



U.S. ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Quick Reaction Report

Costs Claimed under EPA Grants XP96909501 and XP97963701 Awarded to the Washoe County Department of Water Resources, Nevada

Report No. 09-2-0011

October 20, 2008



Report Contributors:

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Abbreviations

CFR	Code of Federal Regulations
EPA	U.S. Environmental Protection Agency
FSR	Financial Status Report
Grantee	Washoe County Department of Water Resources
OIG	Office of Inspector General
OMB	Office of Management and Budget
Region	Environmental Protection Agency Region 9
SAAP	Special Appropriation Act Project
USGS	U.S. Geological Survey

Cover photo: Lemmon Valley Project. (Picture taken by OIG staff in February 2008)



At a Glance

Catalyst for Improving the Environment

Why We Did This Review

The U.S. Environmental Protection Agency (EPA) Office of Inspector General is reviewing Special Appropriation Act Project (SAAP) grants to identify issues warranting further analysis. We selected Washoe County Department of Water Resources (grantee) for one of these reviews.

Background

The grantee received two SAAP grants from EPA Region 9. Grant XP96909501 was to replace private water supply wells with community public water supply services. Grant XP97963701 was for a nitrate remediation pilot project. These grants provided the grantee with \$2,067,700 in Federal assistance.

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/2009/20081020-09-2-0011.pdf

Costs Claimed under EPA Grants XP96909501 and XP97963701 Awarded to the Washoe County Department of Water Resources, Nevada

What We Found

The grantee did not meet financial management requirements specified by Federal policy and regulations. In particular, the grantee:

- Claimed indirect costs without approved rates or cost allocation plans;
- Charged estimated labor costs to the grants without adjusting to actual costs;
- Claimed fringe benefit costs that were not based on approved rates or a cost allocation plan;
- Procured sole source contracts without cost analysis;
- Claimed contract costs under one grant that were not allocable; and
- Claimed unallowable interest expenses.

Because of these issues, EPA will need to recover \$291,494 in questioned costs under the two grants. As of September 2008, Region 9 had recovered \$26,774 of the questioned costs from the grantee. The grantee also needs to strengthen its internal controls.

What We Recommend

We recommend that EPA Region 9's Regional Administrator:

1. Disallow and recover the remaining uncollected balance of the \$291,494 questioned if the grantee is unable to provide documentation that meets appropriate Federal financial management requirements.
2. Require the grantee to establish procedures to ensure that it: (a) charges labor and benefit costs to the Federal grants in accordance with Federal policy; (b) conducts procurement in accordance with Federal regulations; (c) properly identifies unallowable costs and excludes them from billings to the Federal Government; (d) limits cash draws for Federal grants to actual disbursements; and (e) pays contract costs charged to Federal grants in accordance with contract terms and conditions.



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

October 20, 2008

MEMORANDUM

SUBJECT: Costs Claimed under EPA Grants XP96909501 and XP97963701
Awarded to the Washoe County Department of Water Resources, Nevada
Report No. 09-2-0011

FROM: Robert K. Adachi 
Director of Forensic Audits

TO: Wayne Nastri
Regional Administrator
EPA Region 9

This report contains a time-critical issue the Office of Inspector General (OIG) identified. This report represents the opinion of the OIG and does not necessarily represent the final position of the U.S. Environmental Protection Agency (EPA). EPA managers will make final determinations on matters in this report.

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 \$144,657.

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 recipient. Your proposed decision is due in 120 days, or on February 17, 2009. To expedite the resolution process, please e-mail an electronic version of your proposed management decision to adachi.robert@epa.gov.

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 have any questions, please contact me at (415) 947-4537 or at the e-mail address above.

Purpose

The Office of Inspector General (OIG) is reviewing Special Appropriation Act Project (SAAP) grants to identify issues warranting further analysis. This process includes reviewing the total project costs incurred by selected SAAP grant recipients. During our review of the SAAP grants awarded to the Washoe County Department of Water Resources (grantee), we identified the following condition that we believe requires immediate attention. The grantee did not meet financial management requirements specified by Office of Management and Budget (OMB) Circular A-87, Title 40 Code of Federal Regulations (CFR) Part 31, and EPA policy.

Background

The grantee received two SAAP grants from the U.S. Environmental Protection Agency (EPA) Region 9 (Region). Grant XP96909501 was awarded on September 30, 2004, to replace private water supply wells with community public water supply services to Lemmon Valley (Lemmon Valley grant). Grant XP97963701 was awarded on September 30, 2003, for a nitrate remediation pilot project in the Spanish Springs Valley (Spanish Springs grant). Total funds awarded under the two grants are \$2,067,700. EPA is responsible for 55 percent of the eligible project costs; the grantee is responsible for the remaining 45 percent.

The grantee reported total outlays of \$3,260,089 under the two grants as of the period ended September 30, 2007. Table 1 below provides basic information about the grants.

Table 1: Grant and Outlay Summary			
Grant Number	XP96909501 (Lemmon Valley)	XP97963701 (Spanish Springs)	Totals
Awarded Amount	\$1,300,100	\$767,600	\$2,067,700
Project Period	08/01/04 to 06/30/09	10/01/03 to 10/31/08	
Total Outlays Reported	\$2,189,366	\$1,070,723	\$3,260,089
EPA's Share (55%)	\$1,204,151	\$588,898	\$1,793,049
Grantee's Share (45%)	\$985,215	\$481,825	\$1,467,040

Sources: The information is from the grant award documents and *Financial Status Reports*.

