Report to Management

FEDERAL FUNDS JUSTIFICATION AUDIT

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Texas Water Development Board

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KEY POINTS OF INTEREST

Overall Conclusion

At the direction of the TWDB Executive Administrator (EA), a thorough review of the federal funds justification memoranda was initiated by a policy analyst (PA) from the Policy Integration and Federal Coordination Division in the summer of 2010. The EA also directed the PA to develop an action plan to increase budgetary oversight of the Clean Water and Drinking Water state revolving funds. Although the PA was assigned to this task temporarily (six months), the TWDB Executive Administrator has decided to continue to support a position that is responsible for the continued review and analyses of the budget and expenditures of both state revolving funds.

Based on the review conducted by the PA, and the supporting documentation of the justification memoranda, it appears that the spending of federal funds was reasonable. The analyses conducted by the PA are a good foundation for further expansion of analytical reviews in upcoming fiscal years.

Key Facts and Observations

Prior to the FY 2010 budget process, the justification memoranda were forwarded and reviewed by Finance. The review function was transferred to the Policy Integration and Federal Coordination (PI&FC) division upon its creation in May 2009. In preparation for the FY 2010 budget, the PI&FC division initiated a process for reviewing the justification memoranda. At the direction of the Executive Administrator, this process was further expanded for the FY 2011 budget process.

As part of the Justification Process, each DEA area must justify any use of State Revolving Funds (SRFs) through an SRF Justification Memorandum. The memoranda were forwarded to a PA from PI&FC division who was directed to perform the reviews.

The supporting documentation for the federal funds justification process was reviewed and the use of funds appeared to be reasonable.

The PA, in conjunction with Finance and Budget, is developing policies, procedures and guidance and training to better clarify the appropriate uses of the state revolving funds for FY 2011 and beyond. Per the EA's request, the PA developed a work plan to strengthen the administration and management of the budgetary processes of the SRFs.

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FEDERAL FUNDS JUSTIFICATION AUDIT

A. Management Summary

1. Purpose

The purpose of this report is to present the conclusion, observations, recommended action plans, and management responses from an audit of the Federal Funds Justification process. This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* and Generally Accepted Government Auditing Standards.

The government standards require the audit to be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for observations and conclusions based on the selected audit objectives. The evidence obtained provides a reasonable basis for the observations and conclusions based on these objectives.

2. Background

The audit of the Federal Funds Justification process was conducted in accordance with Internal Audit's annual audit plan. Although the scope of the audit encompassed the entire agency, its focus centered upon the work performed on the process by the policy analyst (PA) in the Policy Integration and Federal Coordination (PI&FC) division.

The submission and review of the State Revolving Fund (SRF) Justification Memoranda has been in place for over a decade. Prior to FY 2010 and the establishment of the PI&FC division, the responsibility was most recently housed in Finance. In the earlier years the Deputy Executive Administrator (DEA) and the Budget Officer for the Office of Project Finance and Construction Assistance monitored the budgetary process. In part, it was in recognition that the process needed a more focused review, that the PI&FC division was created.

In June 2010, the Executive Administrator (EA) decided that the entire budgetary process for the SRFs should be reviewed to assure program accountability was maintained by the areas in the agency primarily responsible for administration of the capitalization grants. He assigned the PA from the PI&FC division to this special project on a six-month basis. Subsequently, the EA decided to continue to support a position that is responsible for the review and analyses of future SRF justification memoranda and budgetary review of the SRFs.

As part of the budget process, which begins in the spring (April-May), the DEAs submit their requests for the upcoming fiscal year, based upon current funding baseline, full time equivalents (FTEs), operating expenses, equipment, professional fees, etc. For purposes of this audit, DEAs include the EA, the General Counsel and the Chief Financial Officer.

Any use of administrative four percent set-aside of either the Clean Water SRF or the Drinking Water SRF must be detailed through an SRF Justification Memorandum from every DEA. This includes the administrative charges against the American Recovery and Reinvestment Act (ARRA) SRFs as well.

3. Scope and Objectives

The scope of this audit encompassed the examination and evaluation of the adequacy and effectiveness of the internal controls and quality of performance in carrying out assigned responsibilities in relation to the federal funds justification process. The scope included specific program steps designed to assess:

- Reliability and integrity of information.

The objectives included procedures designed to determine if:

- A process for the justification of use of federal funds is in place;
- Supporting documentation for the federal funds justification process exists; and
- Supporting documentation for the federal funds justification process is reviewed.

4. Conclusion

At the direction of the EA, a thorough review of the federal funds justification memos was initiated by a PA from the PI&FC division in the summer of 2010. The EA also directed the PA to develop an action plan to increase budgetary oversight of the revolving funds. Although the PA was assigned to this task temporarily (six months), the EA has decided to continue to support a position that is responsible for the continued review and analyses of the budget and expenditures of both state revolving funds.

Based on the review conducted by the PA and the supporting documentation of the justification memos, it appears that the spending of federal funds was reasonable. The analyses conducted by the PA are a good foundation for further expansion of analytical reviews in upcoming fiscal years.

