

DEPARTMENT OF EDUCATION

CURRENT AUDIT FINDINGS AND RECOMMENDATIONS

Federal Compliance Audit Findings:

Finding No. 2015-003:

The South Dakota Department of Education (DOE) did not have adequate controls in place to properly monitor subrecipient compliance with federal regulations or evaluate and mitigate risk associated with related party transactions.

CFDA Title: Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP)

CFDA Number: 84.334

Federal Award Number: P334S110022

Federal Award Year: 2013; 2014; 2015

Federal Agency: Department of Education

Type of Finding: Material Weakness

Category of Finding: Subrecipient Monitoring

Analysis:

The DOE had a partnership agreement with Mid-Central Educational Cooperative (MEC) for administration of the GEAR UP program. According to the agreement, the DOE awarded MEC \$3,391,732 for Federal Fiscal Year (FFY) 2013, \$4,793,992 for FFY 2014 and \$4,287,228 for FFY 2015. The agreement states, in part:

The State will serve as the lead partner and will be responsible for ensuring that the project is carried out by the partnership group in accordance with Federal requirements.

....

The State agrees to make monthly fixed installments in the amount of \$50,000. Additional installments will be made monthly based upon receipt of a detailed invoice submitted by the Grant Partner that documents actual expenses incurred and matching documentation.

MEC partnered with the American Indian Institute for Innovation (AIII) to administer portions of the GEAR UP program using the program budget and scope of work provided by the DOE. The partnership agreement between MEC and AIII did not provide for a specific amount of GEAR UP funds that AIII was authorized to expend, but rather incorporated the total budget between the DOE and MEC by reference. According to the agreement, MEC was to reimburse AIII monthly upon receipt of a detailed reimbursement voucher showing all expenses and AIII was only to be reimbursed for expenses that were allowable under the GEAR UP program in accordance with the approved budgets.

U.S. Office of Management and Budget Circular A-133 (Circular A-133), section 210 provides criteria for determining whether an agreement involving the expenditure of federal funds is a subaward or a contract for services. Using these criteria, we determined the partnership agreement between MEC and AIII was a subaward of GEAR UP funds and not a contract for services. As a subaward, the DOE would be considered the pass-through entity and the AIII would be considered a subrecipient of the GEAR UP funds.

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Section 400(d) of Circular A-133 describes the responsibilities of a pass-through entity with regard to the federal subawards made to subrecipients. These responsibilities include monitoring the activities of subrecipients to ensure compliance with federal laws and regulations. Federal law requires that subrecipients expending \$500,000 or more in Federal awards during their fiscal year have an audit conducted in accordance with the requirements of the Single Audit Act and Circular A-133.

According to AIII's Internal Revenue Service Form 990-PF (form 990) filed for 2012, 2013, and 2014, the AIII recognized revenue from direct and pass-through federal awards in excess of \$500,000 in each of these three years. Thus, we believe AIII should have had a Single Audit for the years 2012, 2013 and 2014. However, we found no evidence that Single Audits of AIII for those periods were performed. Neither the DOE nor MEC had internal controls in place to ensure that MEC's agreement with AIII was correctly identified as a subaward and that AIII had complied with the Single Audit Act.

While we believe Single Audits of AIII should have been performed because it met federal requirements for such an audit, we also believe audits should have been required of AIII by the DOE and MEC because of the nature of employment and contractual relationships that existed between employees and officers of MEC and AIII. The following employment and contractual relationships existed during our audit period.

Stacy Phelps was both an employee of MEC and the Chief Executive Officer (CEO) of AIII. We found that \$65,000 of Stacy Phelps' MEC salary was reimbursed by the DOE from GEAR UP funds for FFY 2014. In addition, in August 2014 MEC reimbursed AIII \$34,000 from GEAR UP funds for contractual services provided by Stacy Phelps. Although AIII was reimbursed \$34,000 for Stacy Phelps's services in 2014, we found that AIII's form 990 for calendar 2014 reported zero compensation for Stacy Phelps. In addition, we found that Scott Westerhuis, MEC's Business Manager during 2014, was also identified as AIII's Chief Financial Officer on its form 990 for 2014.

MEC also partnered with Oceti Sakowin Education Consortium (OSEC) to administer portions of the GEAR UP program. According to the OSEC form 990 submitted for OSEC's fiscal year ended June 30, 2014 Nicole Westerhuis, wife of Scott Westerhuis, was compensated \$38,521 as the Business Manager of OSEC. Nicole Westerhuis also had an employment contract with MEC for its fiscal year ended June 30, 2014 in the amount of \$59,740.

