

Department of Health and Human Services

DEPARTMENTAL APPEALS BOARD

Appellate Division

SUBJECT: Mid-Kansas Community DATE: June 25, 2009
 Action Program, Inc.
 Docket No. A-09-39
 Decision No. 2257

DECISION

Mid-Kansas Community Action Program, Inc. (Mid-CAP), a Head Start grantee, appeals the December 15, 2008 decision of the Administration for Children and Families (ACF) disallowing \$248,565 in Head Start funds. Of this amount, Mid-CAP appeals \$240,314, which ACF disallowed as "Cash Disbursements not supported by source documentation as required by 45 C.F.R. § 74.21(b)(7)." ACF Ex. 10, at 1. ACF calculated this portion of the disallowance by extrapolating audit findings for a review of 19 checks to the total amount of Head Start funds expended by Mid-CAP during the audit period ending June 30, 2007.

We uphold ACF's disallowance of \$500 charged to Head Start because Mid-CAP failed to submit adequate documentation for a check in this amount. However, for the following reasons, we are unable to uphold the remainder of the disallowance. First, there is no evidence indicating that the auditor intended to select a statistically valid random sample for the purpose of extrapolating the findings to the universe of Mid-CAP's Head Start expenditures. Second, there is no evidence for ACF's claim that it was impractical to individually review all of Mid-CAP's non-payroll Head Start cash disbursements. Third, there is no evidence that the extrapolation methodology used here was scientifically valid.

Background

Mid-CAP is a "community-based, not-for-profit organization serving a thirteen county, rural area in south-central Kansas"

that operates multiple programs, including Head Start. Appellate Brief (App. Br.) at 1. Head Start is a national program that provides comprehensive developmental services to economically disadvantaged preschool children and their families. 42 U.S.C. § 9831.

Mid-CAP is subject to the Single Audit Act, which requires non-federal entities (such as non-profit organizations like Mid-CAP) that spend more than \$500,000 in federal grant funds during a fiscal year to conduct a single, comprehensive financial and compliance audit of their programs for that year. 31 U.S.C. § 7502(a)(1)(A); Office of Management and Budget Circular A-133 (OMB A-133) (made applicable to non-profits by 45 C.F.R. § 74.26(a)).¹ Head Start grantees' A-133 audits are reviewed by the Department of Health and Human Services (HHS) Office of the Inspector General (OIG) and ACF. ACF Br. at 4.

Mid-CAP's A-133 audit for the year ending June 30, 2007 identified multiple deficiencies and material weaknesses in Mid-CAP's efforts to comply with federal fiscal requirements.² At issue in this case is the material weakness involving cash disbursements, i.e., non-payroll checks, which the auditor found were issued "without proper support and internally required authorization." Appellant Attachment (App. Att.) 3, at 48. The auditor based this finding on its review of 19 non-payroll checks from which it concluded that two (10.53%) of the checks did not have supporting documentation. ACF Ex. 4, at 6. Only one of the two undocumented checks was a Head Start check. The auditor recommended, "Procedures should be implemented prohibiting the issuance of checks without all supporting documentation and required authorization." App. Att. 3, at 49. The auditor did not question any costs related to these checks.

¹ The \$500,000 threshold was established by regulation. 68 Fed. Reg. 38,401 (June 27, 2003).

² The auditor defined "material weakness" as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control." App. Att. 3, at 45.

In March 2008, Mid-CAP submitted its A-133 audit for the year ending June 30, 2007 to the federal audit clearinghouse. ACF Br. at 4, citing App. Att. 3. On August 15, 2008, the OIG notified Mid-CAP that it had reviewed the audit and found that the audit itself "met federal audit requirements." ACF Ex. 4, at 1. It informed Mid-CAP that "final determinations with respect to actions to be taken" based on the audit would be made by a "resolution official of HHS." Id. The OIG recommended generally that, based on the "serious nature of weaknesses identified" in the audit, HHS initiate "closer monitoring and increased attention by grants management staff to protect the Federal interest." Id. at 2. In Attachment A to the letter, the OIG identified material weaknesses and recommendations for each weakness. For the category "cash disbursements," the OIG stated that it "recommends procedures be strengthened to ensure cash disbursements are properly authorized and supported by adequate documentation." Id. at 3. The OIG did not identify questioned costs as to cash disbursements or recommend that such costs be disallowed on the basis of the audit.

