant budgets and for requesting reimbursement from EPA. NRWA distributes indirect costs over a total cost base which includes the costs of subawards and subcontracts. Under the requirements of OMB Circular A-122, Attachment A, Section D.2., NRWA is required to exclude capital expenditures and major subcontracts or subawards from its total cost allocation based. Based upon indirect and direct cost information prepared by NRWA, \$2,021,821 of indirect costs may have been over-allocated to EPA projects, in excess of the amounts that would have been allowed using an indirect cost rate allocated over a modified total direct cost (MTDC) base.

For the fiscal years ending February 29, 2000, through February 29, 2004, NRWA prepared indirect cost proposals allocating indirect costs over both total cost and MTDC bases. In OMB Circular A-122, Attachment A, Section D.3, the nonprofit's administration expenses would be allocated based on MDTC, which *"...consists of all salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants and subcontracts up to the first \$25,000 of each subgrant or subcontract (regardless of the period covered by the subgrant or subcontract)"*. Although NRWA prepared indirect cost proposals allocating indirect costs over both MTDC and total cost bases, the total cost base was used for grant award and reimbursement purposes. A schedule of the indirect rates proposed by NRWA is provided in Table 2-1:

Table 2-1: Schedule of Indirect Cost Rates Proposed

Fiscal Year Ending:	Indirect Rate Using MTDC Base	Indirect Cost Rate Using Total Cost Base
February 29, 2000	38.67%	5.99%
February 28, 2001	39.29%	5.74%
February 28, 2002	39.29%	5.45%
February 28, 2003	36.43%	6.92%
February 29, 2004	35.08%	7.05%

Sources: NRWA's Indirect Cost Rate Proposals for Fiscal Years Ending February 29, 2000, February 28, 2001, February 28, 2002, February 28, 2003, and February 29, 2004.

NRWA officials have stated that, although indirect cost rate proposals are submitted each year, no Federal agency has negotiated final indirect cost rates. Starting with fiscal year ending February 28, 2005, NRWA submitted a cost allocation plan to USDA in lieu of an indirect cost rate proposal.

Based upon indirect and direct cost information NRWA prepared, \$2,021,821 of indirect costs may have been overallocated to EPA projects, in excess of the amounts that would have been allowed using an indirect cost rate allocated over the MTDC base³ proposed by NRWA. For the fiscal years ending February 29, 2000, through February 29, 2004, NRWA could have had \$2,021,821 of additional EPA grant funds available for distribution through subawards to State associations. Table 2-2 summarizes the potential excess allocation by fiscal year for each grant, based upon information contained in NRWA's indirect cost rate proposals.

Table 2-2: Schedule of Potential Overallocation of Indirect Costs by Fiscal Year by EPA Grant

	Grant Number	Indirect Costs Using Total Cost Base	Indirect Costs Using MTDC Base	Potential Overallocation
Fiscal Year Ending 2-29-04				
Technical and Training Assistance	T82896501	\$278,618	\$69,641	\$208,977
Groundwater Source Protection	X82970201	\$263,037	\$67,837	\$195,201
Source Water Protection	X82867201	\$87,688	\$34,421	\$53,267
Vulnerability Assessments	H183101401	\$23,476	\$15,953	\$7,522
	H183105601			
	Subtotal	\$652,819	\$187,852	\$464,967
Fiscal Year Ending 2-28-03				
Technical and Training Assistance	T82896501	\$253,877	\$68,811	\$185,066
Groundwater Source Protection	X82970201 T82741101	\$243,953	\$67,572	\$176,381

³ The exact amount of the indirect over-allocation will be determined during the process of negotiating the indirect cost rate.

	Grant Number	Indirect Costs Using Total Cost Base	Indirect Costs Using MTDC Base	Potential Overallocation
Source Water Protection	X82867201	\$61,191	\$31,658	\$29,533
	Subtotal	\$559,021	\$168,041	\$390,980
Fiscal Year Ending 2-28-02				
Technical and Training Assistance	T82650601 T82896501	\$225,484	\$62,558	\$162,926
Groundwater Source Protection	X82970201 T82741101	\$214,364	\$61,001	\$153,364
Source Water Protection	X82867201	\$48,134	\$34,288	\$13,846
	Subtotal	\$487,982	\$157,847	\$330,136
Fiscal Year Ending 2-28-01				
Technical and Training Assistance	T82650601	\$285,849	\$62,558	\$223,291
Groundwater Source Protection	T82741101	\$267,608	\$61,001	\$206,607
Source Water Protection	X82867201	\$4,027	\$34,288	(\$30,260)
	Subtotal	\$557,485	\$157,847	\$399,638
Fiscal Year Ending 2-29-01				
Technical and Training Assistance	T82650601	\$283,895	\$72,117	\$211,778
Groundwater Source Protection	T82741101	\$292,485	\$68,163	\$224,322
	Subtotal	\$576,380	\$140,280	\$436,100
	Total	\$2,833,688	\$811,867	\$2,021,821

Sources: NRWA's Indirect Cost Rate Proposals for Fiscal Years Ending February 29, 2000, February 28, 2001, February 28, 2002, February 28, 2003, and February 29, 2004.

The overallocation of indirect costs is due to the disproportionate amount of subawards on Federal programs. As shown in Table 2-3 below, subawards represent over 96 percent of total costs on EPA and USDA programs compared to only 2.99 percent for non-Federal programs.

Table 2-3: Schedule of Costs for the Fiscal Year Ending February 28, 2005

	EPA	USDA	Other	Total
Total Costs	\$12,898,618	\$22,052,811	\$3,444,771	\$38,396,200
Subawards	\$12,412,140	\$21,368,428	\$103,160	\$33,883,728
Percentage of Subawards to Total Costs	96.23%	96.90%	2.99%	88.25%

Source: OIG's analysis using NRWA's Indirect Cost Rate Proposal for Fiscal Year Ending February 28, 2005.

Recommendations

We recommend that the Director of the Grants Administration Division:

- 2-1. Obtain final negotiated indirect cost rates based on excluding capital expenditures and major subcontracts and subawards from the allocation base.

- 2-2. Revise the grant awards to reflect indirect costs based upon the rates negotiated in recommendation 2-1.
- 2-3. Require NRWA to submit revised Financial Status Reports to reflect indirect costs based upon the rates negotiated in recommendation 2-1.
- 2-4. Upon completion of recommendation 2 and 3 above, require NRWA to repay amounts paid for indirect costs in excess of the amounts allowed under OMB Circular A-122, Attachment A, Section D.2.

NRWA Response

NRWA did not agree with the finding and recommendations. NRWA believed that the implementation of the OIG's recommended cost allocation basis would cripple NRWA's ability to administer its subgrants and to continue as a nonprofit organization.

- NRWA is not required under OMB Circular A-122, Attachment A, Section D.2.e to allocate its indirect costs using the Modified Total Direct Cost (MTDC) allocation method.
- Under cost accounting principles, the Simplified Allocation Method is the most equitable allocation method for NRWA's indirect costs.
- NRWA's major business activity and major functions are administering hundreds of subgrants to implement necessary Federal programs; this major business activity is the primary cause of NRWA's indirect costs and it should be allocated its fair share of indirect costs. To do otherwise creates distortion.
- Not one of NRWA's subgrants is "major," and therefore none of them can properly be excluded from the cost base of NRWA's indirect cost allocation under A-122.

OIG Comment

Regarding the use of the MTDC allocation method, we have modified the finding to reflect the use of the Simplified Allocation Method and that NRWA is not required to use the MTDC allocation method. While the use of the Simplified Allocation Method may be acceptable, we do not agree that the costs of capital expenditures and major subcontracts and subawards can be included in the distribution base. NRWA does have major subcontracts and subawards that must be excluded. For the fiscal year ending February 28, 2005, NRWA had subawards of \$33,883,728 representing 88 percent of the total direct costs (\$38,396,200). Of the total subawards, \$33,780,568 (99.69 percent) were for Federal programs.