The audited financial statements of MEC and the accompanying notes to the financial statements did not disclose any of these relationships or the related transactions. Generally accepted accounting principles require the terms of material related party transactions to be disclosed in the notes to the financial statements for governmental organizations such as MEC.

Since key employees of MEC were also in compensated officer positions of AIII, a significant subrecipient of GEAR UP pass-through funds, there were significant risks that needed to be addressed by specific subrecipient monitoring procedures at the DOE and MEC. Procedures implemented by the DOE did not address these risks and as a result, the DOE exposed itself to potential violation of federal regulations, and an increased risk of fraud, waste, and abuse of grant funds.

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RECOMMENDATION:

1. We recommend that the DOE adopt additional subrecipient monitoring procedures to ensure compliance with federal regulations and mitigation of the risks associated with related party transactions.

Auditee's Corrective Action Plan:

The Department of Education agrees with Department of Legislative Audit recommendations of adopting additional subrecipient monitoring procedures to ensure compliance with federal regulations and mitigation of the risks associated with related party transactions. Throughout FY2015, the Department implemented increasing levels of expenditure review and compliance monitoring for the Gear Up grant. This included annual review of the independent audit reports and requiring that MEC upload supporting documentation for all expenses being claimed to a system called Egnyte. The Department also reviewed the independent audit reports for signs of risk in the operations of MEC. Each year, the independent audit reports came back with no significant findings. Regarding expenses being claimed, if questionable or undocumented costs were noted during the expenditure review, the cost was removed and payment was withheld pending a satisfactory response from the subrecipient. When potential issues of compliance were noted the Department provided technical assistance to the subrecipient in an effort to correct these issues.

Despite these efforts, the Department continued to note questionable or unsupported costs. In September 2015 the Department began processes to terminate the partnership with MEC at the end of then current award period. On September 16, 2015, the Department notified MEC of the intent to terminate via phone. A subsequent termination letter was issued on September 21, 2015.

While the Department does perform a risk assessment of new grantees, we will implement a system to perform a more in depth risk analysis of the financial management capacity of potential subawardees of discretionary or competitive grant programs, including their ability to identify and appropriately document match. The department will also perform a more in depth review of key staff. Beginning in FY2017, the department will require grantees to submit a conflict of interest policy and to submit documentation disclosing any related parties. The Department will require any entities providing subawards to affirmatively notify the Department of any subawards and to submit to the Department a signed written acknowledgment by both the entity and the subrecipient acknowledging that: 1) they are aware of federal requirements regarding subawards and 2) any entity receiving a subaward is required to meet audit requirements under uniform guidance if their total federal awards exceed the threshold.

As stated previously, the Department has terminated its partnership with MEC for the Gear Up program. In order to insure that students continue to receive services, the Department is partnering with the South Dakota Board of Regents (BOR) to continue activities under the Gear Up grant and is working closely with the individuals involved to make sure they are aware of all federal requirements and insure they are being followed. To accomplish this, the Department created a new position whose duties are to work on the Gear Up program to ensure that federal program requirements are being met and students continue to receive services. Department administrative staff have attended trainings specific to federal grants management. Department and BOR staff will attend future training opportunities specific to Gear Up and on federal grant management and will provide additional training and support to all grant partners.

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Finding No. 2015-004:

The Mid-Central Educational Cooperative (MEC) did not comply with matching requirements.

CFDA Title: Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP)

CFDA Number: 84.334

Federal Award Number: P334S110022

Federal Award Year: 2014

Federal Agency: Department of Education

Type of Finding: Material Noncompliance

Category of Finding: Matching, Level of Effort, Earmarking

Analysis:

Title 34 of the Code of Federal Regulations (CFR), part 694.7 specifies that at least 50 percent of the GEAR UP project costs be matched with cash or in-kind contributions from non-Federal sources.

The South Dakota Department of Education (DOE) partnered with MEC for the administration of GEAR UP and required matching contributions were documented by MEC. The partnership agreement specifies that:

Documentation of matching contributions must contain adequate source documentation for the claimed cost sharing, provide clear valuation of in-kind matching and provide support of cost sharing by grant partners. Matching contributions must be valued in accordance with U.S. Office of Management and Budget (OMB) circulars and the Education Department General Administrative Regulations (EDGAR).

34 CFR 80.24(b)(6) states:

Costs and third party in-kind contributions counting towards satisfying a cost sharing or matching requirement must be verifiable from the records of grantees and subgrantee or cost-type contractors. These records must show how the value placed on third party in-kind contributions was derived....

34 CFR 80.24(d) states:

Valuation of third party donated supplies and loaned equipment or space. (1) If a third party donates supplies, the contribution will be valued at the market value of the supplies at the time of donation....

