



August 24, 2006

OIG Audit Report No. 06-21

**MEMORANDUM FOR: FEDERAL CO-CHAIR
 ARC EXECUTIVE DIRECTOR**

SUBJECT: Review of Kentucky Finance and
 Administration Cabinet
 Appalachian Kentucky Entrepreneurship Initiative Project
 KY-13795

PURPOSE

The purposes of our review were to determine; (1) the allowability of the costs claimed under the ARC grant; (2) if the grant objectives were met and; (3) the current status of the project.

SCOPE

Our review included procedures to review costs incurred and claimed for reimbursement under the grant, as well as costs claimed as matching funds. The period of performance for the grant was September 1, 2001 through February 28, 2003, with two requested extensions to continue the project thru February 28, 2005. A change in Governor ended the grant on June 30, 2004.

We reviewed the grantee's reports, examined records, and held discussions with grantee officials in Lexington, Kentucky, on July 7, 2005. A draft report was issued to the grantee for comment on January 11, 2006. A response was requested within 30 days. ARC received a response on June 7, 2006. Discussions were held over the past months with the grantee, the OIG auditor and the ARC Coordinator. As a basis for determining allowable costs and compliance requirements, we used the provisions of the grant agreement, Office of Management and Budget (OMB) Circulars A-87 and A-102, and the ARC Code. Audit work was performed in accordance with Government Auditing Standards.

BACKGROUND

ARC Grant KY-13795 was awarded to the Kentucky Finance and Administration Cabinet to provide funding assistance for a program to support the development of new entrepreneurial businesses and the expansion of existing small firms in the distressed counties of Appalachian Kentucky. ARC funds were to be used to coordinate professional, technical, financial, sales, and marketing and human resource services to selected entrepreneurial firms to expand their business opportunities. Services were to be procured through a competitive selection process.

The total project cost was estimated at \$312,500, with contributing funds as follows:

ARC	\$250,000	80%
Local	<u>62,500</u>	<u>20%</u>
	\$312,500	100%

The draft report was sent to Kentucky Finance and Administration Cabinet on January 11, 2006, and the response was received by ARC on June 7, 2006. There had been phone conversations between the grantee and the ARC Project Coordinator.

RESULTS

Financial Review

During our visit, we reviewed the grantee's accounting records, including invoices and supporting documentation for the grant costs charged to the project. Claimed costs were supported by the grantee's accounting records. The adequacy of the documentation for the expenditures we reviewed were lacking in detail concerning the work actually accomplished for the amounts charged to ARC.

The grantee's last reimbursement request, dated December 17, 2004, claimed total costs of \$228,383, which included ARC grant costs of \$180,600 (80%) and matching costs of \$47,784 (20%). The final report was received November 29, 2004, and the grant was closed on January 25, 2005, with a deobligation of \$69,400.

Some deficiencies were noted as follows:

FINDING 1 - Subcontractor charging consultant fee for travel time

The subcontractor, Advanced Management Solutions (AMS), charges \$125 per hour for his consultant fees, including his associate's consulting time. They also charged the \$125 fee for their travel time; thus, for two hours of travel \$250 was charged to the grant (Exhibit 1). The total amount of travel time charged to the grant was \$53,257, which was **30%** of expended costs for the grant (\$53,257/\$180,600). The contract states that travel will be reimbursed for actual costs of mileage, hotels, etc. The contract does not state that the subcontractor's travel time will be reimbursed at the rate of \$125 an hour over and above actual costs. The subcontractor was reimbursed separately for the usual travel costs of gas and hotel costs, which totaled \$6,578.

RECOMMENDATION - Questioned Costs \$53,257

We recommend that ARC question the \$53,257 charged for travel time using the consultant rate of \$125 per hour, that the grantee allowed the subcontractor to charge. Travel time included time to drive going to accepted client's place of business; to meet with individuals that did not have an existing business; and also to meet with the Project Director of the grant and other related state officials.