Scope and Methodology

We conducted this audit in accordance with generally accepted government auditing standards, except we did not obtain an understanding of the information systems. Our results were based on the output data from the information systems provided by the grantee and our verification of these data to the corroborating documents, such as cancelled checks and vendor invoices. The generally accepted government auditing standards require that we plan and perform the audit to obtain sufficient, appropriate evidence

to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We conducted our fieldwork between February 25, 2008, and September 4, 2008. We made a site visit to the grantee and performed the following steps:

- Conducted a tour of the facilities;
- Obtained and reviewed grantee support for the cumulative amounts reported for the period ended September 30, 2007, including the grantee's electronic accounting records and the supporting payroll reports, invoices, cancelled checks, contracts, and procurement documents;
- Obtained and reviewed the grantee's drawdown supporting documentation; and
- Conducted interviews of grantee personnel.

We also performed work on an employee embezzlement discovered subsequent to our first site visit. We confirmed no Federal funds were involved in the embezzlement of \$2.2 million that resulted in a guilty plea by and conviction of a Washoe County employee. Our work included the following steps:

- Interviewed grantee and Washoe County employees;
- Obtained and reviewed transaction details that related to the embezzlement;
- Obtained and reviewed supporting documents for draws under other Federal grants and loans; and
- Searched for other potential entities associated with the embezzlement.

Findings

The grantee did not meet financial management requirements specified by OMB Circular A-87, Title 40 CFR Part 31, and EPA policy. In particular, the grantee:

- Claimed indirect costs without approved rates or cost allocation plans;
- Charged estimated labor costs to the grants without adjusting to actual costs;
- Claimed fringe benefit costs that were not based on approved rates or a cost allocation plan;
- Procured sole source contracts without cost analysis;
- Claimed contract costs under one grant that were not allocable; and
- Claimed unallowable interest expenses.

Because of the above issues, EPA will need to recover \$291,494 in questioned costs under the two grants. Region 9 provided us with documentation in September 2008 that showed they recently recovered \$26,774 of the questioned costs. Table 2 below summarizes the questioned costs under each grant.

Table 2: Summary of Questioned Costs				
Cost Category	XP96909501 (Lemmon Valley)	XP97963701 (Spanish Springs)	Total	Note
Costs Claimed	\$2,189,366	\$1,070,723	\$3,260,089	
Less: Questioned Costs				
Indirect Costs	66,838	133,745	200,583	1
Labor Costs	26,606	131,648	158,254	2
Fringe Benefit Costs	27,760	49,018	76,778	3
Contracts without Cost Analysis	0	61,365	61,365	4
Unallocable Contract Costs	0	14,230	14,230	5
Interest Expense	12,157	6,622	18,779	6
Total Allowable Costs	2,056,005	674,095	2,730,100	
Federal Share (55%)	1,130,803	370,752	1,501,555	
Payments Made	1,204,151	588,898	1,793,049	
Amount Owed to EPA	\$ 73,348	\$218,146	\$291,494	

Sources: Amounts claimed were from accounting system data the grantee provided in supporting the *Financial Status Report* amounts. Costs questioned were based on OIG's analysis of the data.

- Note 1: See discussion under the Indirect Costs Claimed without Approved Rates or Cost Allocation Plans section below.
- Note 2: See discussion under the Labor Charges Based on Estimates section below.
- Note 3: See discussion under the Fringe Benefit Costs Not Based on Approved Rates or Allocation Method section below.
- Note 4: See discussion under the Contracts Procured without Cost Analysis section below.
- Note 5: See discussion under the Contract Costs Claimed Not Allocable to Grant section below.
- Note 6: See discussion under the Unallowable Interest Expenses section below.

The grantee also needs to strengthen its internal controls to ensure that (1) Federal cash draws reflect its immediate cash needs; (2) contractors are paid in accordance with contract terms and conditions; and (3) Federal requirements concerning financial management, procurement, and contract administration are met.

Indirect Costs Claimed without Approved Rates or Cost Allocation Plans

The grantee claimed indirect costs of \$66,838 under the Lemmon Valley grant and \$133,745 under the Spanish Springs grant that did not meet the requirements of OMB Circular A-87 and EPA policy. Specifically, the grantee did not have cost allocation plans or approved indirect cost rates. OMB Circular A-87 defines indirect costs as those 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. According to OMB Circular A-87, Attachment A, Section C.3.d., a cost allocation plan will be required where an accumulation of indirect costs will ultimately result in charges to a Federal award. EPA policy number GPI 06-01 also requires the grantees to have a current rate agreement, or have submitted an indirect cost rate proposal in order to be entitled to indirect cost reimbursements. The grantee did not have the required cost allocation plans, current rate agreements, or indirect cost rate proposals. As a result, we questioned all indirect costs claimed under the Lemmon Valley and Spanish Springs grants.

This issue was brought to the grantee's attention during the audit. The grantee subsequently submitted indirect cost rate proposals to EPA Headquarters. As of June 2008, the grantee had obtained EPA's approval for all indirect rates. The grantee also submitted a payment request to Region 9 during July 2008 that included an adjustment to the indirect costs previously claimed under the two grants. According to the Region and the grantee, this adjustment was based on the indirect rates approved by EPA. The adjustment identified that the grantee incurred an additional \$48,695 in indirect costs that had not been claimed under the two grants. The Region informed us during September 2008 that they had determined this adjustment was correct. However, the Region has not provided us with the documentation necessary to verify whether the indirect costs in the revised and prior payment requests are fully supported and allocable to the Lemmon Valley and Spanish Springs grants. Therefore, we continue to question the \$66,838 and \$133,745 previously claimed under the Lemmon Valley and Spanish Springs grants, respectively. Some or all of the questioned costs may be allowable if the Region or grantee provides us with documentation that shows the claimed indirect costs are fully supported and allocable to these two grants.

Labor Charges Based on Estimates

We questioned labor costs of \$158,254 claimed under the Lemmon Valley and Spanish Springs grants due to noncompliance with the requirements of OMB Circular A-87. The grantee charged labor costs to the grants based on estimated standard labor rates. This charging practice does not comply with the requirements of OMB Circular A-87, Attachment B, Section 8.h(5)(e), which states:

Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

- *The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;*
- *At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and*

- *The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.*

The grantee did not perform quarterly comparisons between estimated and actual costs to determine whether the estimates produced reasonable approximations of the activities actually performed. As a result, the grantee did not adjust the estimated costs to actual according to the OMB requirement.