While OMB Circular A-122 does not define major subcontracts or subawards, 40 CFR 30.2 may provide criteria that could be used. 40 CFR 30.2 (ee) defines small grants or cooperative agreements as those not exceeding the small purchase

threshold fixed at 41 U.S.C. 403(11), which is currently \$100,000. 40 CFR 30.44(e)(2) defines small contracts as any procurement that does not exceed the small purchase threshold fixed at 41 U.S.C. 403(11). Under this criteria, all of NRWA's subawards and some of its subcontracts (e.g., white paper consultant, lobbyist), exceed the \$100,000 and would not be considered small.

NRWA has other major activities besides the Federal programs. For example, the Asset Management Program is a commercial venture that verifies the existence and condition of collateral for loans. For the fiscal year ending February 28, 2005, the program incurred total costs of \$1,081,633, of which \$103,160 was for subawards. Contrasted with Federal programs, NRWA incurred total costs of \$34,951,429, of which \$33,780,568 was for subawards. NRWA's other functions incur indirect costs and would benefit more than the Federal programs.

OMB Circular A-122 outlines only two methods for the allocation of indirect costs: Simplified Allocation Method and the Multiple Base Allocation Method. The introduction of the Cost Accounting Standards or other criteria used by Government auditors does not demonstrate the equitability of the Simplified Allocation Method. We believe that NRWA's accounting records demonstrate that its indirect costs do not benefit its major programs to the same degree. NRWA does have other direct activities aside from the Federal programs (e.g., AMP, annual conference, lobbying, white papers). According to NRWA's indirect cost rate proposal for the fiscal year ending February 28, 2005:

- NRWA's costs of subawards under Federal programs are 96 percent of the total costs compared to 3 percent on its other direct activities; and
- NRWA's total internal costs (direct costs less subawards) on Federal programs are 35 percent of the total internal costs on other direct activities.

Such a disparity in the cost amid its major direct activities indicates NRWA's indirect costs benefit its major activities in varying degrees. As a result, NRWA may need to prepare its indirect cost rates under the Multiple Base Allocation Method. Under OMB Circular A-122, Attachment A, Section D.3., the Multiple Base Allocation Method is used when an organization's indirect costs benefit its major functions in varying degrees. The Simplified Allocation Method is for an organization that has only one major function encompassing a number of individual projects or activities, and may be used where the level of Federal awards to an organization is relatively small. As demonstrated by the other direct activities, NRWA has more than one major function and its level of Federal awards, with active EPA grants of \$20,151,653, is not relatively small.

NRWA recovers the cost of administering the subawards in other methods besides indirect costs. The costs for the management of the subawards are direct costs to the grant. NRWA also charges state associations \$300 for each grant they receive.

In conclusion:

- NRWA does have major subcontracts and subawards that must be excluded from the distribution base.
- Although OMB A-122 does not define major subcontracts or subawards, 40 CFR 30.2 may provide criteria that can be used.
- NRWA has other major activities besides the Federal programs.
- NRWA's indirect costs benefit its major programs in varying degrees.

Chapter 3

NRWA's Procedure for Identifying Unallowable Costs Is Not Adequate

NRWA's procedures do not identify all unallowable costs. First, because NRWA does not have written procedures for reviewing costs, its current practice does not comply with OMB Circular A-122. Second, NRWA's practice of charging costs based upon the account(s) to which an employee is budgeted does not comply with OMB's definition of direct costs. Third, NRWA does not consistently record costs based upon the actual activity performed. Therefore, NRWA does not comply with its assertion that its cost allocation plan does not include unallowable costs.

NRWA Is Not Properly Identifying Unallowable Costs

NRWA is not adequately identifying its unallowable costs. For example, NRWA claims costs for its in-service training conference that are unallowable under OMB Circular A-122. The agenda for the 2004 in-service training included sessions pertaining to membership activities, fundraising, and lobbying that are unallowable under OMB Circular A-122, Attachment B. NRWA recorded in-service costs either as direct or indirect but did not identify any as unallowable. NRWA does not have written procedures as required under 40 CFR 30.21 (b)(6) for determining the reasonableness, allocability, and allowability of costs in accordance with the provisions of the applicable Federal cost principles and the terms and conditions of the award. Therefore, NRWA does not comply with its assertion that its cost allocation plan does not include unallowable costs.

NRWA is not properly identifying unallowable travel costs associated with lobbying. NRWA currently uses a formula to determine the percentage of travel costs to be allocated when lobbying occurs. The formula includes the number of hours charged on the timesheet for lobbying divided by the number of quarters spent on travel status. To be consistent, NRWA needs to divide the hours charged to lobbying by the total hours charged to the timesheet. For example, an employee spent 14 hours conducting lobbying activities out of a total of 40.5 hours worked while on travel status. This resulted in 25 percent of the employee's travel expenses being charged to lobbying, when 35 percent should have been charged based upon the computation shown in Table 3-1:

Table 3-1: Percentage of Travel Expenses Charged to Lobbying

	NRWA Method Computation	Allowable Computation Method
Hours lobbying per employee timesheet	14	14
Total hours	56	40.5
Basis for total hours	14 quarters on travel status multiplied by 4 hours per quarter	Total hours per employee timesheet
Percentage of employee travel expenses charged to lobbying (lobbying hours divided by total hours)	25 percent	35 percent

Sources: NRWA Method Computation is based on interviews with NRWA personnel along with timesheet and travel voucher samples. Allowable Computation Method is based on OIG analysis.

As a result, unallowable costs were understated and allocated to EPA grants.

NRWA Is Not Allocating Costs Properly

NRWA’s practice of charging costs based upon the account(s) to which an employee is budgeted does not comply with OMB’s definition of direct costs. OMB Circular A-122, Attachment A, Section B.1 defines direct costs as:

Direct costs are those that can be identified specifically with a particular final cost objective, i.e., a particular award, project, service, or other direct activity of an organization. However, a cost may not be assigned to an award as a direct cost if any other cost incurred for the same purpose, in like circumstance, has been allocated to an award as an indirect cost. Costs identified specifically with awards are direct costs of the awards and are to be assigned directly thereto. Costs identified specifically with other final cost objectives of the organization are direct costs of those cost objectives and are not to be assigned to other awards directly or indirectly.

NRWA’s practice is to charge an employee’s time and associated costs based upon how the employee is budgeted. This results in the cost of in-service training and annual conference being charged three different ways: (1) directly to Federal projects, (2) included in the indirect cost pool, or (3) identified to a cost center, as shown in Table 3-2.

Table 3-2: Cost Charging for In-Service Training and Conferences

Type of Cost	Method for Charging Costs to Grants
Labor and travel of staff who generally work directly on Federal grants	Direct
Labor and travel of executive and accounting staff	Indirect
Labor and travel of all other staff	Cost Center
All other costs of in-service training and conference	Cost Center

Sources: Interviews with NRWA personnel and analysis of the NRWA accounting data for the Fiscal Year Ending February 28, 2005.

According to OMB Circular A-122, a cost may not be charged as a direct cost if in similar circumstances it is also charged as an indirect cost. NRWA is charging the cost of the same activity; i.e., in-service training and conferences, as both a direct and indirect cost, which is not allowable.

NRWA’s allocation of cost centers also does not meet the requirements of OMB Circular A-122. Labor costs for the environmental engineers and State support staff are initially charged to a cost center and then allocated to the Federal programs using income from Federal grants as the basis. OMB Circular A-122, Attachment A, Section D describes allocation bases of MTDC or total direct costs (excluding capital expenditures and other distorting items, such as major subcontracts or subgrants) but not income. According to NRWA, it would be difficult to directly charge the labor costs for the environmental engineers and State support staff due to the fact that they can assist multiple Federal programs at once. OMB Circular A-122, Attachment A, Section C.1 defines indirect costs as “...those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.” As a result, the environmental engineers and State support staff should be allocated indirectly on a basis other than income.

NRWA Is Not Properly Recording Costs

NRWA does not always record costs based upon the actual activity performed. OMB Circular A-122, Attachment B, Section 8.m.(2)(a) states that accounting reports in support of labor costs must “... reflect an after-the-fact determination of the actual activity of each employee.”

We found that NRWA records travel and labor costs based on the cost account(s) to which an employee is budgeted, and not on the employee’s actual activity. We found 8 of 21 instances where travel and labor costs were charged indirectly, when the employee was performing work that could have benefited Federal programs or other direct cost objectives. See Exhibit 1 for a listing of the eight instances noted during our examination.

