

Schedule of Federal Audit Findings and Questioned Costs

**Town of Cathlamet
Wahkiakum County
January 1, 2012 through December 31, 2012**

- 1. The Town's internal controls were not adequate to ensure compliance with suspension and debarment requirements.**

CFDA Number and Title:	10.760 – Water and Waste Disposal Systems for Rural Communities
Federal Grantor Name:	U.S. Department of Agriculture
Federal Award/Contract Number:	08
Pass-through Entity Name:	NA
Pass-through Award/Contract Number:	NA
Questioned Cost Amount:	\$0

Description of Condition

During 2012, the Town spent \$2,632,766 of a federal loan through the Water and Waste Disposal Systems for Rural Communities program.

Suspension and Debarment

Federal grant regulations prohibit recipients from contracting with or making subawards to parties suspended or debarred from doing business with the federal government. For vendor contracts of \$25,000 or more and all subawards, the City must ensure the vendor or subrecipient is not suspended or debarred.

To meet this requirement, the vendor or subrecipient can certify in writing that it has not been suspended or debarred, either as part of the contract or in a separate certification. Alternatively, the City can check for suspended or debarred parties by reviewing the federal Excluded Parties List System maintained by the U.S. General Services Administration. The City must also inform the primary contractor of its responsibility to check the status of any covered transactions they enter into at the next lower level. The City must meet these requirements prior to entering into contracts with vendors or subrecipients.

The Town paid \$92,334 of its grant funding to one vendor for services for engineering and project management for the waste water treatment facility project. The Town was not aware of this federal requirement and thus did not verify the federal suspension and debarment status of this vendor using one of the three options.

Cause of Condition

The Town's staff responsible for this grant was not aware of the suspension and debarment requirements for federally funded contracts.

Effect of Condition

Without proper controls, the Town increases the risk of awarding funds to vendors or subrecipients that are suspended or debarred from participating in federal programs. Any payments made to an ineligible party are unallowable and would be subject to recovery by the funding agency. Failure to comply with federal requirements may jeopardize the City's eligibility for future federal assistance.

We were able to verify that the vendor was not suspended or debarred; therefore, we will not question costs paid under the contract.

Recommendation

We recommend the City develop appropriate internal controls, including training for staff, to ensure it complies with federal suspension and debarment requirements.

Town's Response

The Town of Cathlamet has for years employed an engineering firm that does business with numerous municipalities and other public agencies across the state of Washington. This firm was tasked with project management for the Town's wastewater treatment facility. Part of their responsibility was to vet the general contractor and all subcontractors to determine if they had been suspended or debarred from doing business with the federal government. That task was undertaken in compliance with the law.

Yet the Town omitted undertaking a formal check of its engineering firm to determine whether this firm had been suspended or debarred from doing business with the federal government. A simple statement from the firm stating that it had not been suspended or debarred, or contract language indicating such, would have sufficed. This was not done because the Town was not aware that the suspension and debarment rules applied also to a vendor originally hired many years before the waste water treatment plant project was launched.

We consider the oversight to be 1) minor and 2) of the sort that are inevitable when undertaking a project of the scale and scope of our waste water treatment facility for the first time. It is regrettable that a mistake of this nature would result in a federal audit finding.

We are perplexed by the recommendation of additional training as a corrective measure. Given the lifespan of infrastructure projects, it is unlikely that our current staff or elected officials will again undertake a project of similar scale to our wastewater treatment facility. If that assessment is incorrect, this finding will serve as a reminder to conduct suspension and debarment checks in the future.

Auditor's Remarks

The Town is required to be knowledgeable of federal requirements when accepting federal awards in order to ensure compliance. Training is a method to obtain this knowledge.

We appreciate the discussions with management on suspension and debarment and will review the corrective action during our next regularly schedule audit.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-133, *Audits of states, Local Governments, and Non-Profit Organizations*, Section 300, states in part:

The auditee shall:

(b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.

(c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

Title 2, Code of Federal Regulations, Section 180.220, states in part, Are any procurement contracts included as covered transactions?

(b) Specifically, a contract for goods or services is a covered transaction if any of the following applies:

(1) The contract is awarded by a participant in a non-procurement transaction that is covered under §180.210, and the amount of the contract is expected to equal or exceed \$25,000 . . .

(c) A subcontract also is a covered transaction if,—

(1) It is awarded by a participant in a procurement transaction under a nonprocurement transaction of a Federal agency that extends the coverage of paragraph (b)(1) of this section to additional tiers of contracts (see the diagram in the appendix to this part showing that optional lower tier coverage); and

(2) The value of the subcontract is expected to equal or exceed \$25,000.

Title 2, Code of Federal Regulations, Section 180.300 – What must I do before I enter into a covered transaction with another person at the next lower tier?

When you enter into a covered transaction with another person at the next lower tier, you must verify that the person with whom you intend to do business is not excluded or disqualified. You do this by:

- (a) Checking the EPLS; or
- (b) Collecting a certification from that person; or
- (c) Adding a clause or condition to the covered transaction with that person.