This issue was discussed with the grantee during our fieldwork. The grantee subsequently submitted comparisons of the estimated labor costs claimed with actual costs incurred. We reviewed the cost comparisons and questioned labor costs of \$26,606 and \$131,648, respectively under the Lemmon Valley and Spanish Springs grants. The costs questioned represent amounts claimed in excess of actual costs incurred.

To address the questioned costs, the grantee submitted a labor and fringe benefit allocation methodology to EPA Headquarters. EPA approved this methodology during May 2008. The grantee also included an adjustment to the direct labor costs that were previously claimed under the two grants in the payment request submitted to the Region during July 2008. The Region and the grantee informed us that this adjustment to the labor costs was based on this approved methodology. The adjustment identified that the grantee incurred \$100,408 less in direct labor costs than previously claimed under the two grants.

The Region disclosed to us during September 2008 that it had determined that the adjusted costs were correct. The Region also provided us with analysis documentation to support its position. However, this documentation did not demonstrate that the Region had verified the labor costs adjustments were fully supported and complied with the approved methodology. Some or all of the remaining questioned costs may be allowable if the Region or grantee provides us with documentation that shows the claimed direct labor costs are fully supported and allocable to Lemmon Valley and Spanish Springs grants.

Fringe Benefit Costs Not Based on Approved Rates or Allocation Method

The grantee claimed fringe benefit costs of \$27,760 under the Lemmon Valley grant and \$49,018 under the Spanish Springs grant based on rates that did not meet requirements specified by OMB Circular A-87. According to OMB Circular A-87, Attachment B, Section 8.d(5), benefit costs are allowable if they are allocated to the Federal awards and all other activities in a manner consistent with the pattern of benefits attributable to the individuals or group(s) of employees whose salaries and wages are chargeable to such Federal awards and other activities. The grantee did not have indirect cost rates or an allocation method that was approved by EPA. Without an approved rate or allocation method, we have no assurance that the fringe benefit costs were excluded from indirect costs and consistently allocated to the two grants and other applicable activities

conducted by the grantee. Therefore, we questioned fringe benefits costs of \$27,760 and \$49,018 claimed under the Lemmon Valley and Spanish Springs grants, respectively.

We discussed this issue with the grantee during our fieldwork. As discussed in the previous section, EPA approved the grantee's labor and fringe benefit methodology during May 2008. To address the questioned costs, the Region and grantee said that the grantee's July 2008 payment request included an adjustment to the fringe benefits costs that were previously claimed under the two grants. They also said that the adjustment was based on the approved methodology. The adjustment identified that the grantee incurred an additional \$36,042 in fringe benefits costs that had not been claimed under the two grants. The Region informed us that the grantee's revised request had resolved the questioned fringe benefits costs. However, the Region has not provided us with documentation to demonstrate that it has verified that the fringe benefit adjustments were fully supported and complied with the approved methodology. Some or all of the questioned costs may be allowable if the Region or grantee provides us with documentation that shows the claimed fringe benefits costs are fully supported and allocable to Lemmon Valley and Spanish Springs grants.

Contracts Procured without Cost Analysis

We questioned contract costs of \$61,365 claimed because the grantee did not comply with the Federal procurement requirements in the award of two sole source contracts under the Spanish Springs grant. The contracts were for well analysis and depth discrete flow and contamination testing. The grantee awarded the contracts to one contractor without conducting a cost analysis. Title 40 CFR 31.36(d) (4) (ii) and 31.36(f) require the grantees to perform a cost analysis on sole source procurements to verify the cost data and evaluate the specific elements of costs and profits. Without the required cost analysis, we have no assurance that the contract prices were fair and reasonable. Therefore, we questioned the \$61,365 claimed for payments made to the contractor under these contracts.

This issue was brought to the grantee's attention during our fieldwork. The grantee subsequently attempted to demonstrate price reasonableness by providing a comparison of the contractor's labor rates with the rates of two other companies that Washoe County contracted with for similar work. The grantee also provided qualification requirements for each of the contractor's labor categories. However, we were not able to determine whether the costs for the sole source contracts were reasonable for the following reasons:

- The labor rate information for the other two companies did not show that the labor categories were equivalent to the labor rates of the sole source contractor.
- The qualification requirements for the other two companies did not include the information necessary for an assessment of the companies' technical proficiencies. Therefore, we were not able to determine whether the two companies' technical capabilities were comparable to those of the selected contractor.

- The two sole source contracts included subcontract costs of \$38,200. The subcontract costs represent approximately 62 percent of the \$61,365 claimed under the two sole source contracts. The grantee did not provide the necessary documentation to show that the subcontract prices are fair and reasonable.

Contract Costs Claimed Not Allocable to Grant

The grantee claimed contract costs of \$14,230 paid to U.S. Geological Survey (USGS) under the Spanish Springs grant that are not allocable to the grant. According to OMB Circular A-87, Attachment A, Section C.1.b, a cost must be allocable to the grant in order to be allowable. The grantee had two separate agreements with USGS. One of these agreements was for work not covered by the Spanish Springs grant. The grantee inadvertently claimed \$14,230 of costs for work conducted under this USGS agreement. Because the Spanish Springs grant did not receive any benefit from the work done under the USGS agreement, the charges are not allocable to the grant. As a result, we questioned the \$14,230 claimed under the grant.

In response to our audit, the grantee included a \$14,230 credit adjustment for these contract costs in the payment request submitted to the Region during July 2008.

Unallowable Interest Expenses

The grantee claimed interest expenses of \$12,157 and \$6,622, respectively, under the Lemmon Valley and Spanish Springs grants that were unallowable under OMB Circular A-87. Table 3 provides additional details on the interest expenses for each grant.