For example, one travel voucher identified the purpose of the trip as meetings with USDA staff in Washington, DC. Since the purpose of the trip benefited the USDA project, the associated costs would fit the OMB definition of a direct cost. None of the costs for the travel or the related labor were charged to the USDA grant. Instead the travel and labor costs were charged indirectly. As a result, indirect costs were overcharged and eventually allocated to nonbenefiting final cost objectives.

Recommendations

We recommend that the Director of the Grants Administration Division require NRWA to:

- 3-1. Establish written procedures to:
 - a. Identify unallowable costs that are in compliance with OMB Circular A-122.
 - b. Charge costs consistent with OMB Circular A-122's definition of direct and indirect costs.
 - c. Allocate costs on a basis other than income.
 - d. Record costs based upon actual activity.
- 3-2. Ensure only allowable costs are included in the indirect cost rates negotiated in connection with recommendation 2-1.
- 3-3. Submit revised financial status reports and ensure only allowable costs are included.

NRWA Response

NRWA did not agree with the finding and recommendations.

Identification of Unallowable Costs

NRWA agreed with OIG that the agenda for its 2004 meeting contained sessions that were labeled "membership activities," "fundraising," and "lobbying." However, these sessions were merely for information purposes and not dedicated to the membership activities, fundraising, and lobbying of NRWA itself. At most, these sessions could be considered as providing information to NRWA's member affiliates about *their* organizations and its mission. For example, the sessions labeled "fundraising" in the agenda concerned distributing information concerning fundraising to NRWA's member affiliates, not a forum for raising funds for NRWA.

Regarding the identification of unallowable travel costs associated with lobbying, the formula NRWA uses was put into place because it was deemed to be a logical means of allocating the costs, by quarters of travel time. NRWA believes that OIG's recommended method would create an unequitable result because utilizing the total hours of travel would cause lobbying to be charged on all travel time rather than just to the working hours of the employee.

Allocating Costs Properly

NRWA states that it is not charging the same costs as both direct and indirect. The costs being charged to indirect are the costs of travel and time for those individuals that are categorized as indirect. Their time and associated costs are not readily identifiable with a particular cost objective, and are therefore properly *not charged as direct costs* under OMB A-122. This is true of both the in-service and conference travel and time costs for indirect employees because their positions warrant them to engage in management activities for which it would be difficult to assign a benefit to a specific program.

Recording Costs Properly

NRWA also disagrees that the instances relied upon by OIG show that NRWA is not properly recording its costs. When an employee goes to Washington, DC, to visit with the agencies or even to visit with one agency, that employee will be talking with the agency about more than one program. For example, when the Deputy Chief Executive Officer visits with EPA, he will be talking about the Technical Assistance Program, Wellhead Program and the Source Water Program. He will speak to more than one person at a time. It would be very difficult to separately identify the benefits his time and travel provide to the functions, and NRWA accordingly treats these as indirect costs. Such treatment is expressly permitted under OMB Circular A-122 which provides that: "Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives."

OIG Comment

Identification of Unallowable Costs

In its response, NRWA states that the sessions pertaining to fundraising, membership activities, and lobbying provided information to NRWA's member affiliates. Any assistance provided to member affiliates to perform unallowable activities is also unallowable. For example:

- OMB Circular A-122 Section 17 states that costs incurred solely to raise capital are unallowable. One of the in-service training sessions entitled

Making Golf Pay was to provide members with information on how to maximize revenue from golf tournaments at State annual conferences. The training is associated with raising capital, and is therefore unallowable.

- OMB Circular A-122, Section 25 states that costs associated with administering, contributing to, and paying the expenses of a political action committee are unallowable. In-service training included a session on what is acceptable and how to involve staff and members in political action committees. The training was associated with an unallowable activity, and is therefore unallowable.

NRWA's formula to allocate travel expenses associated with lobbying activities does not use the actual hours worked as reflected on the employee's timesheet. The hours used are based on quarters in travel status which is not reflective of the actual hours the employee worked in a paid status, as shown in Table 3-1 on page 10.

Allocating Costs Properly

NRWA is not allocating costs properly. An employee who is budgeted as indirect charges his or her labor and travel expenses related to the inservice meeting to the indirect cost objective. An employee who is budgeted as direct will charge his or her labor and travel expenses for the same event to a direct cost objective. This is contrary to OMB Circular A-122, which states that if a cost is charged directly, other expenses for the same cost objective cannot be charged indirectly. In NRWA's case, labor and travel costs associated with the same training are charged both directly and indirectly. It is the OIG's opinion that all expenses related to inservice and conferences be charged to the respective cost centers and allocated on a basis other than income.

Recording Costs Properly

NRWA is not properly recording costs. NRWA stated it could not always identify the benefits to a specific grant. However, we found that NRWA's records did identify specific programs. For example, one travel voucher identified the purpose of the trip to be the USDA Source Water program, which is a direct activity in NRWA's accounting system. Therefore, the travel should have been allocated directly to the activity, rather than included in the indirect costs.

NRWA also stated that the costs identified in the report were minor amounts. We disagree. A random sample of 21 travel vouchers found 8 instances, with a total value of \$3,800, which should have been charged directly rather than included in the indirect cost pool. The sample items represented 46 percent of the total sample (\$8,220). The number of errors was significant and, if projected to the universe of travel costs, would have a material impact on the indirect cost pool.

Chapter 4

NRWA Is Not Complying with Federal Procedures When Making Cash Draws

NRWA is not complying with Federal procedures when making cash draws. First, NRWA does not have written procedures regarding the timing and amount of cash draws. Second, NRWA is basing its draws for the State associations upon budgeted amounts and not on actual expenditures. Thus, NRWA's current practice does not comply with EPA regulations. Because NRWA is distributing payments based on budgeted and not actual State associations' costs, it may be providing cash advances in excess of the State associations' immediate needs.

NRWA currently does not have written procedures in place which are required under 40 CFR 30.21. Administrative requirements, which include financial management systems and payments requested by grant recipients, are outlined in 40 CFR Part 30.21 and 30.22. 40 CFR 30.21 (b)(5) requires that a nonprofit grantee's financial management system contain:

Written procedures to minimize the time elapsing between the transfer of funds to the recipient from the U.S. Treasury and the issuance or redemption of checks, warrants or payments by other means for program purposes by the recipient.

40 CFR 30.22 (b) states that:

Cash advances to a recipient organization shall be limited to the minimum amounts needed and be timed to be in accordance with the actual, immediate cash requirements of the recipient organization in carrying out the purpose of the approved program or project. The timing and amount of cash advances shall be as close as is administratively feasible to the actual disbursements by the recipient organization for direct program or project costs and the proportionate share of any allowable indirect costs.

NRWA is basing cash payments to the State associations on its determined budget, not on actual expenditures. NRWA determines the monthly payments to be made to the State associations during its annual budget process. To determine the monthly payments, NRWA first determines the amount of funding it will need to meet its internal expenses to manage the grant program. Then NRWA distributes the remaining amount to the State associations in 12 monthly payments. At the end of the program year, the funds provided to the State associations are reconciled with the actual expenses. If a State association has excess cash, its future payments are reduced by the amount of excess funds.

During our review of cash management, we found an example where NRWA demonstrated the capability to make draws based on actual expenditures by the State associations. The EPA Vulnerability Assessment grant, H183105601, was set up by NRWA as a cost reimbursement with a maximum limit. NRWA's cash draws were based upon its own internal costs and invoices submitted by the State associations. As a result, the State associations have demonstrated the capability to provide actual costs to NRWA and that cash draws can reflect actual costs.

Recommendations

We recommend that the Director of the Grants Administration Division require NRWA to:

- 4-1. Develop written procedures for the preparation of cash draws. Any procedures should require NRWA to draw funds based upon actual costs and not budgeted amounts.

NRWA Response

NRWA does its best to comply with all Federal procedures and making cash draws is no exception. The cash draws are scheduled to be made at the first of each month. However, there are periods when there can be no cash draws because of the unavailability of funds through EPA. When such a period occurs, it generally begins in October and lasts as long as August of the following year.