5. Action Plan

The following steps are recommended:

- The analyses of the SRF funds should be continued. It was due to the EA's guidance, experience, and authority that the PA began the analyses of the justification memos and was granted the cooperation and collaboration of the various offices. If continued, this position would be responsible for monitoring and initiating any needed changes in the funding of activities and agency staff positions from Clean Water (CW) SRF and Drinking Water (DW) SRF. The EA's continued guidance and authority is needed for this position until such time as it is evident that grant management staff in the Project Finance divisions have fully assumed this role. Additionally, training in the area of grants management should be promoted to ensure that the agency staff has the skill sets necessary to both develop and manage these complex federal grants. Better processes, procedures and documentation for agency staff will, over time, result in a deeper understanding of the appropriate uses of the administrative funds.

B. Detailed Observations

1. A Review of Federal Funds Justification Memos Has Been Initiated

As part of the Justification Process, each DEA area must justify any use of SRFs through an SRF Justification Memorandum. The process is labor intensive. In the recent past, the memoranda were submitted to Budget, which is located within Finance. However, Budget did not have sufficient expertise in program requirements to ensure that the justifications for the use of SRFs were deemed reasonable, necessary and applicable.

In 2009, in response to the previous IA audit of the Federal Funds Justification Process, the PI&FC division was created. It was at this point that the EA initiated an in-depth study of the SRFs and management of the SRFs' capitalization grants.

Upon the formation of the PI&FC division in May 2009, the policy analyst (PA) from that division was instructed by the EA to begin reviewing the justification process. The memoranda were due in early June for FY 2010. The PA initiated some review processes, but only had an opportunity to become familiar with, and review, the memos. It was agreed that a more exhaustive review would be conducted for the memoranda submitted for FY 2011.

For FY 2011, the PA had more time to complete in-depth analyses of each DEA area. The key questions from the analyses were:

- How many agency full-time or partial staff positions were funded by the SRFs?
- What was their justification for being funded?
- Do the charges tie to the requirements of the programs; are they essential services or are the professional fees essential to the program?
- How does this year's request compare to last year's?
- What percentage of all staff positions in each area are funded by the SRFs, and does this look reasonable?

The PA compared FY 2011 justification memoranda to FY 2010 memoranda. As part of background research for duties related to SRFs, the PA asked each area to define the duties of their staff, provide verification of those duties and, where applicable, examples of work product or work processes.

On June 18, 2010, the Director of the PI&FC division and the EA announced they were loaning the services of the PA to Project Finance, effective June 28, 2010. The PA would report to both Project Finance (primarily) and Construction Assistance for a term of six months (the PA had already been devoting almost half of staff time to assist Construction Assistance on TxWISE development).

Due to the PA's programmatic and budgetary knowledge of the of the SRF programs, the PA was asked to develop a work plan to strengthen administration of the SRFs, and to help Project Finance implement any necessary administrative changes in the programs.

Although the PA was assigned to this task temporarily, the EA has decided to continue to have a position responsible for the review and analyses of future SRF Justification memoranda and budgetary processes.

Recommended Action Plan 1: None required.

2. Supporting Documentation for the Federal Funds Justification Process Exists

As part of the Justification Process, each DEA area must justify any use of SRF through an SRF Justification Memorandum.

The PA received the following memoranda in the summer of 2010:

ARRA:

- "Justification for State Revolving Funds – American Recovery and Reinvestment Act(ARRA) for Related Work in Fiscal Years 2010 and 2011"

Construction Assistance:

- "State Revolving Fund Memo" from Construction Assistance

Chief Financial Officer:

- "CWSRF/DWSRF Level of Effort and Allocation for Financial Monitoring Team Justification and Calculation Methodology for SRF Funding";
- "CWSRF/DWSRF Justification and Calculation methodology" from the Director of Debt and Portfolio Management; and
- CWSRF/DWSRF Justification and Calculation Methodology from the Director of Administration in the Accounting Office

Operations and Administration:

- "SRF Justification Memo for Records Management";
- "State Revolving Fund (SRF) Justification Memo for Data Center Services" from Information Technology;
- "State Revolving Fund (SRF) Justification Memo for Information Technology"; and
- "CWSRF/DWSRF State Revolving Fund (SRF) Justification for Contracting and Purchasing Staff, Fiscal Year 2011

Project Finance:

- "Justification for State Revolving Funds – Project Finance Office" addressed to the CFO;

Water Resources Planning & Information (WRPI):

- "WRPI State Revolving Fund Allocation for Fiscal Year 2011"

Water Science & Conservation:

- "CWSRF/DWSRF Level of Effort and Allocation for Water Science and Conservation for Fiscal Year 2011."

Legal Services:

- "ARRA SRF Justification Memo for Legal Services"; and
- "SRF Justification Memo for Legal Services"

Policy Integration and Federal Coordination Division:

The PA also authored a memo to the CFO and Budget director justifying the use of the SRF funds for the PA's position:

- "Division SRF Justification Memo for Fiscal Year 2011" from the Policy Integration and Federal Coordination division addressed to the CFO and Budget Director.

The documentation was extensive and sufficient to support the requests for SRF funding.

Recommended Action Plan 2: None required.