Table 3: Summary of Interest Expenses			
Grant Number	Bond Interest	Interest on Retentions	Total
XP96909501 (Lemmon Valley)	\$10,084	\$2,073	\$ 12,157
XP97963701 (Spanish Springs)	6,622	0	6,622
Total	\$16,706	\$2,073	\$18,779

Sources: Interest expense amounts were from accounting system data the grantee provided in support of the *Financial Status Report* amounts and OIG's analysis of the data.

The grantee claimed \$16,706 for interest on bonds issued by Washoe County to fund the grantee's share of the costs under the two grants. OMB Circular A-87, Attachment B, Section 23(b) specifies that financing costs (including interest) associated with the otherwise allowable costs of building acquisition, construction, or fabrication, reconstruction or remodeling are allowable if four conditions are met. One of these four conditions is that the financing is provided by a bona fide third party external to the governmental unit. Because the bonds were issued by Washoe County, the financing was

not provided by an external bona fide third party. Therefore, we questioned all bond interest claimed by the grantee.

Interest of \$2,073 paid on construction contract retentions was also claimed by the grantee under the Lemmon Valley grant. This interest was incurred while the grantee held 10 percent of all amounts billed under two construction contracts to assure satisfactory completion of the work. The grantee explained that Washoe County law requires the grantee to pay interest while withholding payments as contract retentions. Therefore, the payments withheld under the contracts were the grantee's own funds and did not represent financing from a bona fide third party. As a result, we questioned all interest on the contract retentions. To address this issue, the grantee included an \$18,779 credit adjustment to the interest costs in the payment request submitted to the Region during July 2008.

Internal Control Weakness

The grantee also needs to strengthen its internal controls to ensure that (1) Federal cash draws reflect its immediate cash needs; (2) contractors are paid in accordance with contract terms and conditions; and (3) Federal requirements concerning financial management, procurement, and contract administration are met.

Cash Management Needs Improvement

The grantee did not have adequate cash management procedures to ensure that Federal cash draws reflect its immediate cash needs. During the course of the Lemmon Valley grant, the grantee made several draws, totaling \$104,193, for construction contract payment retentions. The grantee held the drawn amounts for 2 to 6 months before actual payment of the retentions.

According to 40 CFR 31.21(g)(3), payments shall be made by the Federal agency when the grantees or subgrantees actually disburse withheld funds to the contractors or to escrow accounts established to assure satisfactory completion of work. Title 40 CFR 31.20(b)(7) also requires the grantee to make drawdowns as close as possible to the time of making disbursements.

This issue did not result in questioned costs because the retention amounts were eventually paid at contract completion, which was within the time period audited. However, this non-compliance issue, if not corrected for future grants, will result in lost interest income opportunities for the Federal Government.

Contract Management Needs Improvement

The grantee needs to improve its contract administration system to ensure that it pays contractors in accordance with contract terms and conditions. Of the eight payments made to a contractor under the Spanish Springs grant, five payments included an instance where the amount billed and paid did not match the contract rate. Two of these instances

were for a labor category not in the contract and the remaining three were billed at rates either higher or lower than the contract rates.

Title 40 CFR 31.36(b)(2) requires grantees to maintain a contract administration system, which ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders. As a result of weaknesses in Washoe County's contract administration system, the grantee overpaid the contractor and over-billed the EPA grant by \$621. Although the overpayment is immaterial, this condition may result in significant overpayments that are not allowable for future grants if the grantee's contract administration system is not strengthened.

Grantee Needs to Comply with Federal Requirements

The grantee needs to establish procedures to comply with Federal requirements concerning financial management, procurement, and contract administration. The grantee claimed indirect, direct labor, fringe benefit, and interest costs based on criteria that did not meet Federal financial requirements. The grantee needs to improve its procurement processes. The grantee awarded sole source contracts without conducting a cost analysis, and claimed contract costs that did not match the contract rates. The grantee also did not comply with Federal cash management requirements and claimed unallowable costs.

Recommendations

We recommend that EPA Region 9's Regional Administrator:

1. Disallow and recover the remaining uncollected balance of the \$291,494 questioned under Grants XP96909501 and XP97963701. If the grantee provides documentation that meets appropriate Federal financial management requirements and shows that some or all of the remaining uncollected questioned costs are allocable and allowable to these EPA grants, the amounts to be recovered should be adjusted accordingly.
2. Require the grantee to establish procedures to ensure that it:
 - a. Charges labor and benefit costs to the Federal grants in accordance with OMB Circular A-87;
 - b. Conducts procurement in accordance with 40 CFR 31.36, including cost analysis for all sole source contracts;
 - c. Properly identifies unallowable costs and excludes them from billings to the Federal Government;
 - d. Limits cash draws for Federal grants to actual disbursements; and
 - e. Pays contract costs charged to Federal grants in accordance with contract terms and conditions.

Region 9's and Auditee's Comments

Region 9 and the grantee submitted written comments on the discussion draft dated September 11 and September 12, 2008, respectively. We also held an exit conference with the Region and grantee on September 15, 2008. In general, the Region and grantee concurred with the findings. However, the Region and grantee believed that the corrective actions taken subsequent to our fieldwork resolved most, if not all, of the issues identified in the discussion draft. The Region and grantee explained that these subsequent actions included submitting a payment request in July 2008 that adjusted the indirect costs, labor costs, and fringe benefit costs previously claimed under the two grants to reflect the rates and methodologies approved by the EPA. The grantee also said that the revised payment request reimbursed the Government \$48,680 for unallowable costs claimed under the Lemmon Valley and Spanish Springs grants. Because of the corrective actions, the grantee and Region requested that our report be changed to acknowledge the efforts taken to resolve the findings.