GRANTEE'S RESPONSE

The grantee stated that these costs were duly approved.

ARC Response

ARC staff has requested reimbursement of approximately one half of the travel costs, or \$26,600 in questioned costs. In its response, ARC stated that it recognizes that travel is often difficult in the target region of eastern Kentucky. Bearing that in mind, ARC determined to allow approximately one-half of the invoiced travel costs as eligible. ARC staff stated that it found that contractors typically invoice ARC at reduced rates for travel time incurred, and that allowing payment for a portion of the travel costs is appropriate.

AUDITOR'S COMMENTS

The OIG does not consider the difficulty to get around eastern Kentucky as a viable reason to pay \$125 per hour for driving to meetings. The grantee, being the State of Kentucky, should have made the budget more clear that over and above the usual travel expenses the subcontractor would also charge \$125 per hour for travel time. Also, ARC should have been

made aware of or reviewed a monthly expense statement which stated that one third of grant costs was for travel time. The grantee should be responsible for reimbursing the \$26,600 as they approved the costs and not the subcontractor after the fact. One third of grant expenses billed for travel is extreme.

OIG considers this finding closed. The grantee has submitted the \$26,600 to ARC.

FINDING 2 – Legal Fees

The grantee charged \$3,883.83 for legal fees to produce basic boiler plate types of contracts for the subcontractor. The subcontractor stated he was told by the Kentucky ARC Coordinator to hire an attorney to create these contracts. The law firm of Wyatt Tarrant & Combs, LLP, worked on the contracts from September 11, 2002 to December 9, 2002, the total hours billed were 34.20 hours. Three blank contracts submitted to ARC appear to be for a contract between AMS and their hiring additional consultants, which did not occur; and another is for clients they may sign up. A third contract was for a Confidentiality and Trade Secret Agreement (Exhibit 2).

RECOMMENDATION – Questioned Costs \$3,883.83

We recommend that ARC question the \$3,883.83 paid to Wyatt Tarrant & Combs, LLP, as unreasonable and unnecessary for this grant.

GRANTEE'S RESPONSE

When the AKEI project began, neither Economic Development, nor the Kentucky Appalachian Commission had the in-house resources to devote to adequate discussion and development of contracts that would be needed during the life of the project. Therefore, the contractor as directed to obtain legal assistance outside state government. This approved by Ewell Balltrip, then Executive Director of the Kentucky Appalachian Commission, and the Cabinet for Economic Development.

The contracts developed by the legal firm were consistent with instructions provided by Advanced Management Solutions and the Executive Director with regard to content and processing of the contracts. These contracts were developed in good faith and expected to be needed by the contractor. These efforts included:

- Confidentiality/trade secret agreements to be developed to protect the client.
- Consultant agreements were needed to evaluate and provide process engineering or related services to expand manufacturing and marketing capabilities.
- Various agreements to protect the client, contractor(s) and the Commonwealth were determined to be an absolute necessity.
- Confidentiality and trade agreements require specialized legal services for the protection of all parties to the agreement.

ARC Response

Grantee's supplemental response deemed sufficient.

AUDITOR'S COMMENTS

OIG accepts the Grantee's response and considers this finding closed. However, there appears to be some duplication of forms created. OIG recommends that the Kentucky Cabinet for Economic Development keep these forms available for future economic development projects even though they apparently have been functioning without such basic contracts available in the past. Further, ARC staff should inform new grantees of this availability.

FINDING 3 – Ineligible Clients

This grant was to support existing businesses to expand and support the development of new businesses, including job opportunities. The grantee gave the consultant a list of names of those supposedly wanting to start or expand a business. The grantee or consultant could have called the individuals first and determined if they were an established business and eligible to participate in this project, rather than spending \$125 an hour for the subcontractor to drive and interview in person (Exhibit 3). Five of the companies/or persons were either not an established business or not manufacturing a product and had no future outlook on hiring anyone. The subcontractor stated he was under the direction of the KY Department of Economic Development and they gave him the names and expected him to personally interview each one.