Title 2 Code of Federal Regulations, Section 180.330 – What requirements must I pass down to persons at lower tiers with whom I intend to do business?

Before entering into a covered transaction with a participant at the next lower tier, you must require that participant to—

(a) Comply with this subpart as a condition of participation in the transaction. You may do so using any method(s), unless the regulation of the Federal agency responsible for the transaction requires you to use specific methods.

(b) Pass the requirement to comply with this subpart to each person with whom the participant enters into a covered transaction at the next lower tier.

Schedule of Audit Findings and Responses

Town of Cathlamet Wahkiakum County January 1, 2012 through December 31, 2012

2. The Town does not have adequate internal controls over accounting and financial statement preparation to ensure accurate reporting.

Background

It is the responsibility of the Town to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting. Controls must ensure that financial data is reliably authorized, processed and reported. Our audit identified deficiencies in internal controls over financial reporting that could affect the Town's ability to produce reliable financial statements.

In addition to annual financial statements, all entities in the state of Washington that receive federal money are required to prepare a Schedule of Expenditures of Federal Awards (SEFA) as part of their annual financial report. The SEFA should include all expenditures of federal money made by the Town in each fiscal year. The SEFA aids in the selection of programs we review as part of the Town's federal compliance audit.

Description of Condition

We identified the following weaknesses in internal controls that, when taken together represent a significant deficiency:

- The Town did not have an understanding of how to report grants and loans on the SEFA. Specifically, the guidance from the *Budget, Accounting and Reporting System* (BARS) manual was not used to ensure financial reporting was done in accordance with the BARS manual.
- The Clerk-Treasurer prepares journal entries and reconciles bank statements. However, there is no oversight or review of the journal entries or the bank reconciliation by a person independent of the preparation for accuracy or completeness.
- The Town has assigned responsibility for preparing all portions of the financial statements to one individual. No independent review process was in place to ensure financial statements were complete and accurate.

Cause of Condition

Historically, the Town has not received many federal grants or loans. As a result, the Town has not designed sufficient controls to address federal reporting. In addition, the Town has not committed the necessary resources, such as training for staff and oversight, to ensure accurate and complete financial reporting of Town operations.

Effect of Condition

Our audit identified the following errors, which the Town has corrected:

Financial statements

- The Town did not properly consolidate funds on this schedule in accordance with BARS requirements.

Long Term Liabilities

- The Town did not report the USDA rural development loan activity on their schedule of Long Term Liabilities in the amount of \$2.3 million.
- The Town reported its compensated absences twice, resulting in the liability being over reported by \$20,124.

SEFA

- The Town did not report federal loans of \$2,632,766 on its original SEFA provided for audit. Inaccurate reporting of the federal expenditures affected the number of audit programs required under federal Office of Management and Budget Circular A-133.
- The Town did not report a federal grant program of which the Town expended \$96,333 in grant expenditures.

Recommendation

We recommend the Town establish internal controls procedures and dedicate the resources to make sure financial reports are complete and accurate. The Town should ensure:

- Staff responsible for preparing and reviewing the financial statements are knowledgeable of reporting requirements and follow BARS Manual guidance.
- Bank statements and journal entries are reviewed for accuracy and completeness.
- Someone knowledgeable of the BARS Manual perform a thorough and independent review of the financial statements and supporting schedules to ensure they are accurate, complete and presented in accordance with the BARS Manual.

Town's Response

The Town of Cathlamet recognizes that its internal financial controls over accounting and financial statements are not perfect and takes the issue very seriously. Reforms are ongoing, and guidance from the State Auditor's Office is welcome.

In this instance; however, we believe the problems identified in this audit could have been addressed in the form of a Management Letter. One condition identified by the SAO resulted from incorrect guidance given to us by an SAO auditor, resulting in key data being submitted in footnotes rather than on a federal expenditures schedule. We also believe that complications with the audit process, which included technical problems transmitting financial information, tainted this audit in a manner unfavorable to the Town.

We address several identified condition in detail:

Schedule of Expenditures of Federal Awards: We dispute the SAO assertion that our SEFA was prepared incorrectly. A review of the BARS Manual (p.343) indicates that expenditures are reported "when the loan proceeds are used." The USDA-RD's loan portion of our wastewater treatment plant project was spent in 2013, not 2012. We believe our approach is validated by the BARS Manual section "Question: When do I report a loan on my SEFA?"

Before preparing the SEFA, our Clerk-Treasurer sought guidance from the major funding agency for our wastewater treatment facility (USDA-RD) and from an auditor for the SAO; the specific issue was how to report funding received but not yet spent. Following that guidance, on the SEFA submitted our expenditures were reported and a federal grant was in fact reported, though reference to it appearing only in a footnote. No financial loss resulted from this approach.

Long Term Liabilities: The Town did in fact report expenditures, but indicated (correctly) that the source of funding was interim financing, which is short term bank funding and not actual federal money. The Town also indicated that in 2013 this debt would upon the issuance of a bond become long term debt from a federal entity (USDA-RD).

