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Office of Inspector General
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AUDIT
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TO: Thomas L. Tidwell
Chief
Forest Service

ATTN: Donna M. Carmical
Chief Financial Officer

FROM: Gil H. Harden /s/
Assistant Inspector General
for Audit

SUBJECT: State Agency Charged Recovery Act Grants and Non-Recovery Act Grants
\$14.4 Million in Unallowable Costs – The Recovery Act - Forest Service (FS)
Hazardous Fuels Reduction and Ecosystem Restoration on Non-Federal Lands (7)

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provided the Department of Agriculture (USDA) with \$28 billion in funding.¹ Of this amount, \$1.15 billion was allotted to the Forest Service (FS) to implement projects that sustain the nation's forests and grasslands, create jobs, and promote U.S. economic recovery. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. Further, on February 18, 2009, the Office of Management and Budget (OMB) issued initial guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.² OMB issued additional guidance on April 3, 2009, to clarify existing requirements and establish additional steps that must be taken to facilitate the accountability and transparency objectives of the Recovery Act. Moreover, OMB emphasized that, due to the unique implementation risks of the Recovery Act, agencies must take steps, beyond standard practice, to initiate the additional oversight mechanisms.³ The USDA's Office of Inspector General (OIG) was charged with the responsibility of overseeing FS and other agencies' activities in order to ensure Recovery Act funds are spent in a manner that minimizes the risk of improper use.

¹ Public Law 111-5, February 17, 2009.

² OMB M-09-10, *Initial Implementing Guidance for the Recovery and Reinvestment Act of 2009*, February 18, 2009.

³ OMB M-09-15, *Updated OMB M-09-10, Initial Implementing Guidance for the Recovery and Reinvestment Act of 2009*, April 3, 2009.

The Recovery Act included \$200 million⁴ in grant funding for FS to implement Wildland Fire Management (WFM) activities on State, county, and private lands.⁵ From May through September 2009, FS approved 171 WFM grants for projects on non-Federal lands. Our audit examined a sample of 20 of these grants. FS awarded two of the sampled grants to the State of Alabama's Forestry Commission (the Commission). In addition to the two sampled grants, the Commission received another Recovery Act-funded grant for a total of three Recovery Act-funded grants valued at around \$13 million.

Federal regulations require that all costs charged to Federal grants be tracked and accounted for separately from other grants, and that grant funds be charged only for activities that support the purpose of the grant.⁶ However, the Commission's accounting system did not comply with Federal regulations governing grant funds, as it commingled the majority of its Recovery Act-funded grant costs, non-Recovery Act-funded grant costs, and general operating costs into one single commingled "pool" of costs, and then allocated the commingled costs to both its FS Recovery Act and non-Recovery Act grants.⁷ This occurred because the Commission's Chief Financial Officer (CFO), who designed the accounting system,⁸ was either unaware of, or misinterpreted, Federal grant accounting requirements.⁹ Further, the Commission's flawed accounting system and non-compliance with Federal regulations was not identified by FS officials because FS did not perform its required financial assessments before it awarded the grants to the Commission.¹⁰ As a result, during the 2.5-year period we reviewed, the Commission allocated tens of thousands of commingled costs to its FS grants even though the costs were unallowable and did not support grant objectives. In total, \$14.4 million of the Commission's charges to its FS grants during the period reviewed were unallowable.¹¹ This issue, along with other issues identified, will be consolidated into a final report at the conclusion of our fieldwork.

During our review of the sampled Recovery Act-funded grants, we found that the deficiencies in the Commission's accounting system were systemic and, therefore, also affected the

⁴ This amount excludes \$50 million designated for non-Federal wood to energy grants.

⁵ These activities include hazardous fuels reduction, forest health, and ecosystem improvements.

⁶ 2 CFR Part 225, Cost Principles for State, Local, and Indian Tribal Governments, August 31, 2005, and 7 CFR, Part 3016, Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments, January 1, 2003.

⁷ OMB Circular 09-15, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009, prohibits the commingling of Recovery Act and non-Recovery Act funds. OMB circulars have defined commingling as depositing or recording funds in a general account without the ability to identify each specific source of funds for any expenditure. Grant funds can only be consolidated with other Federal, State, local, and private funding sources if there is a clear audit trail linking expenditures to the applicable Federally awarded funds.