Our review identified individually significant in-kind matching contributions that were not adequately supported for the Federal Fiscal Year (FFY) 2014 GEAR UP grant, which had a project period of September 26, 2013 through September 25, 2014. We reviewed the non-Federal matching amounts recorded for the FFY 2014 grant and identified three different issues as described below:

1. MEC provided the DOE with a match contribution in the form of payroll from a partner school totaling \$165,185.09. The payroll logs provided show the entire payroll for the summer months of July and August, 2014 for all teachers in the first through eighth grades totaling \$1,785,784.72. The school and MEC determined that only 25% of the total salaries are paid

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from the General Fund of the school and therefore only 25%, or \$446,446.18, of the salaries could be used as a match for GEAR UP. The school and MEC next determined that GEAR UP only served grades six through eight which equated to 37% of the total grades available from first through eighth and as a result, \$165,185.09 of the \$446,446.18 was used as an in-kind match. Documentation did not identify which teachers actually taught grades six through eight or if their activities would be allowable under GEAR UP.

2. MEC provided a letter to the DOE from Microsoft valuing a contribution of \$2 million for providing 500 DreamSpark Premium software licenses. The records for the in-kind match did not identify how the software was used to meet the purpose of the grant or the number of students using the software. In addition, the same documentation submitted by MEC and used for the FFY 2013 match was also used for the FFY 2014 match. According to the approved federal budget in the DOE's GEAR UP grant application, the total in-kind match contribution for Microsoft Programs was budgeted to be \$750,000 per year. The match claimed for Microsoft totaled \$2,000,000, which is \$1,250,000 more than the budget approved by the U.S. Department of Education. The excess in match claimed for Microsoft resulted in less match than budgeted being provided for salaries and benefits, supplies and equipment, and other contractual services.

3. MEC provided an invoice to the DOE from Learning Solutions valuing an unlimited number of licenses for Reading Plus and Think Through Math software programs at a value of \$746,000 each for a period of two years. \$225,000 was paid by MEC to Learning Solutions for each software program and was subsequently reimbursed by the DOE as part of the GEAR UP program. The remaining \$521,000 difference between the value and amount paid for the software programs was used as contribution for in-kind match for a total of \$1,042,000. The records provided did not show how the \$746,000 value was derived. Additionally, the records did not identify the number of students using the software, or how the software was used to meet the purpose of the program. According to the approved federal budget in the DOE's GEAR UP grant application, the total in-kind match contribution for Math and Reading Programs was budgeted to be \$150,000 per year. The match claimed above totals \$1,042,000 over two years which is \$742,000 more than the budget approved by the U.S. Department of Education. The excess in match claimed for Learning Solutions resulted in less match than budgeted being provided for salaries and benefits, supplies and equipment, and other contractual services.

As a result, the DOE was not in compliance with federal matching requirements. Because the GEAR UP grant is a multi-year program, questioned costs would not be calculated until the end of the award period.

RECOMMENDATION:

2. We recommend that the DOE implement procedures to monitor subrecipient matching amounts to ensure compliance with federal requirements.

Auditee's Corrective Action Plan:

The Department of Education agrees with the Department of Legislative Audit recommendation to implement procedures to monitor sub recipient matching amounts. Throughout FY2015, the department implemented increasing levels of review on all Gear Up fiscal activities, including documentation of match. Despite efforts to obtain adequate source documentation from MEC, the department continued to have concerns about MEC's ability to meet match requirements. Concerns regarding MEC's ability to provide appropriate match was a factor in the Department's

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decision to terminate its partnership with MEC for the Gear Up program. In September 2015 the Department began processes to terminate the partnership with MEC at the end of the current award period. On September 16, 2015, the Department notified MEC of the intent to terminate via phone. A subsequent termination letter was issued on September 21, 2015.

The Department has made multiple requests to MEC for match documentation since the termination of the contract with MEC. The Department has not received timely and sufficient responses from MEC. As a result, the Department has engaged a specialist to help in acquiring adequate supporting documentation for match for the Gear Up grant. The Department will identify and catalog existing match documentation and conduct outreach to Gear Up sub recipients to document recoverable match.

The Department will maintain oversight to ensure key BOR staff possess experience in documenting match in compliance with federal requirements. Department staff and key BOR staff have attended training opportunities specific to Gear Up and federal match requirements and will continue to attend additional developmental trainings required under the Gear Up grant.

Finding No. 2015-005:

Controls were not effective over proper monitoring of the subrecipient to ensure compliance with allowable costs and cost principles requirements.