OIG Comment

The availability of funds does not relieve NRWA from complying with U.S. Treasury draw procedures. During the audit exit conference, NRWA officials stated that it would be able to comply with U.S. Treasury regulation, if funding was available in a timely manner. Regarding the availability of funds, a review of the last grant awarded for each of the programs (training, ground water, and source water) indicate that funds were available shortly after award. A comparison of when funding was available and the project period does show that funds may not be available at the beginning of the project period, but the longest delay was 2 months. See table 4-1 for details.

Table 4-1: Comparison of Grant Award, Funding, and Project Dates

Amendment #	Date Awarded	Date Funding Available	Project Year Beginning	Amount Awarded
Training Grant T-83169601				
Original Award	05/26/2004	06/02/2004	05/1/2004	\$2,627,959
1	06/30/2005	07/01/2005	05/1/2005	\$4,943,986
2	02/15/2006	02/16/2006	05/1/2006	\$4,976,200
Ground Water Protection Grant X-683236101				
Original Award	07/13/2005	07/22/2005	07/1/2005	\$1,139,738
1	02/15/2006	02/17/2006	07/1/2006	\$4,976,200
Source Water Protection Grant X-83284401				
Original Award	01/18/2005	01/26/2006	01/1/2006	\$1,487,570

Sources: EPA's Integrated Grants Management System and EPA's Financial Data Warehouse.

Status of Recommendations and Potential Monetary Benefits

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
2-1	5	Obtain final negotiated indirect cost rates which exclude capital expenditures and major subcontracts and subawards from the allocation base.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
2-2	6	Revise the grant awards to reflect indirect costs based upon the rates negotiated in recommendation 2-1.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
2-3	6	Require NRWA to submit revised financial status reports to reflect indirect costs based upon the rates negotiated in recommendation 2-1.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
2-4	6	Upon completion of recommendation 2 and 3 above, require NRWA to repay amounts paid for indirect costs in excess of the amounts allowed under OMB Circular A-122, Attachment A, Section D.2.	U	Assistant Administrator, Office of Administration and Resources Management		\$2,021	-
3-1	12	Establish written procedures to: a. Identify unallowable costs that comply with OMB Circular A-122. b. Charge costs consistent with OMB Circular A-122's definition of direct and indirect costs. c. Allocate costs on a basis other than income. d. Record costs based upon actual activity.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
3-2	12	Ensure only allowable costs are included in the indirect cost rates negotiated in connection with recommendation 2-1.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
3-3	12	Submit revised financial status reports and ensure only allowable costs are included.	U	Assistant Administrator, Office of Administration and Resources Management		-	-
4-1	16	Develop written procedures for preparing cash draws. Any procedures should require NRWA to draw funds based upon actual costs and not budgeted amounts.	U	Assistant Administrator, Office of Administration and Resources Management		-	-

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

Exhibit 1

***Schedule of Incorrect Charging
Based Upon Sampling***

We present the schedule to show examples found during our statistical sampling of indirect travel costs, where the purpose of the trip was for Federal projects or benefited other direct activities, but the costs were recorded as indirect.

ACCOUNT TITLE	DATE	AMOUNT	COMMENTS
CEO Travel	7/20/2004	432.82	Purpose of the trip was for the USDA Agriculture Source Water Program which is a Federal program. NRWA established a separate cost account for this program.
Other Indirect Staff Travel	7/20/2004	643.92	Purpose of the trip was to attend the in-service training. NRWA established a separate cost center for in-service.
Deputy CEO Travel	2/17/2005	183.37	Purpose of the trip was to meet with the USDA and the EPA. NRWA has various separate cost accounts for USDA and EPA Federal programs.
President Travel Indirect	1/18/2005	99.00	Purpose of the meeting was to discuss EPA Federal programs. NRWA has various separate cost accounts for USDA and EPA Federal programs.
President Travel Indirect	3/25/2004	587.35	Purpose of the trip was the annual conference. NRWA has established a separate cost account for this activity.
Deputy CEO Travel	7/31/2004	12.00	Purpose of the trip was training for NRWA board of directors and to discuss Federal programs. NRWA has established separate cost accounts for the various Federal programs.
Deputy CEO Travel	7/8/2004	190.63	Purpose of the trip was a meeting regarding the fleet purchase program. The fleet purchase program is a direct activity.
CEO Travel	2/28/2005	1,651.33	The credit card statement included expenses for five separate trips. One trip was for lobbying purposes. Lobbying is not an allowable expense.

Source: NRWA travel documents.

Additional Details on NRWA

NRWA began as a group of eight States in 1976 to “improve the quality of life in rural areas and in small communities.” NRWA has evolved into a nonprofit federation consisting of 48 State associations representing 49 States. The State associations have water and wastewater system members in excess of 24,550. NRWA also has programs in developing countries. NRWA is the sponsoring organization for the International Rural Water Association, which shares the same location and phone number with NRWA in Duncan, Oklahoma.

NRWA has a board of directors that meets twice a year for the purpose of “determining direction and positions of the associations.” The board is made up of elected representatives from each of the member State associations. The State association representatives come from local rural systems. Idaho is currently the only State association that is not represented on the NRWA board of directors.

As of March 7, 2006, NRWA had three active EPA grants, as detailed in Table A-1. The purpose of these grants is for wellhead protection, source water protection, and technical assistance and training.

Table A-1: Summary of Active EPA Grants

Grant No.	Project Period	Total Grant Budget	Total Amount Awarded	Purpose of Grant
X683236101	7/1/2005 to 6/30/2008	\$15,591,428	\$6,115,938	Facilitate developing and implementing wellhead protection plans at the local community level.
X82384401	1/1/2006 to 12/31/2006	1,487,570	1,487,570	Facilitate developing and initially implementing source water protection plans at the local community level.
T83169601	5/1/2004 to 4/30/2007	16,134,800	12,548,145	Nationwide technical assistance training program to assist rural water system personnel in increasing their knowledge and skills in drinking water rural implementation, drinking water capacity development, and drinking water contamination prevention.
Totals		\$33,213,798	\$20,151,653	

Source: EPA's Integrated Grants Management System.

NRWA also receives funding from the USDA Rural Utilities Service. For the fiscal year ending February 28, 2005, NRWA received over \$23 million from the USDA Rural Utilities Service. NRWA receives funding from the USDA-Rural Utilities Service for:

- **Waste Water Technician:** Technical assistance and training in the 48 contiguous States and a full-time water technician in Puerto Rico for wastewater systems serving populations less than 10,000.
- **Circuit Rider:** Technical assistance to rural development eligible systems in operation and maintenance, treatment compliance, construction, financial management, general management, and board training.
- **Source Water Protection:** Assistance in implementing source water protection plans within selected States.

Details on Scope and Methodology

We performed our examination in accordance with the *Government Auditing Standards*, issued by the Comptroller General of the United States, and the attestation standards established by the American Institute of Certified Public Accountants. We conducted our fieldwork between April 3, 2006, and June 30, 2006.

We based our conclusions on applicable laws and regulations and, in part, on statistical sampling techniques used to identify unallowable outlays. We limited the testing to high risk indirect cost accounts. Since we considered direct costs to be a low risk area, we performed no statistical sampling for these direct costs.

We made site visits to NRWA's office in Duncan, Oklahoma, and included the following steps:

- Interviewed NRWA personnel to understand the internal controls related to the EPA grants, specifically State association expenses, labor, travel, FSR preparation, and cash draws.
- Reviewed NRWA's internal controls specifically related to our objectives, including State association expenses, labor, and travel.
- Performed tests of internal controls on indirect labor and indirect travel to determine whether they are in place and operating effectively.
- Reviewed the most recent single audit report to identify issues that may impact our examination.
- Performed analytical tests on vulnerable accounts identified through review of the chart of accounts.
- Performed analytical procedures on direct costs to comply with the standard for fraud and illegal acts.
- Designed sampling plan and sample steps to test vulnerable accounts.
- Selected samples, on a statistical basis, from indirect labor and indirect travel from March 1, 2004, to February 28, 2005.
- Selected cash draw samples on a judgmental basis, from draws from March 1, 2004, to February 28, 2005.
- Verified the source and accuracy of information NRWA used to prepare cash draw requests.