By letter dated September 2, 2008, ACF placed Mid-CAP on "high risk status," which resulted in special award conditions being placed on its grant. ACF Ex. 5. Thereafter, ACF and Mid-CAP corresponded and met about the problems identified in the audit and Mid-CAP's efforts to improve its oversight of federal funds. ACF Exs. 6-9. During this process, Mid-CAP supplied, at ACF's request, "all available back-up documentation" for the 19 checks reviewed by the auditors in evaluating Mid-CAP's control mechanisms for cash disbursements. App. Br. at 4; see also ACF Br. at 9, citing ACF Ex. 11.

By letter dated December 15, 2008, ACF disallowed \$240,314 for inadequately documented cash disbursements, \$3,301 for bonus checks, and \$4,950 for Christmas gifts to employees. ACF Ex. 10, at 1. As to the cash disbursements, ACF stated:

The Office of Head Start directs the grantee to repay \$240,314 (the total amount of Head Start expenditures reported[,] \$2,403,140[,] x 10%) due to the lack of supporting documentation as required by 45 C.F.R. § 74.21(b)(7).

Id. at 5. Mid-CAP appeals only the disallowance of cash disbursements.

Analysis

1. We reverse the disallowance to the extent it is based on statistical sampling.

ACF calculated this disallowance by extrapolating the results of the auditor's review of 19 checks to the universe of Head Start expenditures of \$2,403,140. ACF Ex. 10, at 5. Mid-CAP challenges ACF's extrapolation of the results of this review as improper use of statistical sampling. App. Br. at 5-6. Where a grantee challenges the use of statistical sampling, the agency has the burden of showing that sampling is appropriate to use in the context of the particular disallowance and that the sampling and extrapolation methodology used to calculate that disallowance is scientifically valid.³ For the following reasons, we conclude that ACF has not met its burden of showing either that the use of sampling was appropriate in this case or that its methodology was scientifically valid.

ACF asserts that statistical sampling was appropriate here because it was not "practical to undertake a review of every transaction." ACF Br. at 11. The only support ACF cites for this assertion is the fact that "Mid-CAP indicates that it averages 235 monthly checking transactions." Id. at n.11, citing ACF Ex. 9, at 8. For the following reasons, we disagree with ACF's position.

First, nothing in the audit suggests that the auditor was in fact selecting a sample in order to statistically extrapolate totals of unallowable costs. On the contrary, the auditor was merely reviewing sufficient transactions to determine whether mid-CAP's "financial statements . . . present fairly, in all

³ See, e.g., Illinois Dept. of Children and Family Services, DAB No. 1564 (1996) (use of sampling to calculate the title IV-E disallowance was not contrary to title IV-E; extrapolation of sample results was appropriate); New York Dept. of Social Services, DAB No. 1531 (1995) (federal agency demonstrated that its statistical sampling methodology was scientifically valid); Washington State University, DAB No. 145 (1981) (federal agency failed to identify why it would be reasonable to apply the findings for one year to the prior year).

material respects, the financial position of [Mid-CAP] as of June 30, 2007" and to report on its review of Mid-CAP's "internal control over financial reporting." App. Att. 3, at 1. Because nothing indicates that the auditor sought to generate a scientifically valid random sample for identifying unallowable costs, it is not appropriate to use the audit as a basis for calculating a disallowance by extrapolating the auditor's findings for these 19 checks.

Second, Board cases upholding the use of sampling have looked to whether "individual review of the underlying records would be impractical due to volume and cost." New York State Dept. of Social Services, DAB No. 1394, at 22 (1993). "Typically sampling is used when a claim for federal funds is based on the sum of numerous cost items (each subject to proof of allowability), because it is impossible, or at least costly and impractical, to examine each item" New York State Dept. of Social Services, DAB No. 1235, at 8-9 (1991) (review of claims for mental health services for 117,002 clients over one-year period).⁴ In such situations, the Board has relied on an extrapolated finding because "[i]f done in accordance with accepted rules . . . [it] has a high degree of probability of being close to the finding which would have resulted from consideration of all the cost items." Id. at 9.

Because ACF has not shown how many transactions would have required review, ACF has provided no basis for concluding, as it asserts, that actual review of the checks at issue was not "practical." ACF's justification for the use of statistical sampling - 235 monthly checking transactions - overstates the number of transactions that would require review in at least two ways. First, Mid-CAP operates and issues checks for multiple programs other than Head Start. App. Att. 3, at 17-36. (In fact, of the 19 cash disbursement checks the auditors reviewed, only six were Head Start checks. See ACF Ex. 11, at 1; App. Att. 3, at 17.) Consequently, the figure of 235 monthly checks overstates the number of Mid-Cap's Head Start checks that would