With regard to the two sole source contracts procured without a cost analysis, the grantee commented that the procedures performed complied with the Federal guidelines. The grantee explained that the Spanish Springs grant supports the investigation of nitrates that are contaminating the public water supply, and that the subcontractor, under the sole source award, is the only manufacturer of the sampling equipment used for the investigation. The grantee also said that hiring any firm other than this subcontractor would have significantly exceeded the \$38,200 subcontract cost. To further demonstrate the reasonableness of the subcontract costs, the grantee said it is requesting additional supporting documentation from the subcontractor.

The grantee also said that it followed Washoe County Purchasing Procedures for the sole source contracts. The grantee stated the breakdown of labor rates for the sole source contractor was reviewed and deemed appropriate by the project manager, based on his experience working with similar consulting firms. The grantee explained that the sole source procurement was approved by its senior management, as well as the District Attorney and the Washoe County Board of County Commissioners prior to the award. In addition, the grantee said it subsequently gathered comparable class specification and pay scale information from two comparable firms to demonstrate that the rates and fees paid to the sole source contractor were reasonable and appropriate. The grantee further stated that the Region deemed these comparisons suitable and in compliance with all required Federal guidelines.

In response to the \$61,365 of sole source contract costs we questioned, the Region stated that it does not have documentation available to show that the subcontract costs of \$38,200 are fair and reasonable. The Region said it will address the subcontracts issue during audit resolution. For the other \$23,165 paid to the sole source contractor, the Region stated that the grantee has complied with the procurement requirements of 40 CFR Part 31.36. The Region explained that these regulations allow for sole source procurement and that the grantee's sole source award complied with the regulations. The Region also stated that the job description and rate comparisons provided by the grantee

met the requirements of 40 CFR 31.36; therefore, at a minimum, the questioned costs should be reduced to \$38,200.

The grantee and the Region also commented on the internal control weaknesses we identified. The grantee stated that it has established procedures that correct the weaknesses. The Region commented that it would follow up with the grantee to ensure that appropriate cash management procedures are in place. In addition, the Region said that it would work with the grantee to set up procedure to ensure contract bills and payments comply with contract rates. However, the Region did not fully agree that the grantee needs to establish procedures to comply with Federal requirements for financial management, procurement, and contract administration. The Region stated that if the grantee's procedures for drawdown of retention funds and procurement in terms of sole source contracts have weaknesses, the Region will work with the grantee to develop procedures as needed.

Appendix A provides the full text of the Region's and the grantee's comments.

OIG Response

Our position on the issues remains unchanged. We made changes to the report, as appropriate, to acknowledge recent actions taken by the grantee to address the financial management and internal control weaknesses identified by the audit. Although the grantee commented that it has repaid EPA \$48,680 in response to our audit, the actual amount repaid through the July 2008 payment request was \$26,774 (55 percent Federal share of the cost adjustment amount of \$48,680), as shown in Table 4 below.

Table 4: Summary of July 2008 Cost Adjustments			
Cost Category	Cost Adjustment XP96909501 (Lemmon Valley)	Cost Adjustment XP97963701 (Spanish Springs)	Total
Indirect Costs	\$23,985	\$24,710	\$48,695
Labor	(16)	(100,392)	(100,408)
Fringe Benefits	14,505	21,537	36,042
Contract Costs		(14,230)	(14,230)
Interest Expenses	(12,157)	(6,622)	(18,779)
Total Adjustments	26,317	(74,997)	(48,680)
EPA Share of Adjustments (55% Federal share)	14,474	(41,248)	(26,774)

Sources: OIG analysis of grantee's July 15, 2008, payment request for Grants XP96909501 and XP97963701.

The Region and grantee have not yet completely resolved the questioned costs and internal control issues. The Region needs to provide us with documentation that demonstrates that the grantee's adjustments in the July 2008 payment request satisfactorily resolved the indirect, direct labor, fringe benefit, and sole source contract costs we questioned. The Region also needs to ensure that the grantee has established

procedures that satisfactorily address the internal control weaknesses identified by the audit.

With regard to the grantee's and Region's comments on the sole source contracts, we do not agree that the information used for the comparison between the sole source contractor and two other firms has demonstrated compliance with Federal procurement regulations. Although the grantee stated that the sole source awards have been justified and approved by the grantee's senior management, the District Attorney and the Washoe County Board of County Commissioners, they have not met the cost analysis requirement under 40 CFR 31.36(d)(4) (ii) and 31.36(f). 40 CFR 31.36(f)(3) also requires that the costs included in negotiated prices to be consistent with the Federal cost principles outlined in 40 CFR 31.22. The cost principle applicable to for-profit organizations, such as the grantee's sole source contractor, is the Federal Acquisition Regulation (FAR), which provides detailed guidance on cost or price analysis. According to FAR 15.404-1(c), cost analysis is the review and evaluation of the separate cost elements and profit in the offeror's proposal (including cost or pricing data). FAR 15.404-1(c)(2)(iii) provides cost analysis techniques and procedures to ensure a fair and reasonable price. These techniques and procedures include the comparison of costs proposed by the offeror for individual cost elements with:

- Actual costs previously incurred by the same offeror;
- Previous cost estimates from the offeror or from other offerors for the same or similar items;
- Other cost estimates received in response to the Government's request;
- Independent Government cost estimates by technical personnel; and
- Forecasts of planned expenditures.

Since the grantee and the Region have not provided adequate documentation to satisfy Federal cost analysis requirements, we maintain our position on the issue. If additional documentation is provided during audit resolution, the Region should adjust the amount for recovery accordingly.