Our conclusion is based solely upon documentation NRWA provided based on our requests.

Prior Audit Coverage

The OIG Report No. 1998-S-00010, *National Rural Water Association Lobbying and Noncompetitive Contracting under Federal Assistance Agreements and Contracts*, issued on March 31, 1998, identified the following issues:

- (i) NRWA did not establish adequate controls to ensure that both direct and indirect lobbying costs were systematically identified and excluded from charges to Federal assistance agreements and contracts.
- (ii) NRWA improperly used earmarked Federal funds to influence the management of State associations and took specific actions which adversely affected the financial stability of some State associations.
- (iii) EPA and USDA allowed NRWA to award noncompetitive contracts to State associations contrary to Federal regulations.

The report recommended that:

- (i) NRWA develop and implement adequate internal controls that systematically identify and exclude from Federal participation all direct and indirect costs associated with NRWA's and the State associations' lobbying activities.
- (ii) NRWA quantify the dollar amount of all unallowable costs of lobbying activities that were improperly charged directly or indirectly to Federal assistance agreements and contracts.
- (iii) NRWA award all contracts on a competitive basis.

EPA Grants Administration Division contracted with Leon Snead & Company, P. C., to conduct a limited scope review of NRWA's financial management system. The review determined that the financial management system was adequate. The scope of the review did not include a determination of whether NRWA's indirect cost rate or its costing practices complied with OMB Circular A-122.

NRWA's Response

Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, NW
Washington, DC 20004
Tel. 202.739.3000
Fax: 202.739.3001
www.morganlewis.com

Morgan Lewis
C O U N S E L O R S A T L A W

Thomas Alan Schmutz
Partner
202.739.5484
tschmutz@morganlewis.com

October 26, 2006

BY EMAIL

Robert Adachi
Environmental Protection Agency
Office of the Inspector General
75 Hawthorne Street, 7th Floor (Mail Code IGA-1)
San Francisco, CA 94105-3901

Re: Draft Attestation Examination of Financial Management Practices of the National Rural Water Association, Duncan, Oklahoma

Dear Mr. Adachi:

Enclosed please find the comments of the National Rural Water Association (“NRWA”) on the Draft Attestation Examination of Financial Management Practices of the NRWA. Should you have any questions, please feel free to contact me at (202) 739-5484 or Joseph Lowell at (202) 739-5384.

Sincerely,

Thomas A. Schmutz

Thomas Alan Schmutz
Joseph W. Lowell
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, N.W.
Washington, DC 20004

Attorneys for the National Rural Water
Association

I. INTRODUCTION

NRWA thanks the EPA Office of Inspector General (“OIG”) for the opportunity to comment on the draft audit report (“OIG Report”). NRWA has found its collaboration with EPA over the years to be extremely productive in improving the nation’s water supply and waste management systems.

NRWA addresses all of the findings and recommendations of the OIG report below. Although NRWA disagrees with most of the OIG’s recommendations, NRWA is particularly concerned with OIG’s recommendation that NRWA should have to return \$2 million in grant money to the EPA. NRWA believes that OIG’s analysis is incorrect and that NRWA’s continued use of the Simple allocation method is the most appropriate method. NRWA’s comments are provided below.

II. CHAPTER 2 OF THE OIG REPORT

At the outset, NRWA must emphasize that implementation of the OIG’s recommended cost allocation basis would cripple NRWA’s ability to administer its subgrants and, indeed, to continue as a non-profit organization at all. Furthermore, OIG is simply wrong in suggesting that the Modified Total Direct Cost allocation method would produce an additional \$2 million that could be sub-granted. Instead, forcing NRWA to adopt OIG’s recommended cost allocation method would cripple NRWA and ensure that *no* additional funds are sub-granted.

In discussing its issues with Chapter 2 of the OIG’s Report, NRWA wishes to highlight the following points:

- NRWA is not required under OMB Circular A-122, Attachment A, Section D.2.e to allocate its indirect costs using the Modified Total Direct Cost (“MTDC”) allocation method.
- Under cost accounting principles, the Simplified allocation method is the most equitable allocation method for NRWA’s indirect costs.
- NRWA’s major business activity and major functions are the administration of hundreds of subgrants to implement necessary federal programs; this major business activity is the primary cause of NRWA’s indirect costs and it should be allocated its fair share of indirect costs. To do otherwise creates distortion.
- No one of NRWA’s subgrants is “major,” and therefore none of them can properly be excluded from the cost base of NRWA’s indirect cost allocation under A-122.

A. OMB A-122 Does Not Require the Use of the MTDC Allocation Method When an Organization Receives more than \$10 Million in a Fiscal Year

Respectfully, NRWA submits that OIG is mistaken in concluding that, pursuant to OMB A-122, NRWA must use the MTDC allocation method. OIG states that “[u]nder [Attachment A, Section D.2.e], when an organization receives more than \$10 million in funding directly from the Federal government in a fiscal year, the multiple allocation base method is used.” OIG Report at 3. However, the circular makes no mention of a \$10 million threshold that dictates the proper cost allocation method.

The section of A-122 that OIG relies upon for its finding that NRWA must use the Multiple allocation method is Attachment A, Section D.2.e., which does not require NRWA to use the Multiple allocation method. That section only requires that “[f]or an organization that receives more than \$10 million in Federal funding of direct costs in a fiscal year, a breakout of the indirect cost component into two broad categories, Facilities and Administration as defined in subparagraph C.3, is required...” NRWA has complied with this section, breaking out the indirect costs into the required categories, in its indirect cost proposals.

OMB A-122 does not have a “bright-line” test for determining the appropriate method of allocating indirect costs.⁴ The primary test for determining the appropriate allocation method instead involves a determination of whether the organization’s major functions benefit from its indirect costs to approximately the same degree, or whether the organization’s major functions benefit from its indirect costs in varying degrees.

NRWA notes that, over ten years ago, OMB *proposed* to revise A-122 to incorporate the limit OIG interprets it to contain now. In 1995, OMB proposed to revise A-122 to impose a \$10 million threshold. Attachment A, Section D.1.f, as worded, would have provided that “where the Federal funding covered by this Circular of an organization does not exceed \$10 million in a fiscal year, the organization can use one of the three allocation methods herein described as: simple, multiple or direct allocation method.” See Office of the Management and Budget, Cost Principles for Non-Profit Organizations; Proposed Revisions, 60 Fed. Reg. 52522, 52523 (Oct. 6, 1995). Further, Section D.1.g provided that “where the Federal funding covered by this circular exceeds \$10 million in a fiscal year, the organization shall use the multiple allocation method.” See id.

⁴ NRWA notes that interpreting OMB A-122 as containing a bright-line, \$10 million threshold for use of the MTDC would be at odds with the purpose of OMB A-122. The circular specifically provides: “[t]he [OMB A-122] principles are designed to provides that the Federal Government bear its fair share of costs except where restricted or prohibited by law. The principles do not attempt to prescribe the extent of cost sharing or matching on grants, contracts, or other agreements. However, such cost sharing or matching shall not be accomplished through arbitrary limitations on individual cost elements by Federal agencies.” See OMB A-122.1.

In 1998, however, OMB issued its final version of A-122 that removed the \$10 million threshold found in the 1995 version. OMB explained that “the Circular is revised to allow the use of the current three allocation methodologies for all non-profit organizations.... [the multiple allocation basis] is not a requirement for non-profit organizations and remains one of the three available methodologies in the Circular for computing indirect costs.” See Office of the Management and Budget, Final Revision of OMB Circular A-122, “Cost Principles for Non-Profit Institutions,” 63 Fed. Reg. 29794, 29797 (Jun. 1, 1998).

In A-122’s current state, as last substantively revised in 2004, there remains no threshold on using the Simplified allocation method.⁵ See Office of the Management and Budget, Revisions to OMB Circulars A-21, A-87 and A-122, 69 Fed. Reg. 25970 (May 10, 2004). This version supersedes all others. See id. As a result, NRWA is not required by A-122 to use the Multiple allocation method because it receives more than \$10 million in funding directly from the federal government in a fiscal year.