⁸ The State agency had no procedural manuals, instructions, etc., to document the accounting processes it used. The Commission's accounting procedures had to be verbally explained to us by the CFO.

⁹ OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, May 10, 2004.

¹⁰ FS Handbook 1509.11, Chapter 20, Section 23.52, required FS staff to evaluate the State agency's financial accounting systems to ensure that it had adequate accounting policies and procedures (including the ability to separately track project costs on a grant-by-grant basis), and that the grant applicant's financial strength and capability were acceptable.

¹¹ 7 CFR Part 3016 specifies that any costs identified as unallowable must be refunded by the grant recipient.

Commission's non-Recovery Act-funded FS grants. Thus, we included all of its general FS grants in our analysis as well. Out of \$17.3 million the Commission received in total grant funds between October 1, 2008, and April 27, 2011, it charged \$3.4 million in unallowable costs to Recovery Act-funded grants and \$11 million in unallowable costs to non-Recovery Act-funded grants.

For the 2.5-year period we reviewed, the Commission's commingled pool had a total of \$62 million in costs from over 73,000 transactions related to Recovery Act-funded grants, non-Recovery Act-funded grants, and the agency's general operating expenses. These costs encompassed most of the agency's work (both grant and non-grant), including salary expenses, transportation costs, and other operating costs.¹² After the Commission commingled the costs, it allocated them from the commingled pool to its FS grants and other grant and non-grant programs using an accounting system that did not provide an accounting trail back to specific invoices. Therefore, it was not possible to identify which of the commingled charges related to grant work and which did not.

The CFO believed that the Commission's charges to FS grants were fair because the charges in the cost pool reflected the cost of operating the Commission's various functions and services, and since grants indirectly benefitted from these functions and services, the grants should pay a portion of the costs. However, commingling grant costs with other costs is prohibited by Federal regulations because it reduces accountability. In addition, we found that the Commission's initial act of commingling created several other accounting problems, such as unauthorized, unsupported, and inappropriate costs. Each problem taken individually would also make the costs unallowable. An illustrative example of these problems is reflected in the Commission's unsupported and unreasonable process for charging salary costs to grants.

We examined the work records for all of the Commission's employees during the 2.5-year period under our review. Using the number of hours employees recorded as worked on FS Recovery Act-funded grants, we estimated the Commission should have charged its FS Recovery Act-funded grants about \$846,000 for salary costs. However, over the 2.5-year period, the Commission actually charged an estimated \$2.8 million in salary costs to its Recovery Act-funded grants. The fact that the Commission's commingled allocation process was overstating grant costs was further evident in our analysis of salary charges for specific fiscal years. For the first half of fiscal year 2011, we found that the Commission employees recorded 12,595 hours of work on Recovery Act-funded grants. The employees who recorded work on the grants had an average salary cost of \$21.37 an hour. However, because the Commission commingled the salaries of all of its employees in the pool—including the salaries of high level managers who were not working on Recovery Act-funded projects—the Commission actually charged the Recovery Act-funded grants at a rate of \$51.86 per hour.¹³

¹² References to salary costs in this report refer to both base salary and fringe benefits.

¹³ The per hour salary figures were calculated by dividing the total number of hours tracked to Recovery Act grants by our estimated cost of direct salaries and the estimated charge for salaries to the Recovery Act grants.

It should be noted that the \$2.8 million in salary costs discussed above is only an estimate because the Commission's accounting methods did not allow grant charges to be traced back to specific transactions or source documents. Therefore, it was impossible for us to determine which portion of the commingled \$3.4 million the Commission charged to its Recovery Act-funded grants was attributable to salary costs. Since we found that approximately 80 percent of the costs in the Commission's commingled pool were made up of salary costs during the period we reviewed, we concluded that 80 percent of the commingled costs the Commission charged to the FS Recovery Act-funded grants likely represented salary costs.¹⁴

The incorrect salary charges stemmed from the way that the accounting system allocated charges to the Commission's different activities. The allocation method charged specific activities for costs in the commingled pool, which included most of the agency's operating costs and all of its salaries—many of which had no relation to the activity or grant work.