Status of Recommendations and Potential Monetary Benefits

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
1	9	Disallow and recover the remaining uncollected balance of the \$291,494 of costs questioned under Grants XP96909501 and XP97963701. If the grantee provides documentation that meets appropriate Federal financial management requirements and shows that some or all of the remaining uncollected questioned costs are allocable and allowable to these EPA grants, the amounts to be recovered should be adjusted accordingly.	U	Region 9 Regional Administrator		\$291	\$27
2	9	Require the grantee to establish procedures to ensure that it: <ul style="list-style-type: none"> a. Charges labor and benefit costs to the Federal grants in accordance with OMB Circular A-87; b. Conducts procurement in accordance with 40 CFR 31.36, including cost analysis for all sole source contracts; c. Properly identifies unallowable costs and excludes them from billings to the Federal Government; d. Limits cash draws for Federal grants to actual disbursements; and e. Pays contract costs charged to Federal grants in accordance with contract terms and conditions. 	U	Region 9 Regional Administrator			

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

Appendix A***Region 9 and Grantee Responses***

SUBJECT: Draft Audit Report for EPA Grants XP96909501 and XP97963701 - Washoe County Department of Water Resources

FROM: Wayne Natri
Regional Administrator

TO: Robert Adachi
Director of Forensic Audits
Office of the Inspector General
USEPA (IGA-1)

We appreciate the opportunity to comment on the subject draft audit report. Over the past five months, Washoe County, Region, the OIG, and we completed an extensive amount of work to resolve issues found during the audit of the subject grants. To more accurately reflect the current status of the audit's findings, we request that these efforts be documented in the final audit report. We understand the comments which follow will become part of the report.

FINDING 1: The OIG questioned Indirect Costs as they were claimed without Approved Rates or Acceptable Cost Allocation Plans.

RESPONSE: As documented in Attachment 1, the Recipient has received approval from EPA HQ for all indirect cost rates as of June 26, 2008. The Region has determined that the Recipient has correctly applied those rates to the approved methodology (Attachment 5). As this issue has been successfully resolved, we request it be removed from the report, or at minimum, that the new approved rates be acknowledged.

FINDING 2: Labor charges incurred were based on estimates and not compared to actual costs incurred.

RESPONSE: The Recipient has corrected this situation by receiving EPA HQ approval of their labor allocation methodology, comparing actual costs incurred to what was charged to the grant, and submitting a payment request to reflect the difference between the estimated costs charged and the actual costs incurred (See Attachments 1 through 5). The Region acknowledges that the information in this memorandum's Attachments 2, 3 and 4 for salary expenses do not match what was provided to OIG staff during the audit. This is a direct result of EPA HQ approving a labor allocation methodology different than the methodology used by the Recipient prior to receiving approval from EPA HQ. To clarify, we have provided an analysis of each year's expenses using both methodologies to display the correctly applied rates. (Attachments 2, 3 and 4 reflect the old methodology; Attachments 2A and 3A reflect the new approved methodology). As this

issue has been successfully resolved, we request it be removed from the report, or at minimum that the results of our efforts be acknowledged.

FINDING 3: Fringe Benefit Costs were not based on Approved Rates or Allocation Method.

RESPONSE: This Finding has been corrected. The approval of the indirect cost rates as stated in our response to Finding 1 also approved the fringe benefit rate. The Recipient resolved this situation by submitting a payment request to reflect the difference between the charged costs (calculated using the incorrect fringe benefit rate) and the actual costs incurred (calculated using the correct fringe benefit rate). As this issue has been successfully resolved, we request it be removed from the report, or at minimum that the results of our efforts be acknowledged.

FINDING 4: The OIG questioned the Recipient's compliance with federal requirements concerning contract costs of \$61,365 incurred in the award of two sole source contracts under Grant #XP97963701.

RESPONSE: The Region disagrees with this Finding. The Recipient's documentation (Attachments 10 and 11) provides evidence they were in compliance with regulations when they completed the sole source procurement and the required cost analysis. Grant regulations at 40 CFR Part 31.36(4)I(a) allow sole source procurement when the item is available only from a single source. Attachment 11 documents compliance with federal regulations by showing that the chosen contractor has specialized experience, and their subcontractor has patented tools needed to perform the necessary work. In addition, their product is available only from them or their authorized representative.

Our review also revealed that the Recipient has provided documentation that meets the requirements of an "evaluation of the specific elements of cost and profit" as required by 40 CFR Part 31.36(4)(D). The Region reviewed job descriptions and rates of pay from LFR (the contractor selected for the sole source) and two other potential sources (Intera and Worley Parsons). We determined the sources offered comparable services and requirements. As sole source requirements were met, the Region requests the amount of this Finding be reduced at a minimum from \$61,365 to \$38,200, as \$23,165 of the costs were procured in accordance with regulatory requirements (\$61,365-\$38,200 sub contract costs = \$23,165).

As part of this Finding, the OIG questions \$38,200 of the \$61,365 due to the fact that documentation was not provided to show the subcontract prices were fair and reasonable. The Region does not have the documentation available and will address it in the audit resolution.

FINDINGS 5 & 6: The OIG questioned contract costs of \$14,230 from the United States Geological Survey (USGS) and interest costs of \$12,157 and \$6,622.

RESPONSE: The Region agrees that the USGS costs as well as the interest costs were unallowable and the Recipient has already reimbursed the government (Attachments 2, 3 and 4). We request this be noted in the report.

INTERNAL CONTROL WEAKNESSES:

CASH MANAGEMENT: The OIG feels that the Recipient's cash management procedures need improvement as they found instances where Recipient draw-downs for retention were not expended in a timely manner as required by regulation.

RESPONSE: The Region believes these were isolated incidences and only dealt with retention funds. Nevertheless, we will ask our Grants Management Office (GMO) to follow-up with the Recipient and ensure that appropriate cash management procedures are in place for draw-downs of retention funds.

CONTRACT MANAGEMENT NEEDS IMPROVEMENT: The OIG noted that of eight payments made to a contractor under Grant #XP97963701, five payments included an instance where the amount billed and paid did not comply with contract rates.

RESPONSE: The Region agrees this is problematic. Our GMO will work with the Recipient to set up procedures to ensure this does not happen in the future.

COMPLYING WITH FEDERAL REQUIREMENTS: The Recipient claimed indirect, direct labor, fringe benefit and interest costs based on criteria that did not meet federal standards.