B. NRWA May Use the Simplified Allocation Method

Under A-122, the primary test for determining the appropriate allocation method instead involves a determination of whether the organization’s major functions benefit from its indirect costs to approximately the same degree, see A-122, Attachment A, Section D.1.a., or whether the organization’s major functions benefit from its indirect costs in varying degrees. See A-122, Attachment A, Section D.1.b. Because all of NRWA’s major functions benefit from its indirect costs to the same degree, NRWA is expressly permitted by A-122 to use the Simple allocation method. See A-122, Attachment A, Section D.1.A.

1. NRWA’s Major Functions Benefit from its Indirect Costs to Approximately the Same Degree

OMB A-122, Attachment A, D.1.d. explains that the determination of what constitutes an organization’s major functions will depend on its purpose in being; the types of services it renders to the public, its clients and its members; and the amount of effort it devotes to such activities as fundraising, public information and membership activities.

NRWA’s purpose in being is to operate a non-profit organization made up of state rural water associations which are all concerned with the distribution of adequate water to rural areas

⁵ The last substantive change to A-122 occurred in 2004; however, in 2005, OMB relocated A- 122 to the Code of Federal Regulations. See Office of the Management and Budget, Relocation of policy guidance to 2 CFR Chapter II, 70 Fed. Reg. 51927 (Aug. 31, 2005).

and the promotion of clean water. NRWA accomplishes its purpose in being through funds awarded by federal grants, part of which are awarded pursuant to the Safe Water Drinking Act.

The only business activities NRWA performs outside of those relating to the subgrants it administers are those characteristic of any association and are activities related to its annual conference, rally, magazine and membership. As concerns the subject matter of this audit, these association-type expenses are funded individually through their own activity, and indirect costs are charged to them.

Over the years 1999-2004, which are the subject of the OIG Report, NRWA administered 118 subgrants pursuant to EPA grants alone (not including its United States Department of Agriculture grants) to its member affiliates. These 118 subgrants over that time period totaled \$43,430,839.54 in federal funds. NRWA also administers 244 subgrants, pursuant to the USDA grants. With continuing obligations to administer over three hundred subgrants, it can safely be said that NRWA's indirect costs benefit its major functions to approximately the same degree.

2. NRWA's Indirect Costs Are Created by the Administration of the Subgrants

NRWA's major functions of administering hundreds of subgrants under the federal programs creates NRWA's costs. The federal grant programs mentioned above share a common purpose of improving the quality of water management at a local level. NRWA, consisting of 25,735 members, most of which are rural and small community water and wastewater systems throughout the United States, is perfectly suited to assist in achieving the objectives of these federal grant programs. NRWA prepares grant proposals and then distributes the funds NRWA is awarded to its members for the purposes of achieving the overall objectives of the grant. While NRWA does not actually perform the subgrants for its affiliate members, NRWA assists each of its members to implement each subgrant, thereby ensuring that the grant's objectives are met.

NRWA's assistance to its affiliate members takes the form of training specialists in each program to implement the technical aspects of each grant's program, monitoring each subgrantee's progress in meeting the program's objectives, and monitoring to ensure that each subgrantee's financial accounting procedures conform to the terms of the government grant. NRWA's role in assisting its members implement each subgrant is therefore an ongoing one.

NRWA's role in implementing each subgrant associated with an EPA program is documented in each of the grant agreements NRWA has with the EPA. As already mentioned, NRWA has three active EPA grants: (1) Wellhead protection; (2) Sourcewater; and (3) Technical Assistance Training. NRWA repeats some of the EPA-approved, continuing obligations of NRWA under the grant agreements here:

Drinking Water Technical Assistance Training Program for Small and Rural Water System Personnel:

- NRWA develops and administers 20 hours of upgrade training to include a minimum of 12 hours of specialized training and 8 hours of cross training.
- NRWA develops and provides performance procedure manuals.
- NRWA monitors to ensure each state conducts an annual critical needs symposium in order to develop an operating plan that meets the objectives of the grant.
- NRWA provides quarterly reports 30 days after the end of the reporting period to include:
 - Personnel changes;
 - Number of personnel and number of sessions of classroom and on-site training that covers Rule Implementation, Contamination Prevention, and Capacity Development; and
 - Number of hours of training support.
- NRWA conducts orientation training to any new project specialists hired during the project year.

Source Water Protection:

- NRWA provides the 13 selected states with letters notifying them of their selection;
- NRWA provides the EPA Project Officer with the names of the personnel hired by their state affiliate offices for these 13 positions;
- NRWA notifies the Project Officer of any changes in personnel during the project year;
- NRWA provides orientation training to any new project specialists hired during the Project Year, and provides all specialists training on the new NRWA/EPA cooperative agreement.
- NRWA submits quarterly performance/cost reports to the EPA Project Officer within 30 days after the end of each reporting period;
- NRWA compiles monthly progress reports submitted by the Specialists and provides these to the EPA Project Officer at the same time as the quarterly reports.

Wellhead Protection Program:

- NRWA develops and provides performance procedure manuals.

- NRWA monitors to ensure each state conducts an annual forum in order to develop an operating plan that meets the objectives of the grant.
- NRWA conducts orientation training to any new project specialists hired during the project year.

NRWA's indirect costs must be allocated to a cost base that includes the subgrants, to provide support for implementation of the subgrants. *NRWA's major functions create the indirect costs in the first place.* It is simply impossible to administer so many subgrants without incurring the indirect costs of NRWA.

C. NRWA Does Not Have Any Major Subcontracts

OIG acknowledges the possibility of the simplified allocation method for NRWA, but OIG claims that "subawards should never have been included in NRWA's distribution base because, under the simplified allocation method, the distribution base may be total direct costs (excluding capital expenditures and other distorting items, such as major subcontracts or subgrants), direct salaries and wages, or other base which results in an equitable distribution." OIG Report at p. 4 n.4.

NRWA disagrees. OIG's reasoning presupposes that the subgrants administered by NRWA fall into the category of costs under OMB A-122 that are "distorting items, such as major subcontracts or subgrants." See A-122, Attachment A, Section D.2.c. Apparently, OIG considers the scores of small subgrants, which require extensive oversight, to each be a "major subcontract." OIG does not explain, however, by what measure it concludes that the NRWA's subgrants are "major." OIG also does not address whether and to what extent NRWA's subgrants are "distorting items," although under the plain wording of OMB A-122, the only subgrants that can be affirmatively excluded from the total cost basis are major subcontracts that distort the cost base.

OMB A-122 does not define the terms "major subcontract or subgrants." "distorting items," or "equitable distribution."⁶ In addition, the applicable EPA regulations and NRWA's cooperative agreements and grants with the EPA do not define these terms.

What OIG overlooks is that NRWA does not have any major subcontracts or subgrants. OIG is wrong in suggesting that NRWA must exclude *all* of its subgrants from its total direct cost basis. As shown on the attachment included with response, the subgrants from NRWA to a member affiliate in each year are practically identical to each other. No single subgrant is

⁶ In fact, OMB issued the initial version of A-122 with no comment on these terms. Nor do the other OMB Circulars in place at the time, addressing cost principles for educational institutions and governments, illuminate what is meant by major subcontracts or subgrants.

significantly larger, or “major,” relative to any other subgrant. In fact, the total amount of subgrants received by a member affiliate from NRWA is only approximately 2% of the total amount of subgrants received by all member affiliates from NRWA.

D. NRWA’s Inclusion of the Full Cost of its Subgrants in the Distribution Base is Equitable and Consistent with Basic Cost Accounting Principles

Although OMB A-122 does not provide significant guidance on identifying distortion in a cost base and using a cost base that achieves an equitable distribution of indirect costs, government auditors have addressed these issues in applying the Cost Accounting Standards (“CAS”) in reviewing government contract costs. CAS 410 and 418 are the primary accounting principles governing the recovery of indirect cost in government contracting. CAS 410(d) addresses the proper cost input base for allocating General and Administrative (“G&A”) expenses in government contracts and is analogous to OMB A-122, Attachment A. Like OMB A-122, CAS 410(d) governs the allocation of indirect costs related to the appropriate cost base. Also like OMB A-122, CAS 410(d) requires the removal of subcontract costs from the total cost base when the subcontract costs would create a distortion. Specifically, CAS 410(d) provides:

(d) The cost input base used to allocate the G&A expense pool shall include all significant elements of that cost input which represent the total activity of the business unit. The cost input base selected to represent the total activity of a business unit during a cost accounting period may be: total cost-input; value-added cost input; or single element cost input. The determination of which cost input base best represents the total activity of a business unit must be judged on the basis of the circumstances of each business unit.