The allocation method was based on the number of hours employees tracked to specific activities (e.g., urban forestry work). However, less than half of the total employees' hours were tracked to a specific activity. The rest of the employees' hours were recorded simply as general administration, or vacation time, etc. The allocation method distributed all of the charges in the cost pool only to the specific activities with tracked work hours. In essence, this resulted in these specific activities bearing almost the entire cost of operating the agency, while the non-specific activities bore no charges at all.

More specifically, if on a given day 5 percent of the hours employees tracked to specific activities were attributed to urban forestry, then urban forestry would receive 5 percent of the commingled cost pool—a portion of every transaction—even though many of the costs in the pool had nothing to do with urban forestry. Using this method, eventually the urban forestry grants could be charged for 5 percent of a county's bridge repair, 5 percent of a tractor purchase, and 5 percent of a district manager's salary, even though those costs had nothing whatsoever to do with urban forestry or grant work.

The CFO justified his method of allocating costs by stating that OMB A-87 allows recipients to allocate costs to Federal grants under a cost allocation plan option. OMB allows indirect costs to be allocated if the recipient receives approval for a cost allocation plan (which identifies the amount of indirect costs the recipient can apportion to a grant) or approval for an indirect cost rate (in which an indirect rate is established for the grant recipient to add to direct grant costs). However, the Commission's cost allocation plan was invalid for the following reasons:

First, a cost allocation plan is meant to deal with indirect costs, which are those that benefit more than one grant or objective, such as utilities and rent costs. Although OMB states that direct costs—those that can be tied to specific activities—cannot be included in the plan, they were included in the Commission's plan.

¹⁴ The \$2.8 million in salary charges discussed above was determined by multiplying \$3.4 million by 80 percent.

Second, a cost allocation plan must include an annual estimate of the indirect cost amounts that a grant recipient expects to allocate over the next year based on actual costs from previous years.¹⁵ However, the Commission's cost allocation plan only contained a narrative explaining the methodology of how the accounting system allocated costs. It contained no annual estimates or actual costs from previous years. The CFO created the plan in 1994 and assumed that this documentation was sufficient to support any and all costs the Commission allocated to FS grants from the cost pool over the subsequent 17-year period.

Third, both cost allocation plans and indirect cost rates must receive approval from either the Department of Health and Human Services (HHS), which is responsible for approving cost allocation plans Government-wide, or FS, which would have been responsible for approving the indirect cost rate proposal for these grants. The Commission's cost allocation plan was not submitted to or approved by HHS. Further, FS officials stated that they had never reviewed or approved the plan.

Finally, if the Commission had created an indirect cost rate proposal, 20 percent is likely the indirect cost rate the agency would have been allowed to charge to its grants.¹⁶ However, the way that the Commission allocated costs resulted in an indirect cost rate of 462 percent.¹⁷ OMB specifies that any indirect costs charged to Federal grants without the support of a reviewed and approved indirect cost rate proposal or cost allocation plan are unallowable.

Further, the Commission's grant charges did not comply with Federal regulations and OMB requirements for supporting documentation.¹⁸ Costs charged to Federal grants must be adequately supported by source documentation such as cancelled checks, paid bills, employee time and attendance records, etc. However, only the direct cost portion of the Commission's Recovery Act charges (\$2.9 million) could be traced to source documentation such as invoices. The only way to trace grant charges from the commingled pool to supporting documentation would entail reviewing the thousands of individual source documents associated with the thousands of costs in the pool at any given time. When we attempted to perform this reconciliation, the CFO informed us that the Commission did not maintain a historical record of any particular day's cost pool totals or allocation amounts. It was therefore not possible for us to identify the specific transactions in the pool that were charged to FS grants. Because we could

¹⁵ Cost allocation plans must describe the services being provided, the units providing and receiving the services, the service expenses and the basis of the allocation, and be supported by comprehensive annual financial reports for each service included in the plan.

¹⁶ Similar FS State agency grant recipients evaluated during our review had approved indirect cost rates averaging 17 percent.