3. Supporting Documentation for the Federal Funds Justification Process is Reviewed and Assures the Reasonableness of Funds Used

A review of the copies of justification memoranda indicated that all were addressed to either the CFO or the PA. At times, a subsequent and revised version of the memorandum was sent from a DEA, which implies a review of the previous version and communication with the area regarding adjustments. The files of the PA also contained correspondence regarding changes to area budgets.

At the direction of the EA, all direct charges against the SRF's were scrutinized. This resulted in identifying opportunities to shift funding from the SRFs to other funding sources and to reduce the overall charges to the programs. While the past charges were justified, the available resources of the administrative funding are now more constrained.

Due to a short time frame, the PA concentrated on the direct charged staff and professional fees and did not review the indirect charges to the SRF. However, the process of calculating the indirect rate is well documented in Budget and Finance and is approved by the Environmental Protection Agency. During the review, the PA, in close collaboration with the DEAs, identified 15.74 full time equivalents that could be funded from sources outside the SRFs. Conversely, in one division the analysis resulted in an increased use of SRF funding for 2.46 positions.

The PA compared the FY 2010 spreadsheet to the FY 2011 spreadsheet and determined that many units were using increasing amounts of SRF funding. For example, a unit may have four employees justified and then hire a fifth, who would also be funded by SRF.

The PA tied DEA areas' SRF Justification Memoranda back to the position control numbers.

The PA reviewed all budgets and spending in SRFs to determine if they appeared reasonable. A review of expenses for each DEA area was part of this process; a review of respective revenues is anticipated in the future.

Finally, as a best practices exercise, the PA compared base administrative charges for CWSRF (over the life of the CWSRF program) for the top ten states based upon total CWSRF loan assistance. This data was analyzed a number of ways to

determine whether or not Texas was in line with the other large CWSRFs. Generally, Texas' administrative funding appears to be comparable with the other top ten states.

Recommended Action Plan 3: The analyses of the SRFs should be continued. It was due to the EA's guidance, experience, and authority that the PA began the analyses of the justification memos and was granted the cooperation and collaboration of the various offices. If continued, this position would be responsible for monitoring and initiating any needed changes in the funding of activities and agency staff positions from CWSRF and DWSRF. The EA's continued guidance and authority is needed for this position until such time as it is evident that grant management staff in the Project Finance divisions have fully assumed this role.

Additionally, training in the area of grants management should be promoted to ensure that the agency staff has the skill sets necessary to both develop and manage these complex federal grants. Better processes, procedures and documentation for agency staff will, over time, result in a deeper understanding of the appropriate uses of the administrative funds.

Management Response 3: *Generally, management agrees with the recommendation. The evaluation of the use of SRF funds for administrative purposes will continue, as the agency strives to strengthen all areas of financial management and fiscal prudence. Such scrutiny and continuous improvement are a priority for management.*

The Executive Administrator will direct his deputies to fully cooperate and collaborate in the monitoring and management of SRF administrative expenses. The EA will delegate oversight of the daily activities for evaluating and strengthening management of SRF administrative funding to the Director of Policy Integration and Federal Coordination. The Policy Analyst from the Policy Integration and Federal Coordination division will continue to serve as the lead staff in identifying needs and issues and recommending improvements and solutions. This activity is ongoing and perpetual.

The Executive Administrator will direct the Deputy Executive Administrator for Project Finance to establish an organizational structure and process for managing the SRF grants. The Deputy should identify training needs, development of procedures and accountability measures to ensure effective and efficient management of the programs. The Deputy will be charged with consulting with the Chief Financial Officer on final plans and procedures, and should incorporate Accounting and Budget staff as necessary.

Responsible parties: *Deputy Executive Administrator of Project Finance*

Estimated completion date: *March 31, 2011*

4. <u>The Review Process is Evolving and Expanding</u>

The PA is developing and clarifying guidance, standards, and processes for directly charging the SRFs. Toward this end, the PA is currently working closely with the agency's Chief Financial Officer and Budget Director to develop a

budgetary and encumbrance tracking mechanisms and processes. They will also develop training for the budget officers and agency staff so all have a better understanding of the appropriate uses of the administrative set aside funds.

Under the EA's direction, a work plan was developed to strengthen the administration and management of the SRFs to include the eventual review of the fees that the programs charge to borrowers. This work plan includes a comprehensive look at both the revenue and expense side of the budgetary process. The assignment is also to analyze operations to ensure the program is meeting goals and requirements of Clean Water Act /Safe Drinking Water Act.

The PA performed an analysis of professional fees charged against the SRFs. This initiated a change: Now an SRF justification memo is required for all professional contracts. For instance, a review of a contract for the Lower Colorado River Authority for groundwater analyses, which is funded in part from the DWSRF, revealed that the data collected is also used by the Texas Commission on Environmental Quality (TCEQ) for a required report. The TWDB has formally requested that the TCEQ consider funding this expense from their DWSRF set-asides. Should this occur, it would provide a modicum of relief to our four percent set-aside. The amount of the request is for $184,000 per year. To date, no agreement has been reached.

Recommended Action Plan 4: None required.

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