⁴ See, e.g., California Dept. of Social Services, DAB No. 816 (1986) (review of over one million federal assistance payments); California Dept. of Social Services, DAB No. 524 (1986) (review of the costs of federal child care services over two and a half years in four counties).

require review. Second, the auditor excluded payroll checks from the category of cash disbursements. ACF Ex. 11, at 1 (auditor worksheet showing that auditors selected 25 checks for review but then eliminated the six payroll checks from the cash disbursement category). Therefore, the figure of 235 monthly checks also overstates the number of checks in the category of Head Start cash disbursements. Because ACF did not take either of these factors into account, ACF failed to accurately determine the number of monthly check transactions that would have required review here and, therefore, had no reliable basis for asserting that review of the individual Head Start non-payroll transactions was not practical.

In addition, ACF has failed to show that the methodology used to calculate the disallowance was scientifically valid. For example, ACF does not provide any evidence from a statistician or even assert that the 19 checks reviewed by the auditor constitute a statistically valid random sample or were otherwise selected pursuant to a scientifically valid sampling methodology. ACF also fails to cite anything in the record that would support a finding that ACF used a scientifically valid methodology to extrapolate its finding that 10% of Mid-CAP's expenditures should be disallowed. Moreover, ACF's extrapolation methodology is facially invalid in the following way. The auditor's finding on which ACF relied was based on a review of cash disbursements (a category that did not include payroll checks), but ACF applied the resulting 10% disallowance rate to Mid-CAP's total Head Start expenditures, including payroll expenditures. Thus, the universe of sampled transactions was smaller than the universe of transactions to which the sampling result was applied. Because payroll expenditures were over a third of Mid-CAP's Head Start expenditures (App. Att. 3, at 17-18), this aspect of the methodology would cause the disallowance to be significantly overstated.

Finally, as discussed below, the cases on which ACF relies do not support its position here.

ACF cites Dallas County Community Action Agency, DAB No. 1265 (1991), for the proposition that "[r]eviews of audit reports by OIG and the resulting recommendations including recommendations based on sampling have been recognized as reliable bases upon which ACF might 'take' a disallowance" against a Head Start grantee for inadequately documented costs. ACF Br. at 8. ACF's

statement mischaracterizes both the holding in Dallas County and its application to the facts of this case.

- First, while the Dallas County disallowance was based on the OIG's recommendations resulting from the OIG's review of independent audits, nothing in that decision indicates that the OIG used statistical sampling in calculating the questioned costs or that ACF used statistical sampling in calculating the disallowance.⁵ Therefore, ACF is incorrect when it asserts that, in Dallas County, the Board upheld the use of statistical sampling as a basis for disallowing inadequately documented Head Start expenditures.
- Second, unlike in Dallas County, the OIG here did not question specific cash disbursements or recommend that ACF take a disallowance, much less suggest that ACF should calculate a disallowance by extrapolating the auditor's findings about the 19 checks to the universe of Head Start expenditures. See ACF Ex. 4, at 1-4; ACF Ex. 10, at 10-12. Thus, it is misleading for ACF to state that "the disallowance was specifically tied to an OIG recommendation with respect to the absence of documentation for 10.53% of the checks tested by Mid-CAP's independent auditor." ACF Br. at 8.

ACF also relies on the following language from the Board's December 27, 1989 Ruling on Request for Reconsideration (Ruling) of West Virginia Dept. of Human Services, DAB No. 1107 (1989). ACF Br. at 8. "The key requirement for a disallowance is that 'the federal agency must articulate a reasonable basis for the disallowance with sufficient detail so that the grantee may respond.'" Ruling, citing West Virginia, DAB No. 1107, at 6.

⁵ While the first audit of the three audits at issue in Dallas County speaks of "costs for a particular sampled employee and non-payroll transactions," the costs disallowed under the first audit were \$4,118.12. Absent information to the contrary, the reference to "particular costs" and the small amount of costs disallowed for that audit indicates that ACF disallowed specific costs identified in the sampled transactions as opposed to extrapolating the sample results to the universe of expenditures.

ACF asserts that it met this requirement because "Mid-CAP was sufficiently apprised as to which costs were questioned and why, and how the disallowed portion of its aggregate claim was determined." ACF Br. at 8.

Neither West Virginia nor the subsequent Ruling supports ACF's position here. In the Ruling, the Board noted in dicta that that "sampling methodology . . . may be the most appropriate technique when the federal agency is examining the propriety of a large number of individual claims." Ruling at 5 (emphasis added). As discussed above, ACF failed to set forth any basis for concluding that statistical sampling was an "appropriate technique" under the circumstances of this case. Moreover, while ACF may have "apprised" Mid-CAP of how it calculated the disallowance (as required in West Virginia), clarity about the methodology alone does not cure the flaws in the methodology or make it scientifically valid.