¹⁷ Over the 2.5 year period we reviewed, the State agency charged \$13,455,906 in direct costs and \$62,138,845 in allocated indirect costs to its programs and Federal grants. We calculated the indirect cost rate to be 461.8 percent by dividing \$62,138,845 (indirect costs) by \$13,455,906 (direct costs). Also, our calculation of the Commission's 462 percent indirect cost rate is a conservative estimate, because we included sub-grants in our direct cost totals, even though sub-grant awards are generally excluded from indirect cost rate calculations. If the sub-grant amounts are removed from the direct cost totals, the Commission's effective indirect cost rate would increase to approximately 3,271 percent.

¹⁸ OMB Circular A-87 and 2 CFR Part 225, Cost Principles for State, Local, and Indian Tribal Governments, May 10, 2004 and August 31, 2005, respectively.

not identify the transactions that formed the basis for the charges, we also could not trace these charges to source documentation.

Due to all of the prohibited activities described above, we estimate that \$14.4 million of the Commission's charges to FS grants were unallowable. We recommend that FS recover these unallowable costs and require the Commission to make significant changes to its accounting procedures—including creating new procedures that comply with Federal regulations and OMB requirements, documenting those procedures in manuals, and providing the manuals for FS review—before FS provides it with any further grant funds. On November 8, 2011, we discussed our concerns with FS officials who agreed with our finding and recommendations.

Recommendations:

1. Recover from the State agency the \$14.4 million in unallowable costs for the FS Recovery Act and non-Recovery Act-funded grants reviewed and any additional unallowable amount accrued since April 27, 2011.
2. Postpone further grant reimbursements and grant awards to the State agency until it provides the necessary assurances and documentation that it is able to fully comply with the OMB cost requirements and Federal regulations discussed in this report.
3. Direct the State agency to immediately stop (1) commingling FS grant funds with State funds; (2) using unapproved allocation processes to charge costs to its FS grants; and (3) charging indirect costs to FS grants using its current method.
4. If the State agency wants to continue to charge indirect costs to its FS grants, direct the State agency to submit to FS an indirect cost rate proposal for FS review and approval. If the State agency elects to charge indirect costs using a cost allocation plan, direct the State agency to prepare and submit its cost allocation plan to HHS for formal review and approval.
5. Direct the State agency to implement procedures that ensure all costs charged to FS grants are allocated and supported in accordance with Federal regulations and OMB requirements.
6. Direct the State agency to document how it accounts for FS grant funds in its operating manuals. At a minimum, it should document its process for identifying and allocating both direct and indirect costs to Federal grants, how it accounts for and supports grant expenditures and disbursements, and how it reconciles grant costs and project accomplishments to grant approved budgets.
7. When the State agency creates its new manuals, assess the State agency's financial accounting processes relating to grants. During the assessment, ensure the State agency has developed procedures to separately track and account for FS grant funds in compliance with OMB requirements. Also confirm that any indirect costs or allocation

procedures used by the grant recipient comply with the indirect cost rate plans or cost allocation plans formally reviewed and approved by FS or HHS. Ensure the Commission corrects any deficiencies.

8. Perform periodic reviews to spot check the State agency's financial accounting practices to ensure that the State agency is properly accounting for the FS grant funds in accordance with OMB requirements.

Please provide a written response within 5 days outlining your proposed corrective action for this issue. If you have any questions, please contact me at (202) 720-6945, or have a member of your staff contact Joseph Mickiewicz, Director, Food, Nutrition, Marketing, and Development Division, at (202) 720-5907.

USDA'S

FOREST SERVICE'S

RESPONSE TO AUDIT REPORT



File 1430
Code:
Route
To:

Date: December 15, 2011

Subject: Response to Office of Inspector General (OIG) FAST Report No. 08703-5-SF(7), State Agency Charged Recovery Act Grants and Non-Recovery Act Grants \$14.4 Million in Unallowable Costs

To: Gil H. Harden, Assistant Inspector General for Audit

This letter is in response to FAST Report No. 08703-5-SF (7) "State Agency Charged Recovery Act Grants and Non-Recovery Act Grants \$14.4 Million in Unallowable Costs" received on November 23, 2011 from the US Department of Agriculture (USDA) Office of the Inspector General (OIG). We appreciate the opportunity to respond to the referenced report. The Forest Service generally concurs with the recommendations and the response for each is as follows:

OIG Recommendation #1: Recover from the State agency the \$14.4 million in unallowable costs for the FS Recovery Act and non-Recovery Act-funded grants reviewed and any additional unallowable amount accrued since April 27, 2011.

