



**U.S. Department of the Interior
Office of Inspector General**

Audit Report

Indirect Cost Fund, Government of the Virgin Islands



Report No. V-IN-VIS-0110-2003

June 2005



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
1849 C Street, NW – MS 5341
Washington, DC 20240

June 22, 2005

Honorable Charles W. Turnbull
Governor of the Virgin Islands
No. 21 Kongens Gade
Charlotte Amalie, Virgin Islands 00802

Subject: Final Audit Report "Indirect Cost Fund, Government of the Virgin Islands" (Report No. V-IN-VIS-0110-2003)

Dear Governor Turnbull:

The attached report presents the results of our audit of the Indirect Cost Fund. The objective of the audit was to determine whether the Government of the Virgin Islands accurately accounted for and properly used indirect cost funds in accordance with applicable Federal and local laws and regulations.

The legislation, as amended (5 U.S.C. app. 3), creating the Office of Inspector General requires that we report to Congress semiannually on all reports issued, actions taken to implement our recommendations, and recommendations that have not been implemented. Therefore, this report will be included in the next semiannual report.

Please provide a response to this report by July 22, 2005. The response should provide the information requested in Appendix 4 and should be addressed to me at the above address, with a copy to our Caribbean Field Office, Ron deLugo Federal Building – Room 207, St. Thomas, VI 00802.

Sincerely,

Anne L. Richards
Assistant Inspector General for Audits

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INTRODUCTION

BACKGROUND

Eight program agencies of the Government of the Virgin Islands (GVI) received Federal grants in the amount of \$87.9 million in 2002 to administer 112 programs. Ten program agencies received \$93 million in 2003 for 118 programs (see Appendix 2). In most instances, the terms of Federal grants allow the recipients to recover the necessary, reasonable, and allowable direct and indirect costs of performing and administering the grants.¹

What Are Indirect Costs?

Costs incurred by non-Federal organizations in running Federal grant programs are comprised of indirect costs and direct costs. Indirect costs are costs that cannot be readily or cost-effectively attributed to an individual project. An example of an indirect cost is the cost of data processing for an organization that administers multiple grant programs. Most governments incur indirect costs on two levels – at a centralized level, such as the cost of a Department of Finance that provides accounting services to operating agencies, and at the operating agency level, such as the agency’s cost of maintaining a building that houses multiple grant programs. A direct cost is one that is easily identified with a specific project, such as the cost of supplies used in a particular grant.²

Why Are Indirect Costs Important?

Because indirect costs inevitably benefit – or burden – all grant-funded programs, they should never be ignored. Pretending they don’t matter can be very dangerous to an organization’s fiscal health. Calculating the full cost of a program is a prerequisite to determining its relative importance within the organization as a whole, to preparing accurate budget forecasts and financial statements, to setting fees for program services, and – perhaps most

¹ Recovery of indirect costs may be limited or prohibited by Federal law, regulation, or the grant agreement.

² U.S. Office of Management and Budget Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments, establishes the standards that governments must follow to determine allowable grant direct and indirect costs. Regarding indirect costs, the Circular establishes mechanisms for governments to recover indirect costs incurred at their central service and operating agency levels. Governments must submit central service cost allocation plans to the U.S. Department of Health and Human Services for approval. Once approved, governments may allocate the central service costs to their operating agencies for inclusion in the operating agencies’ indirect cost proposals. Operating agencies submit their indirect cost proposals for approval to the Federal department that has provided the most Federal assistance to the government during a specified period. Once approved, the operating agencies may use the indirect cost rates to calculate and bill for indirect costs on all their Federal grants and contracts.

importantly for grant administrators – to requesting reimbursement from grant makers.³

To help ensure that reimbursements for indirect costs are used to benefit Federal grant programs, the Legislature of the Virgin Islands established an Indirect Cost Fund (Fund) in 1981 for the deposit of allowable indirect cost reimbursements from Federal grant programs.⁴ The Legislature may appropriate monies in the Fund for the V.I. Office of Management and Budget, to support Federal program activities of the GVI, and for Federal grant matching purposes when other matching funds are not available.