RECOMMENDATION - Questioned Costs- \$4,000

We recommend that ARC question \$4,000 for the 32 hours the grantee allowed the subcontractor to charge to perform face to face interviews to determine if they would be eligible for this project. This was not considered prudent use of federal funds. The hours charged for travel time to and from these individuals have already been questioned in Finding 1.

GRANTEE'S RESPONSE

The Cabinet for Economic Development provided Advanced Management Solutions with an initial list of companies in the Appalachian region for site visits and evaluation. It felt these entrepreneurs were credible and could provide viable projects for the program. Site visits were necessary for several reasons:

- Communication with small business owners is much easier face to face.
- Facilities and equipment can be evaluated.
- Manufacturing processes can be observed.
- Available workforce and physical location can be reviewed.
- Supply and distribution routes can be evaluated.

In this unique area of the state, economic and environmental factors must both be evaluated thoroughly.

In summary, the expenses referred to above are reasonable in amount, consistent with the scope of the grant, and performed at the direction of or with prior approval from the Executive Director of the Kentucky Appalachian Commission or Cabinet for Economic Development.

ARC Response

Grantee's supplemental response is deemed sufficient.

AUDITOR'S COMMENTS

The Kentucky Department of Economic Development gave the subcontractor a list of names to review as possible clients. Eight of the possible clients were not a business and had no product to sell or positions to offer the local population. It was not stated how the KY Department of Economic Development came up with the names, but one phone call would have immediately determined their ineligibility for this program, rather than spending \$125 an hour to travel to and from their homes. This project required at least four clients for this subcontractor to assist and this would be an attempt to obtain at least four clients. This part appears duplicative in that the KY Dept. of Economic Development was capable of calling to determine if they were a viable company with a product to produce and jobs for the local community.

Based on ARC's acceptance of these costs, OIG considers this finding closed.

In-Kind Contribution 20% - \$62,500

The 20% in-kind local contribution was specified to be \$62,500, to be provided by several agencies as stated in the proposal:

-KY Economic Development Cabinet	\$45,000
-KY Appalachian Commission	\$11,900
-KY Department for Local Government	\$ 5,600

The proposal stated this would provide a variety of services such as employee training, marketing research, facilities and equipment, product development and financing. The grantee stated that the in-kind provided was mainly administrative only; such as processing the financial payments. Planning assistance was provided by the KY ARC Representative. The Project Director, who is also the KY Appalachian representative, used his time for matching. The grantee was not able to come up with the total amount of required in-kind matching, affecting the amount of ARC funds available to the grantee.

There appears to be some confusion or misinformation concerning the amount of the grant; in-kind contribution required; and the competitive bidding process. Two memos dated January 28, 2002, and May 2, 2002 (Exhibit 4), from the Controller to the Executive Director and the Secretary, Finance and Administration Cabinet, state that this grant was for \$250,000 annually for three years, rather than for the full grant period; that no in-kind matching was required by the State or local level; and the subcontracting was to be exempt from competitive bidding.

Documentation on competitive bidding was available but considering that AMS wrote and submitted the proposal to the Kentucky Appalachian Commission, along with the content of the above memos, it appears apparent that they would be chosen.

Program Review

The grantee's subcontractor stated that all of their program workpapers were stored in his associate's basement which was flooded during a heavy storm last year and all the papers were ruined. He was not able to provide the write-ups, business plans and documentation of the work performed. A notarized statement of the flooding incident was requested and received from the subcontractor.

The subcontractor accepted three businesses and one county to work with under his program. The KY Dept. of Economic Development and the KY ARC provided him the names of some businesses and other possible businesses to take part in the program. Most of the names provided him did not manufacture a product, or had no ability or intention of hiring new employees, thus making them ineligible.