For the preceding reasons, we reverse the disallowance to the extent that it is based on sampling and extrapolation.

2. We uphold ACF's disallowance of \$500 because the expenditure was not supported by adequate documentation.

The auditors found that two of the 19 checks did not have adequate supporting documentation. ACF Ex. 11, at 1. ACF does not dispute Mid-CAP's assertion that only one of these checks was charged to the Head Start grant. This check was for \$500 and was paid to a local public school. ACF Ex. 11, at 1, 47. In its letter brief, Mid-CAP represents the payment was for "utilities consumed by Mid-CAP's operation of a Head Start Center in the vendor's building." App. Br. at 3. It states, "This routine, monthly payment is made to the vendor for the costs of gas, electricity, water, trash, and janitorial services necessary for the health and safety of the 17 children served by Mid-CAP's Head Start Program." Id.

For costs to be allowable under federal cost principles, they must be reasonable for the performance of the grant award, allocable thereto, and adequately documented. OMB A-122,

Attachment A, ¶¶ A.2.a. and g.⁶ As to documentation, the Uniform Administrative Requirements for Awards and Subawards to . . . Nonprofit Organizations at 45 C.F.R. Part 74 require non-profit recipients of federal funds to have a financial management system that provides for "[r]ecords that identify adequately the source and application of funds for HHS-sponsored activities," including "information pertaining to . . . obligations" and "[a]ccounting records . . . that are supported by source documentation." 45 C.F.R. §§ 74.21(b)(2), 74.21(b)(7). Section 74.2 defines "obligations" as ". . . contracts . . . and similar transactions during a given period that require payments by the recipient during the same or a future period." Under the cost principles and uniform administrative requirements, the Board has consistently held that HHS grantees bear the burden of documenting the allowability of all questioned costs charged to federal funds. See, e.g., Northeast Louisiana Community Development Corporation, DAB No. 2165 (2008); Action for a Better Community, DAB No. 2104 (2007); Marie Detty Youth and Family Services Center, Inc., DAB No. 2024 (2006).

The record contains the following documentary evidence related to the payment: a cancelled check dated December 26, 2006 and written for \$500 to Halstead Middle School (ACF Ex. 11, at 47); a document titled "Payment Voucher" listing payment of \$500 to Halstead Middle School for "HEADSTART-HALSTEAD" "utilities" (id. at 48); a document titled "Voucher" stamped "PAID" and dated December 27 for \$500 that identifies the "vendor" as Halstead Middle School for "utilities" (id. at 49); and a copy of a contract titled "AGREEMENT Involving [Halstead Middle School] and Mid-Kansas Community Action Head Start 2007-08 Program Year" calling, inter alia, for the payment of \$500 per month for the "use, maintenance, and cleaning of classroom and playground space" (App. Att. 2).⁷ The contract is dated February 2007.

⁶ OMB A-122, "Cost Principles for Nonprofit Organizations," is codified at 2 C.F.R. Part 230, and Attachments A and B are designated "Appendix A" and "Appendix B," respectively. OMB A-122 is made applicable to HHS grants to non-profit organizations, including Head Start grantees, by 45 C.F.R. §§ 74.27(a) and 1301.10(a).

⁷ The first three documents were provided to ACF in December 2008. ACF Br. at 9. Mid-CAP does not dispute ACF's
(Continued . . .)

We uphold the disallowance of \$500 because the evidence on which Mid-CAP relies does not document any obligation to pay this \$500 on behalf of its Head Start program in December 2006. Specifically, the contract on which Mid-CAP relies is not adequate documentation of an obligation because it postdates the 2006 check and is for the "2007-08 Program Year." App. Att. 2. While ACF pointed out this fact in its response brief (ACF Br. at 10), Mid-CAP did not thereafter seek to present a contract for the relevant period or any other basis for concluding that it was obligated to make this payment. Therefore, Mid-CAP has failed to present adequate source documentation for this obligation as required by 45 C.F.R. §§ 74.21(b)(2), 74.21(b)(7).

Conclusion

For the reasons stated above, we uphold the disallowance of \$500 and reverse the remainder of the disallowance.

_____/s/_____
Sheila Ann Hegy

_____/s/_____
Leslie A. Sussan

_____/s/_____
Stephen M. Godek
Presiding Board Member

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assertion that the contract "was not among the documents originally submitted to ACF." ACF Br. at 10, n.9.