(1) A total cost input base is generally acceptable as an appropriate measure of the total activity of a business unit.

(2) Value-added cost input shall be used as an allocation base where inclusion of material and subcontract costs would significantly distort the allocation of the G&A expense pool in relation to the benefits received, and where costs other than direct labor are significant measures of total activity.

CAS 410(d)(2) thus requires that material and subcontract costs be removed from the total distribution base - resulting in a “value-added” cost input base - when the inclusion of such costs would “significantly distort” the total activity of a business unit.

In the explanatory comments accompanying the promulgation of CAS 410, it is clear that the overriding purpose of CAS 410(d)(2) is to arrive at the most equitable distribution of indirect costs over direct costs. In the explanatory comments, the Armed Services Board of Contract Appeals (“ASBCA”) described CAS 410 as “based on the concept of full-costing of final cost objectives” and requiring that “the allocation base which a contractor selects should include all significant elements of cost input necessary to represent the total activity.” Under CAS 410, that cost input base which “best represents” a contractor’s “total activity” will or should result in allocations of G&A expense to contracts based on their causal or beneficial relationship. See Ford Aerospace & Communications Corp., ASBCA 23833, 83-2 BCA ¶ 16,813 (1983). The standard contemplates that the base that “best represents total activity” will be the one which most closely and realistically approximates or represents the “beneficial or causal” relationship between G&A and final cost objectives. See id.

Choosing the appropriate cost base over which to allocate indirect costs is therefore a matter of including costs reflective of the organization’s business activities. As the Defense Contract Audit Agency (“DCAA”) Director’s Letter to National Security Industrial Association on CAS 410 Implementation, ¶ 20,040 (March 17, 1987) explains:

The standard allows any one of the three bases as long as that base best represents the total activity of the business unit. This decision process is subjective, and involves a judgment as to whether certain cost elements cause distortions in allocating G&A to final cost objectives. However, because there is not a close relationship between true G&A expense and elements of the base, it is often very difficult to prove distortion.

Although the standard does not define what a distortion is, judgments can be made to try to arrive at reasonable interpretations of when a contractor’s business contains activities that are significantly different from their main activities. However, recognition must be given to the reality that the concept of a perfect base that reflects a business’ total activity is almost always theoretical.

To assist auditors in applying CAS 410, the Cost Accounting Standards Working Group issued Working Paper 78-21 (“W.G. 78-21”), which provided examples of distortion. Once a distortion is identified, the Working Paper suggested that the CAS Board’s published materiality criteria may be helpful in determining whether the distortion is “significant.” An example of distortion from the Working Paper is:

Government-furnished components. The Government may furnish engines in its contract for aircraft. Similar aircraft are sold to commercial customers, but the contractor issues subcontracts for the engines, including engine costs as part of the price. The same general management and administration of the business unit as a whole exists whether the customer furnishes the components or not. Consequently, including the component costs would significantly distort the results of using a total cost input base. Assuming no other circumstances of the contractor's activity would mitigate satisfaction of the standard's criteria for use of a value-added base, exclusion of material and subcontract costs would probably eliminate the distortion (the standard does not permit exclusion of engine costs only).

In the "Government-furnished components" example, the distortion arises because the cost of the engine has no impact on the contractor's general and administrative costs. The contractor's business activity is primarily one of integrating components, including the engine, into a final product – the aircraft. The contractor's business activity does not extend to playing a significant role in creating the component itself. Thus, regardless of whether the cost of the engine is nothing, because the Government supplies the engine for free, or whether the cost of the engine is considerable, and the customer must pay for it as part of the contract price, the contractor's G&A costs remain the same. However, allocating the contractor's G&A costs over a total cost base that includes the price of a contract where the customer must pay for the cost for acquiring the engine results in distortion because the base is not representative of the contractor's business activity.

The result would undoubtedly be different in the first example if the contractor's business activity included a more active role in acquiring the component, rather than simply integrating it into a final product. For example, greater supervision and management of a contract would be required where the contractor had to manufacture the engine itself. In that scenario, the contractor's G&A expense could be expected to vary with the cost of the component, and allocating the G&A expense over the total cost base would not create distortion.

In sharp contrast to the CAS Working Paper example, NRWA explained above how its indirect costs, including primarily general and administrative expenses, are caused by the continuing implementation of the subgrants. In fact, NRWA's primary business activity over any relevant time period is the administration of the subgrants. Thus, to include the costs of the subgrants in NRWA's total cost base results in an equitable distribution of indirect costs over the business activities that create them. Unlike the contractors in the distortion example provided by the CAS Working Group, NRWA is involved in many facets in the successful completion of the

subgrants with its member affiliates. NRWA does not simply distribute the grant funds and “walk away.” Instead, NRWA substantially supervises the successful completion of the objectives of the subgrants. There is therefore little chance of distortion. Indeed, to exclude the subcontracts misrepresents NRWA’s business activities and thereby creates distortion in itself.

III. CHAPTER 3 OF THE OIG REPORT

A. NRWA’s Identification of Unallowable Costs

OIG claims that NRWA’s procedures do not identify all unallowable costs. In particular, OIG states that NRWA is not adequately identifying its unallowable costs, and, as an example, OIG states that “NRWA’s agenda for the 2004 in-service training included sessions pertaining to membership activities, fundraising and lobbying that are unallowable under OMB Circular A-122, Attachment B.” OIG Report at p. 7.

NRWA believes its procedures for identifying unallowable costs are adequate. While NRWA is open to discussions concerning how its procedures can be made better, OIG’s example of the 2004 in-service training does not show that NRWA is including unallowable costs. The costs related to that training are, in fact, allowable under OMB A-122.

NRWA agrees with OIG that the agenda for its 2004 meeting contained sessions that were labeled “membership activities,” “fundraising,” and “lobbying.” However, these sessions were merely for information purposes and not dedicated to the membership activities, fundraising and lobbying of NRWA itself. At most, these sessions could be considered as providing information to NRWA’s member affiliates about *their* organizations and its mission. Again, these sessions are strictly informational, and are not the acts of NRWA’s membership activities, fundraising or lobbying. Informational type training is specifically allowable under OMB Circular A-122.

NRWA does allocate the costs of the 2004 in-service training meeting to the federal programs, since this is a requirement of the programs. In addition, it is allocated to the non-federally funded programs, which include costs for legislative and other non-federal unallowable costs.

NRWA addresses each category identified by OIG separately below:

1. Fundraising

With respect to fundraising, OMB A-122 provides the following: “(a) Costs of organized fund raising, including financial campaigns, endowment drives, solicitation of gifts and bequests, and similar expenses incurred solely to raise capital or obtain contributions are unallowable. (b)

Costs of investment counsel and staff and similar expenses incurred solely to enhance income from investments are unallowable. (c) Fund raising and investment activities shall be allocated an appropriate share of indirect costs under the conditions described in subparagraph B.3 of Attachment A.” See OMB A-122, Attachment B.17.

NRWA respectfully submits that OIG has misinterpreted the agenda item labeled “fundraising” as a forum for NRWA to conduct fundraising. What the sessions in the meeting concerned was disbursing information concerning fundraising to NRWA’s member affiliates, not a forum for raising funds for NRWA. The session provided information to NRWA’s member affiliates about how *they* might engage in fundraising.

The Circular does not make the costs of information disbursement unallowable. In any event, the costs of conducting the 2004 meeting sessions regarding fundraising were not costs to NRWA of raising funds for itself, or otherwise “expenses incurred solely to raise capital or obtain contributions.”