The Town challenges the assertion that it "reported its compensated absences twice." In our actual report these were reported once. During uploading to the SAO website, problems were encountered in which some bars code entries were rejected. In our efforts to complete the transmittal, the same compensation date was accepted both into the proprietary and non-proprietary reports which 1) the Town was unaware of and 2) could not have been deleted if we had known of this glitch. Our compensated absence data was complete and properly prepared. This issue is wholly the result of the technology in use in Town Hall not being fully compatible with the technology used by the SAO last year.

Financial Statements: It is correct to say that the Town did not properly consolidate funds in 2012. It is also true that the Town followed consolidation methodology that would have been correct based on BARS requirements in 2011. The problem arose because, due to scheduling conflicts, our Clerk-Treasurer could not attend a BIAS workshop last year.

It would help small communities immensely if major BARS requirements were modified less frequently. In this case, training undertaken in 2011 (attendance at a BIAS workshop) was inapplicable just one year later.

Conclusion: The Town of Cathlamet operates two utilities, a fire/ambulance service, street and parks programs, and a library. We have two Town Hall employees and three full-time Public Works employees. We set spending priorities based on actual need in our community, though often that does not allow for spending on BARS or BIAS trainings every year. Technology upgrades are by necessity infrequent.

We recognize that our internal controls are not perfect, but considering the constraints under which we operate we believe we have overseen both routine business and major projects effectively. We would encourage the SAO to reinstitute programs focused specifically on small communities.

Auditor's Remarks

Town management is responsible for implementing internal controls to ensure accurate reporting. The financial statements with the errors identified were provided for audit and confirmed by management to be final financial statements. We determined that the deficiencies identified during our audit were significant deficiencies. We are required by auditing standards to report significant deficiencies.

We reaffirm our finding and will review the corrective action taken during the next regular audit.

Applicable Laws and Regulations

RCW 43.09.200 states in part:

The state auditor shall formulate, prescribe, and install a system of accounting and reporting for all local governments, which shall be uniform for every public institution, and every public office, and every public account of the same class.

Budget, Accounting and Reporting System Manual – Part 3, Accounting, Chapter 1. Accounting Principles and General Procedures, Section B. Internal Control states in part:

Internal control is defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), in standards adopted by the American Institute of Certified Public Accountants and by the Federal Office of Management and Budget as follows:

Internal control is a process – affected by those charged with governance, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations
- Reliability of financial reporting

Management and the governing body are responsible for the government's performance, compliance and financial reporting. Therefore, the adequacy of internal control to provide reasonable assurance of achieving these objectives is also the responsibility of management and the governing body. The governing body has *ultimate* responsibility for ensuring adequate controls to achieve objectives, even though *primary* responsibility has been delegated to management. Since management and the governing body are assumed to work in harmony, both parties are collectively referred to as "management" throughout the rest of this section.

Budget, Accounting and Reporting System Manual – Part 4, Reporting, Chapter 3. Supplemental Schedules, Schedule 16. Expenditures of Federal Awards and State/Local Financial Assistance states in part:

Question: When do I report the loan on my SEFA?

Answer: Circular A-133, section 205, and guidance from the AICPA state the loan is considered expended "when the loan proceeds are used".

- Reimbursement Basis: Most loans are funded on a reimbursement basis where the borrower incurs program-related costs and then makes a request to the lender for the loan proceeds. In this case, report the amount expended during the year for which the government will seek loan funding.
- Loan Advances: Some loans are made in advance of any project-related expenditures. Because the federal government is at risk for these loans, the total proceeds received should be reported on the SEFA even if the government has not spent all the funding. Contact the lender to determine if it requires the full amount of proceeds to be reported in the year of receipt.
- Revolving Loans. If the entity receives federal funds and then makes a loan to another party, report the amount of loans the government made during the year. (Refer to additional guidance on revolving loan funds below).

Exceptions to the Rule:

- USDA Interim Financing: Water and Waste Disposal Systems for Rural Communities (CFDA 10.760), Community Facilities Loans and Grants (CFDA 10.766). After the USDA has made a commitment on a loan as evidenced by an approved "request for obligation of funds", the borrower may obtain interim financing from commercial sources (e.g., a bank loan) during the construction period. Expenditures from these commercial loans which will be repaid from a USDA loan should be considered Federal awards expended, included in determining Type A programs, and reported in the Schedule of Expenditures of Federal Awards.

Government Auditing Standards, July 2007 Revision – Section 5.11 provides that auditors should report material weaknesses and significant deficiencies in internal control.

The American Institute of Certified Public Accountants, Statement on Auditing Standards No. 115 defines significant deficiencies and material weaknesses as follows:

- a. Significant deficiency: A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- b. Material weakness: A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, Subpart B; Audits, Section 205, states in part:

Basis for determining Federal awards expended.

- (a) Determining Federal awards expended. The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.
- (b) Loan and loan guarantees (loans). Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:
 - (1) Value of new loans made or received during the fiscal year; plus
 - (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
 - (3) Any interest subsidy, cash, or administrative cost allowance received.