Program agencies contributed indirect costs of \$1.7 million to the Fund in fiscal year 2002 and \$2.5 million in fiscal year 2003. As of September 30, 2003, the Department of Finance reported an Indirect Cost Fund balance of \$6.5 million. The Virgin Islands Legislature made lump-sum appropriations from the Fund totaling \$3.2 million in 2002 and \$3.8 million in 2003 for salaries, operating expenses, and other purposes of the Office of Management and Budget, the Division of Personnel, the Department of Finance, and the Department of Property and Procurement (central service agencies).

In December 2001, representatives of most Federal grantor agencies met with GVI officials to begin developing a comprehensive 3-year Compliance Agreement to assist the Virgin Islands Department of Education and other Virgin Islands agencies to improve their administration of Federally-funded programs. The Compliance Agreement between the Government of the Virgin Islands and the U.S. Department of Education was finalized in September 2002. Sub-Issue 2.2 of the Compliance Agreement specified, among other things, that the GVI eliminate all the underlying problems having to do with indirect costs by 2004, “so that audits and other monitoring procedures will have minimal findings related to indirect cost rates in FY [fiscal year] 2003, and no findings related to indirect cost rates in FY 2004 and 2005.”

OBJECTIVE AND SCOPE

The objective of the audit was to determine whether the GVI accurately accounted for and properly used indirect cost funds in accordance with applicable Federal and local laws and regulations. The scope of the audit included indirect costs paid into and disbursed from the Indirect Cost Fund in fiscal years 2002 and 2003.

³ Understanding Indirect Costs by Henry Flood and Richard W. Phelps (2002).

⁴ 33 VIC §3025.

To accomplish our audit objective, we interviewed officials and reviewed indirect cost agreements, grant awards, payroll records, Statements of Remittance,⁵ appropriations, and expenditures of the Virgin Islands Departments of Agriculture, Education, Finance, Health, Human Services, Justice, Labor, Planning and Natural Resources, Police, Property and Procurement; Offices of Management and Budget, the Adjutant General, the Governor; and Division of Personnel.

Our audit was conducted in accordance with the “Government Auditing Standards,” issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. The “Standards” require that we obtain sufficient, competent, and relevant evidence to afford a reasonable basis for our findings and conclusions.

As part of our audit, we evaluated the internal controls related to financial accountability and administration of the Indirect Cost Fund to the extent we considered necessary to accomplish the audit objective. Internal control weaknesses identified in these areas are discussed in the Results of Audit section of this report. The recommendations, if implemented, should improve the internal controls in these areas.

**PRIOR AUDIT
COVERAGE**

Neither the Office of the Inspector General, U.S. Department of the Interior, nor the Office of the Virgin Islands Inspector General has performed any prior audits of the Indirect Cost Fund.

⁵ A Statement of Remittance is a form used as the source document for recording the receipt and deposit of revenues into the appropriate account in the GVI’s Financial Management System.

RESULTS OF AUDIT

OVERVIEW

The Government of the Virgin Islands (GVI) did not effectively manage the recovery of indirect costs on its Federal grant programs. We attributed this condition to the lack of a sound overall approach for administering indirect costs. As a result, the GVI under-recovered indirect costs and did not make sure that the indirect costs which it did recover were properly accounted for or used only for the management and improvement of Federal grant programs.

UNDER-RECOVERY OF INDIRECT COSTS

The GVI significantly under recovered indirect costs. For example, for fiscal year 2003, recoverable indirect costs could have totaled as much as \$5.9 million,⁶ whereas actual deposits into the Indirect Cost Fund were only \$2.5 million. Indirect costs were under-recovered because some GVI program agencies did not request indirect costs from Federal agencies, billed for indirect costs using incorrect rates, and/or applied the indirect cost rates incorrectly. (The indirect cost rates for fiscal years 2003 through 2005 are presented in Appendix 3.)