2. Membership activities

NRWA’s agenda included a session at the 2004 meeting that was strictly informational in context and not a membership activity service performed by NRWA for its members. OMB A-122 provides that only the following “membership” activities are unallowable: “[c]osts of membership in any country club or social or dining club or organization are unallowable.” See OMB A-122, Attachment B.30. NRWA’s 2004 meeting sessions were not related to such costs.

In any event, OMB A-122 provides a number of examples of *allowable* membership activities. Specifically, OMB A-122, Attachment A, provides: “The costs of activities performed primarily as a service to members, clients, or the general public when significant and necessary to the organization’s mission must be treated as direct costs whether or not allowable and be allocated an equitable share of indirect costs. Some examples of these activities include:

- a. Maintenance of membership rolls, subscriptions, publications, and related functions.
- b. Providing services and information to members, legislative or administrative bodies, or the public.
- c. Promotion, lobbying, and other forms of public relations.
- d. Meetings and conferences except those held to conduct the general administration of the organization.
- e. Maintenance, protection, and investment of special funds not used in operation of the organization.
- f. Administration of group benefits on behalf of members or clients, including life and hospital insurance, annuity or retirement plans, financial aid, etc”.

As NRWA's session at the 2004 meeting did not fall into any of the unallowable cost categories, and were actually only informational to NRWA's state affiliates, it is incorrect to conclude on the basis of their occurrence that NRWA does not properly identify unallowable costs.

3. Lobbying

OIG discusses lobbying both as potentially an unallowable cost incurred at the 2004 in-service training meeting and as an unallowable travel cost of NRWA. NRWA disagrees with these findings.

The 2004 meeting sessions referred to as "lobbying" were, like the other two categories of costs discussed above, for informational purposes. The costs to provide these sessions did not meet the criteria of unallowable lobbying costs, which OMB A-122 defines as:

- (1) Attempts to influence the outcomes of any Federal, State, or local election, referendum, initiative, or similar procedure, through in kind or cash contributions, endorsements, publicity, or similar activity;
- (2) Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections;
- (3) Any attempt to influence: (i) The introduction of Federal or State legislation; or (ii) the enactment or modification of any pending Federal or State legislation through communication with any member or employee of the Congress or State legislature (including efforts to influence State or local officials to engage in similar lobbying activity), or with any Government official or employee in connection with a decision to sign or veto enrolled legislation;
- (4) Any attempt to influence: (i) The introduction of Federal or State legislation; or (ii) the enactment or modification of any pending Federal or State legislation by preparing, distributing or using publicity or propaganda, or by urging members of the general public or any segment thereof to contribute to or participate in any mass demonstration, march, rally, fundraising drive, lobbying campaign or letter writing or telephone campaign; or
- (5) Legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when such activities are carried on in support of or in knowing preparation for an effort to engage in unallowable lobbying.

To reiterate, NRWA does allocate the costs of the in-service training to the federal programs, since this is a requirement of the programs. It is also allocated to the non-federally funded programs, which are the costs for legislative and other non-federal unallowable costs.

NRWA also disagrees with OIG's finding that NRWA is improperly identifying unallowable travel costs associated with lobbying. The formula currently being used by NRWA to allocate any lobbying costs associated with travel was put into place because it was deemed to be a logical means of allocating the costs, by quarters of travel time. NRWA believes that OIG's recommended method would create an inequitable result because utilizing the total hours of travel would cause lobbying to be charged on all travel time rather than just to the working hours of the employee.

B. NRWA Is Allocating Costs Properly

OIG claims that NRWA's practice of charging costs based upon the account(s) to which an employee is budgeted does not comply with OMB's definition of direct costs.

NRWA's practice is to charge an employee's time and associated costs based upon how the employee is budgeted.

OIG claims that costs are being charged by NRWA, particularly with respect to the in-service training and conferences, as both a direct and an indirect cost. However, NRWA does not charge these same costs as both direct and indirect. The costs being charged to indirect are the costs of travel and time for those individuals that are categorized as indirect. Their time and associated costs are not readily identifiable with a particular cost objective, and are therefore properly *not charged as direct costs* under OMB A-122. This is true of both the in-service and conference travel and time costs for these individuals because their positions warrant them to engage in management activities for which it would be difficult to assign a benefit to a specific program. They engage in all aspects of their duties while attending the in-service and the conference. For example, while attending in-service training, the Deputy CEO and the CEO will be speaking with State Affiliate Executive Directors regarding their associations or employees, but at the same time they will use their time to engage with agency personnel attending the function or they will also be managing NRWA employees at NRWA's headquarters office.

C. NRWA Is Properly Recording Costs

OIG states that NRWA is not properly recording costs based upon the actual activity performed. NRWA disagrees. NRWA also disagrees that the instances relied upon by OIG show that NRWA is not properly recording its costs.

Several employees within NRWA have associated costs that have been identified as indirect costs because their functions deal with all of NRWA's activities. Such activities can include not just the In-Service and Conference but the general activities of the NRWA as well. When these individuals in particular participate in the in-service training or the conference, they will be there as a manager for the event, but will also be there to discuss with various people, agency people in particular, about the programs NRWA has through their particular agency. It is very difficult to determine the time spent on each activity, and that is the reason for their submission to the indirect cost pool.

With respect to their time spent in DC with federal agencies, NRWA employees will make multiple visits when in DC. When an employee goes to DC to visit with the agencies or even to visit with one agency, that employee will be talking with the agency about more than one program. For example, when the Deputy CEO visits with EPA, he will be talking about the Technical Assistance Program, Wellhead Program and the Source Water Program. He will speak to more than one person at a time. It would be very difficult to separately identify the benefits his time and travel provide to the functions, and NRWA accordingly treats these as Indirect costs. Such treatment is expressly permitted by OMB Circular A-122 which provides that: "Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives." NRWA is consistent in the accounting of its costs and considers these charges minor in the scope of all the programs and costs.

As for NRWA's lobbying activities, any use of time or travel for lobbying is separated from the Indirect cost pool and charged against our Non-federal funds, such as Membership and Conference. This is true for any staff or board members that participate in lobbying during board meetings or direct activity.

IV. CHAPTER 4 OF THE OIG REPORT

NRWA does its best to comply with all Federal procedures and making cash draws is no exception. The cash draws are scheduled to be made at the first of each month. However, there are periods when there can be no cash draws because of the unavailability of funds through EPA. When such a period occurs, it generally begins in October and lasts as long as August of the following year. This constitutes a period of 11 months when the state associations are using their own funds for the expense of the programs and being reimbursed when funds are available for draws. For many of the state associations this in itself poses a financial burden, i.e., having to fund 3 programs for 11 months with no funds coming in. And, for some state association, it is financially impossible. At the end of this 11 month period, a total of \$3,313,231.90 for Training and \$2,951,392.11 for Wellhead was drawn down. Of these totals, \$3,227,731.01 for Training and \$2,842,359.63 for Wellhead were dispersed to the state associations for expenses they had

incurred during this period. The state associations not only have to utilize their own funds during this period of delay in funding, but they must also utilize their own funds to help support the programs. The following table shows the amounts the state associations have contributed:

	2004	2005	2006
Groundwater	139,486.36	44,354.48	171,976.46
Training	425,160.06	489,389.77	584,416.88
Source Water	107,635.28	62,673.00	

Not receiving the funds on a timely manner in itself poses a problem in complying with the grants and meeting the requirements. In order to make sure the grant requirements are continually met, NRWA will have to lend funds to some states to assure these requirements are met and nothing falls behind.

Therefore, having the state associations “bill” NRWA for their expense each month is really not a valid option. In that situation, there would be no funds available for NRWA to draw down and forward to the state associations. With the current status of a delay in funding, NRWA is funding the state associations after they have incurred the expense.

V. CONCLUSION

For the reasons stated above, NRWA disagrees with OIG’s conclusions and recommendations in its Report. In particular, it is important to emphasize the great harm to NRWA that would be caused by implementation of the MTDC indirect cost methodology. NRWA believes its existing methodology is the appropriate one and is consistent with OMB A-122. NRWA thanks OIG for this opportunity to comment on the draft audit report.

Sincerely,

Thomas A. Schmutz
Thomas Alan Schmutz
Joseph W. Lowell
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 739-5484/5384

Attorneys for the National Rural Water
Association

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