CFDA Title: Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP)

CFDA Number: 84.334

Federal Award Number: P334S110022

Federal Award Year: 2013, 2014

Federal Agency: Department of Education

Type of Finding: Material Weakness

Category of Finding: Allowable Costs/Cost Principles, Subrecipient Monitoring

Analysis:

Per the federal grant award for GEAR UP, costs incurred are subject to the cost principles outlined in U.S. Office of Management and Budget (OMB) Circular A-87, which is codified in Title 2 of the Code of Federal Regulations (CFR), part 225. 2 CFR 225, Appendix B, Section 8(a) states:

Compensation for personnel services includes all remuneration, paid currently or accrued, for services rendered during the period of performance under Federal awards, including but not necessarily limited to wages, salaries, and fringe benefits. The costs of such compensation are allowable to the extent that they satisfy the specific requirements of this and other appendices under 2 CFR Part 225, and that the total compensation for individual employees:

....

(3) Is determined and supported as provided in subsection h.

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2 CFR 225, Appendix B, Section 8(h) states:

h. Support of salaries and wages. These standards regarding time distribution are in addition to the standards for payroll documentation.

- (1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

....

- (3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having firsthand knowledge of the work performed by the employee.

- (4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation....

- (5) Personnel activity reports or equivalent documentation must meet the following standards:

- (a) They must reflect an after-the-fact distribution of the actual activity of each employee,
- (b) They must account for the total activity for which each employee is compensated,
- (c) They must be prepared at least monthly and must coincide with one or more pay periods, and
- (d) They must be signed by the employee.
- (e) Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards....

For Federal Fiscal Year (FFY) 2014 thirteen Mid-Central Educational Cooperative (MEC) employees had a portion of their salaries and benefits charged to the GEAR UP program and subsequently reimbursed by the South Dakota Department of Education (DOE). For eleven of these employees, monthly payroll distribution reports were submitted to the DOE along with the reimbursement requests to support the actual salaries paid to the employees each month. For two of the employees, Stacy Phelps and Scott Westerhuis, the reimbursement request for these employees' salaries was submitted in one lump sum at the end of the year and no supporting payroll distribution reports were included with the reimbursement request. Salaries and benefits charged to the program for FFY14 for these two employees totaled \$88,973.03. Upon request during our audit, the DOE did obtain supporting documentation from MEC to substantiate that the costs were allowable. Therefore, no questioned costs were identified as a result of this finding.

Since the form of the salary reimbursement request for Stacy Phelps and Scott Westerhuis differed from the form used for other MEC employees and because of the risks that existed due to the relationships described in finding 2015-003, the DOE should have ensured that

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supporting payroll documentation was obtained for these two employees before being reimbursed.

RECOMMENDATION:

3. We recommend the DOE strengthen controls to ensure subrecipients are in compliance with the applicable grant agreement and compliance requirements of the GEAR UP grant prior to issuing payment.

Auditee's Corrective Action Plan:

The Department of Education agrees with Department of Legislative Audit recommendations of strengthening controls to ensure subrecipients are in compliance with applicable grant agreement and compliance requirements of the GEAR UP grant prior to issuing payment. Throughout FY2015, the Department implemented increasing levels of expenditure review and compliance monitoring for the Gear Up grant. This included annual review of the independent audit reports and requiring that MEC upload supporting documentation for all expenses being claimed to a system called Egnyte. The Department also reviewed the independent audit reports for signs of risk in the operations of MEC. Each year, the independent audit reports came back with no significant findings. Regarding expenses being claimed, if questionable or undocumented costs were noted during the expenditure review, the cost was removed and payment was withheld pending a satisfactory response from the subrecipient. When potential issues of compliance were noted the Department provided technical assistance to the subrecipient in an effort to correct these issues.

Despite these efforts, the Department continued to note questionable or unsupported costs. In September 2015 the Department began processes to terminate the partnership with MEC at the end of then current award period. On September 16, 2015, the Department notified MEC of the intent to terminate via phone. A subsequent termination letter was issued on September 21, 2015.

In order to comply with the grant agreement with the US Department of Education and to insure that students continue to receive services, the Department is partnering with the South Dakota Board of Regents (BOR) to continue activities under the GEAR UP grant. The BOR is a state entity that administers the State's six universities and two specialty schools. The BOR has its own internal auditor responsible for risk management and control. Furthermore, the Department created a new position whose duties are to work on the Gear Up program to ensure that federal program requirements are being met. Department administrative staff have attended trainings specific to federal grants management. Department and BOR staff will attend future training opportunities specific to Gear Up and on federal grant management and will provide additional training and support to all grant partners.