Forest Service Response: The agency will perform a review and will manage any issues identified as applicable by the OMB Circulars and federal cost accounting principles. These actions will be completed by April 30, 2012.

OIG Recommendation #2: Postpone further grant reimbursements and grant awards to the State agency until it provides the necessary assurances and documentation that it is able to fully comply with the OMB cost requirements and Federal regulations discussed in this report.

Forest Service Response: The FS will postpone further grant reimbursements and grant awards to the State agency until it provides assurances and documentation to the FS that it is able to fully comply with OMB cost requirements and Federal regulations, except where there is documentation that funds are being delivered to a third party, such as a contact vendor or landowner, and the costs comply with OMB requirements and federal regulations. In such instances, the agency will continue reimbursements and awards because there is minimal risk of inappropriate reimbursement to the Alabama Forestry Commission (AFC). Supporting documentation of compliance is due to the FS by February 29, 2012.

OIG Recommendation #3: Direct the State agency to immediately stop (1) co-mingling FS grant funds with State funds; (2) using unapproved allocation processes to charge costs to its FS grants; and (3) charging indirect costs to FS grants using its current method.



Forest Service Response: The FS agrees with this recommendation and the AFC should take appropriate actions in accordance with the applicable OMB Circulars that govern the administration of grants. This recommendation was addressed in a letter sent to Alabama State Forester Linda Casey on December 9, 2011 (enclosed A).

OIG Recommendation # 4: If the State agency wants to continue to charge indirect costs to its FS grants, direct the State agency to submit to FS an indirect cost rate proposal for FS review and approval. If the State agency elects to charge indirect costs using a cost allocation plan, direct the State agency to prepare and submit its cost allocation plan to HHS for formal review and approval.

Forest Service Response: The FS agrees with recommendation. The AFC submitted an Indirect Cost Rate Proposal to the FS. The indirect cost rate has been approved by the Agency (enclosures B).

OIG Recommendation #5: Direct the State agency to implement procedures that ensure all costs charged to FS grants are allocated and supported in accordance with Federal regulations and OMB requirements.

Forest Service Response: The FS generally agrees with this recommendation. FS issued a letter reminding AFC of their responsibility to comply with applicable OMB Circulars that govern the administration of grants. The letter was sent to Alabama State Forester Linda Casey on December 9, 2011 (enclosed A).

OIG Recommendation #6: Direct the State agency to document how it accounts for FS grant funds in its operating manuals. At a minimum, it should document its process for identifying and allocating both direct and indirect costs to Federal grants, how it accounts for and supports grant expenditures and disbursements, and how it reconciles grant costs and project accomplishments to grant approved budget.

Forest Service Response: The FS generally agrees with this recommendation. FS issued a letter reminding AFC of their responsibility to comply with applicable OMB Circulars that govern the administration of grants. The letter was sent to Alabama State Forester Linda Casey on December 9, 2011 (enclosed A).

OIG Recommendation #7: When the State agency creates its new manuals; assess the State agency's financial accounting processes related to grants. During the assessment, ensure the State agency has developed procedures to separately track and account for FS grant funds in compliance with OMB requirements; also confirm that any indirect costs of allocation procedures used by the grant recipient comply with the indirect cost rate plans for cost allocation plans formally reviewed and approved by FS or HHS. Ensure the Commission corrects any deficiencies.

Forest Service Response: The FS agrees with this recommendation and will assess the State's processes relating to grants. This action will be completed by April 30, 2012.

OIG Recommendation #8: Perform periodic reviews to spot check the State agency's financial accounting practices to ensure that the State agency is properly accounting for the FS grant funds in accordance with OMB requirements.

Forest Service Response: The FS agrees with this recommendation and will take appropriate action in accordance with applicable OMB Circular requirements. The FS will conduct periodic reviews on AFC's accounting practices to ensure continued compliance once recommendations 1-7 have been completed as of April 30, 2012.

If you have any additional questions, please contact Donna Carmical, Chief Financial Officer, (202) 205-1321, dcarmical@fs.fed.us.

/s/ Donna M. Carmical

DONNA M. CARMICAL
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