FINDING 4 – Untimely and Incomplete progress reports, Records Denied to ARC

The progress reports were to be submitted quarterly and contain detailed information stating the exact work accomplished by the subcontractor. The subcontractor nor the Project Director submitted progress reports as required and requested by the ARC Coordinator.

The grant was audited by a CPA firm contracted by ARC in March 2003 (Exhibit 5), and the grantee was cited then for the lack of progress reports and specific detail. The grantee responded that their progress reports would be submitted timely and contain the required details. As of the March 2003 date, the CPA firm stated the only objective accomplished thus far was a three year work plan. This was one and a half years into the grant period. The subcontractor's billings started in March 2002.

A memo dated June 3, 2003 (Exhibit 6), from the ARC Program Coordinator to the Project Director requested additional information after receiving the May 29, 2003, progress report. The reply from the subcontractor denied parts of the information requested on grounds of confidentiality agreements with the companies served that stated their business information would not be shared as public information. This does not apply to the ARC Project Coordinator, who is required to have access to **all information** pertaining to a grant that ARC is funding, therefore, his request should not have been denied. This is specifically

stated in the grant that all records be made available to ARC. The information provided did not state specifics as to exactly what the subcontractor accomplished each quarter with his clients (Exhibit 7).

The grantee's contract with the subcontractor on page 7 states "authorized representatives, shall have access to any books, documents, papers, records or other evidence, which are directly pertinent to this contract for the purpose of financial audit or program review." The Kentucky Appalachian Commission Representative, also acting as the Project Director, should have known and ensured the requested information was provided to ARC at that time.

The grant period ended June 2004 and the Final Report received and dated November 2004, five months after the grant ended.

RECOMMENDATION

We recommend that ARC include policy for future grants to immediately stop further payments on grants when requested information is denied or specific information is continuously not included in the progress reports.

GRANTEE'S RESPONSE

Grantee concurs with audit recommendation.

ARC Response

ARC staff will immediately stop further payments on grants when requested information is denied or not provided.

AUDITOR'S COMMENTS

OIG accepts grantees response and will consider this finding closed upon ARC issuance of internal policy incorporating the recommendation.

FINDING 5 – Lack of Oversight

Our review disclosed that the Grantee did not provide proper oversight of the subcontractor. The subcontractor was allowed to bill the grant without explanation of the charges or verification of claimed results. The amount of time charged to write reports at \$125 an hour was unreasonable considering the lack of progress reports; the lack of detailed information of work provided; and the duplication of wording in the reports.

The grantee allowed the subcontractor to charge the \$125 consultant fee for meetings with the grantee and also for meetings between the subcontractor and his associate. Thus a two hour meeting with his own associate would cost ARC over \$1,000 for both their time and travel. The grantee should have stated a more equitable amount to be charged for such meetings. (Exhibit 8)

RECOMMENDATION

We recommend that ARC ensure that Project Directors review and verify information provided in subcontractor's reports, including close review of their invoices. Late reports and continuous duplicate wording are clear signs that Project Directors need to more closely monitor work claimed.

GRANTEE'S RESPONSE

Grantee concurs with audit recommendation.

ARC Response

ARC staff will meet with Project Directors (grantees) when needed to ensure there is close supervision of subcontractor work.

AUDITOR'S COMMENTS

OIG accepts the response and considers this finding closed.

OUTCOMES

The grant did not provide the outcomes expected. No additional job placements could be verified with the businesses interviewed. Some progress and business contacts were made with the client businesses that may pay off in the future for the companies involved. The number of jobs created as stated in the reports pertained to future possibilities of jobs being created. The program appears to have provided limited benefit for the cost to ARC. There were no verifiable tangible outcomes.

CONCLUSION

Our review resulted in 5 Findings and \$26,600 in recovered questioned costs. Finding Four remains open.


Clifford H. Jennings
Inspector General

Exhibits