RESPONSE: All indirect, direct labor, fringe benefit and interest cost issues have been resolved and discussed in earlier parts of the Region's response. As these issues have successfully been resolved, we request this Finding be removed from the report, or at minimum that the results of our efforts be acknowledged.

COMPLYING WITH FEDERAL REQUIREMENTS: The OIG feels the Recipient needs to establish procedures to comply with Federal requirements for financial management, procurement and contract administration.

RESPONSE: The Region disagrees with the breadth of this recommendation. If procedures for draw-down of retention funds and procurement in terms of sole source sub-contracts are lacking, the GMO will work with the Recipient to develop procedures where needed.

ACKNOWLEDGEMENTS

We thank Ms. Deborah Lambreth of Washoe County for the many hours she spent working with the Region on this audit, Ms. Lela Wong and Ms. Janet Lister of the OIG for the professionalism and assistance provided during this audit, and Ms. Jacquelyn Smith of EPA HQ for the outstanding service she provided to Washoe County in reviewing and approving the indirect cost rates.

September 12, 2008

MEMORANDUM

SUBJECT: Costs Claimed under EPA Grants XP96909501 and XP97963701

FROM: Ben Hutchins, CPA, Finance and Customer Services Manager
Washoe County Department of Water Resources

TO: Michael Owen
United States Environmental Protection Agency
San Francisco, California

We appreciate the opportunity to provide additional information on the draft audit report for EPA Grant numbers XP96909501 and XP97963701.

Washoe County Department of Water Resources (DWR) agrees that the United States Environmental Protection Agency (EPA) Memorandum dated September 4, 2008, is factual through May 20, 2008; however, it excludes material facts subsequent to May 20, 2008, that resolves most, if not all, of the items noted in the Memorandum.

As public servants, DWR has the responsibility to provide water services to the community in the most effective and efficient manner possible and we take this responsibility very seriously. To provide water services to the community Federal grants are a vital part of our funding mechanisms. Because the September 4, 2008, Memorandum does not provide a complete account of the current status of issues noted in the audit, and steps taken to resolve these issues, we are concerned that granting agencies could misinterpret the Memorandum in a way that could jeopardize future grant awards.

To this end, we are requesting that the September 4, 2008, Memorandum reflect a current status of all audit finding issues, as noted below, to provide a full disclosure of relevant facts. Also, it is our understanding that our September 12, 2008, Memorandum and the September 11, 2008, Memorandum from EPA Region IX will both be a part of the final report.

Summary (Total Outlays = \$3,260,089)

Cost Category	Questioned Costs @ 5/20/08	Amount Owed @ 7/21/08	Comments
Indirect Costs	\$200,583	\$0	1)
Labor Costs	158,254	0	1)
Fringe Benefits Costs	76,778	0	1)
Sole Source Contract	61,365	0	2)
Unallowable Contract Costs	14,230	0	3)
Interest Expense	18,779	0	3)
Total	529,989	0	
Federal Share 55%	\$291,494	\$0	

- 1) Rates approved by EPA; balance owed paid to EPA July 21, 2008.
- 2) All federal guidelines were met.
- 3) DWR agrees; paid to EPA July 21, 2008.

As the above table indicates, DWR believes that all amounts owed related to audit findings have been fully paid as of July 21, 2008, based on EPA evaluations and approvals subsequent to May 20, 2008. This is the result of joint efforts between DWR, EPA Region IX and the OIG.

Payment to the EPA was made in the amount of \$48,681 through a deduction on a grant claim submitted to the EPA Grants Management Office PMD-7 (GMO) and the EPA Las Vegas Finance Center on July 21, 2008 as follows:

Labor & fringe benefits owed to EPA	\$64,367
Contract costs owed to EPA	14,230
Unallowable grant project interest expense owed to EPA	18,779
Indirect costs owed to DWR	<u>(48,695)</u>
 Total owed to EPA (paid July 21, 2008)	 \$48,681

In addition, procedures that were either questioned or found to be inadequate have been evaluated, modified and implemented in accordance with acceptable federal guidelines.

Indirect Costs Claimed without approved Rates of Cost Allocation Plan

DWR has prepared indirect cost rate proposals for fiscal years 2004, 2005, 2006, 2007, and 2008. The indirect cost rate proposals were reviewed and approved by Jacqueline Smith, Rate Negotiator for the EPA Financial Analysis and Oversight Service

Center (FAOSC). The Negotiation Agreements are dated May 20, June 11 and June 23, 2008.

The revised claim for indirect costs was submitted to the GMO on July 21, 2008. The amounts of indirect costs allowed by the Negotiated Rate versus amount claimed are as follows:

Lemmon Valley:

Costs - previously claimed	\$66,838
Costs - approved rate	<u>(90,823)</u>
Amount under claimed (owed to DWR)	(\$23,985)

Spanish Springs:

Costs - previously claimed	\$133,745
Costs - approved rate	<u>(158,455)</u>
Amount under claimed (owed to DWR)	(\$24,710)

Total owed DWR	(\$48,695)
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Labor Charges Based on Estimates

DWR prepared labor reports based on actual wages by percentage of work performed for grants and other direct jobs, for every quarter starting September 2003 through September 2007. These reports were submitted to FAOSC, along with copies of the Washoe County Comprehensive Annual Financial Reports and Single Audit Reports for each year. The labor costs were analyzed by Jacqueline Smith and determined to be acceptable for use as the basis for application of the indirect cost rate.

Fringe Benefit Costs Not Based on Approved Rates or Allocation Method

The questioned costs for this category were a result of all fringe benefits being disallowed until it was determined that they were not included in indirect costs. As of May 20, 2008, this determination had not yet been made; however, as a part of the work performed by Jacqueline Smith, it was verified that indirect costs did not include any fringe benefits and, as allowed under federal guidelines, were then allowed.

Actual fringe benefit costs were computed for each employee working on DWR grants for every quarter from September 2003 through September 2007. Fringe benefit cost computations were submitted to FAOSC along with the labor and indirect costs. As stated in the OMB CIRCULAR A-87 COGNIZANT AGENCY NEGOTIAION AGREEMENT between FAOSC and DWR, dated June 11, 2008, "Fringe benefits applicable to direct salaries and wages are treated as direct costs and are not included in the base."

Labor Charges and Fringe Benefits Recalculated

The revised claim for labor and fringe benefits was submitted to the GMO on July 21, 2008. The amounts of labor and fringe benefits allowed by the approved methodology versus amounts previously claimed are as follows:

	Previously Claimed	Approved	Difference
Lemmon Valley	\$385,725	\$306,870	\$78,855
Spanish Springs	158,129	172,617	<u>(14,488)</u>
Amount owed EPA (repaid July 21, 2008)			\$64,367

Contracts Procured Without Cost Analysis

Understanding the nature and circumstances surrounding the sole-source contract being questioned during the audit is necessary to be able to demonstrate why procedures performed were in compliance with Federal guidelines.

The Spanish Springs grant is in support of the investigation of nitrates that are contaminating the public water supply to be able to propose remediation remedies. In order to accomplish this task, it is necessary to measure the nitrates. Besst, Inc. (subcontractor to LFR, Inc.) is the only manufacturer of the sampling equipment used for this effort. The US Geological Survey published Fact Sheet 2004-3096 stating "The U.S. Geological Survey, in cooperation with the manufacturer (Besst Inc.), has modified a commercially available gas-displacement sample pump to collect water at selected depths within production wells under pumping conditions." With this new equipment nitrate levels were tested without disrupting well production, resulting in significant cost savings. LFR, Inc. formed a team to analyze the data that would be produced by Besst, Inc. Besst, Inc. proposed a fixed cost bid to travel from California to Reno with two large trucks and trailers, the newly developed highly specialized testing equipment, and three hydrogeologist/engineers. They were on site for at least two days for each of four wells. It is our understanding that they underbid the project because it took longer than expected. There is no other company that could provide this service; therefore, the only other option would be to hire a well drilling company to remove the pumping equipment from four production wells to accommodate water sampling. The cost of this method of sampling would have significantly exceeded \$38,200.

To further demonstrate the reasonableness of these costs DWR is in the process of requesting information from Besst Inc. concerning costs for services they have provided to other municipalities for the same type of service.

It is our belief that DWR is in compliance with federal guidelines for the \$23,165 paid to LFR, Inc. In the proposal received from LFR, Inc. a breakdown of the labor rates for the staff that would provide the analysis of the data was reviewed and deemed

appropriate by the project manager based on his experience working with similar consulting firms.

DWR also followed Washoe County Purchasing Procedures regarding the award of a sole-source contract. In addition to the project manager, the merit of the contract with LFR, Inc. (costs and expertise) was evaluated and approved by Washoe County hydrogeology staff Jeanne Ruefer (DWR Planning Division Manager), Steve Bradhurst (DWR Director), John Balentine (Washoe County Purchasing and Contracts Director), the Finance Department (Ron Steele) and John Rhodes (District Attorney). The contract was then approved by the Washoe County Board of County Commissioners. Please see (attached) one of the LFR, Inc. Board of County Commissioners staff reports (requesting a change order to the agreement), Sole Source Purchase Request Form, and related emails that outline a portion of the above noted sole-source review and approval process.

In addition, DWR has subsequently gathered comparable class specification and pay scale information from two similar firms that provide the same type of services. This information clearly demonstrates that the rates and fees paid to LFR, Inc. were in fact reasonable and appropriate. This information was provided to EPA Region IX Grants Management Office who has deemed the comparisons suitable and in compliance with all required federal guidelines.

Contract Costs Claimed Not Allocable to Grant

DWR agrees that contract costs of \$14,230 paid to U.S. Geological Survey should not have been claimed as grant expense. This amount was repaid on the revised claim submitted to the GMO on July 21, 2008.

Unallowable Interest Expenses

DWR agrees that interest expenses of \$12,157 and \$6,622 are unallowable under OMB Circular A-87. These amounts were repaid on the revised claim submitted to the GMO on July 21, 2008.

Internal Control Weakness

Cash management Improvement

DWR has established procedures to insure that construction contract retention amounts are not submitted for reimbursement until the actual disbursement has been made.

Contract Management Needs Improvement

DWR has established procedures to insure that all contract invoices include only charges for the contracted price.

Grantee Needs to Comply with Federal Requirements

DWR has established procedures that accommodate all concerns noted in the September 4, 2008, Memorandum to comply with all Federal requirements.

Conclusion

DWR has, and will continue working with EPA Region IX's Regional Administrator and OIG to rectify all findings from the audit and believe that final audit conclusions will demonstrate that DWR has paid the total amount owed (\$48,680), has corrected all internal control weaknesses, and has implemented processes and procedures to sufficiently address all issues noted in the September 4, 2008, Memorandum.

As noted above, it is our understanding that our September 12, 2008, Memorandum and the September 11, 2008, Memorandum from EPA Region IX will both be included as an integral part of the final audit findings report.

We appreciate the time and assistance from all of the dedicated representatives from both the OIG and EPA Region IX and look forward to a timely resolution to these matters.

Appendix B

Distribution

Regional Administrator, Region 9
Director, Office of Wastewater Management, Office of Water
Director, Office of Wastewater Management - Municipal Support Division, Office of Water
Director, Office of Grants and Debarment
Director, Grants and Interagency Agreements Management Division
Agency Follow-up Official (the CFO)
Agency Follow-up Coordinator
Associate Administrator for Congressional and Intergovernmental Relations
Associate Administrator for Public Affairs
Region 9 Audit Follow-up Coordinator
Region 9 Public Affairs Office
Director, Washoe County Department of Water Resources, Reno, Nevada
Deputy Inspector General