Agencies Did Not Request Indirect Costs

The Virgin Islands Code⁷ states that every application for Federal grants-in-aid or other form of Federal funding shall request reimbursement to the Territorial Government of all indirect costs when reimbursement for such costs is permitted by Federal law. We identified five program agencies that did not request indirect cost reimbursements from Federal grantor agencies in fiscal years 2002 and 2003. Specifically:

- The Department of Health received Federal grants of \$7.2 million to administer the medical assistance and child health insurance programs for fiscal year 2002. The Program Director informed us that the agency did not request indirect cost reimbursements for fiscal year 2002 because the indirect cost rate was too high and would cut deeply into the programs'

⁶ It was not practical for us to precisely calculate the indirect costs that the GVI should have recovered because doing so would have required a detailed analysis of (1) each grant agreement and associated laws and regulations to identify any limitations on indirect costs and (2) the direct costs of each grant to determine how to apply the approved indirect costs rates. The estimate of \$5.9 million was developed by the public accounting firm contracted by the GVI to prepare the indirect cost proposals and may not have taken into consideration limitations that some Federal grant programs have on the amount of indirect cost recoveries.

⁷ 33 VIC § 3023(b)

administrative budget. We estimated that the Department of Health did not recover indirect cost reimbursements totaling at least \$76,500.

- The Police Department received Federal grants of \$4.8 million to administer seven law enforcement programs for fiscal year 2002. The Director of Financial Management Services informed us that prior to fiscal year 2003, the Department had never requested reimbursement of indirect costs. We estimated that indirect cost reimbursements totaling at least \$20,200 were not recovered. The Police Department also received Federal grants of \$7.9 million to administer four programs in community policing, information technology, crime control, and safe streets for fiscal years 2002 to 2005. The Director of Fiscal Property told us that the Police Department did not budget for indirect costs for the four programs. We could not determine the applicable amount of unreimbursed indirect costs for the four programs because the necessary documents were not readily available.
- The Department of Human Services received Federal grants of \$20 million to administer its pre-school program and \$450,000 for a national and community service program for fiscal years 2002 and 2003. The Deputy Commissioner for Fiscal Operations told us that requests for reimbursement of indirect costs were not made for either program because the indirect cost rates were too high. We estimated that indirect cost reimbursements totaling \$312,300 were not sought.
- The Department of Agriculture received two Federal grants totaling \$165,000 to administer the State and Private Forestry program for fiscal year 2003. The Commissioner said he considered indirect costs to be a tax, and that the employee trained to handle indirect costs was no longer with the Department. Therefore, the Department of Agriculture did not request reimbursement of indirect costs. We were unable to determine the applicable amount of unreimbursed indirect costs because necessary records were not available.
- The Virgin Islands National Guard unit of the Office of Adjutant General did not request reimbursement of indirect costs in fiscal years 2002 and 2003. An agency official informed us that its six programs were exempt from indirect costs because of an agreement with the V.I. Office of Management and Budget. However, officials of the Office of Management and Budget told us that this exemption was only

for the 3-year cycle of fiscal years 1997 to 1999 because of Hurricane Marilyn in September 1995. We requested the grant award documents for the programs, but they were never provided. Therefore, we could not determine the applicable amount of unreimbursed indirect costs.

Agencies Used Incorrect Indirect Cost Rates

Four program agencies did not use the correct indirect cost rates. Specifically:

- The Virgin Islands Territorial Emergency Management Agency unit of the Office of Adjutant General, in a September 2002 letter to the V.I. Office of Management and Budget Director, said that a rate higher than 15 percent would hamper its ability to receive future Federal grants and that an increase in indirect costs would significantly decrease its available funds for program administration and would result in a reduction of staff. As a result, the Agency continued to use its fiscal year 2002 indirect cost rate of 15 percent instead of the approved rate of 25.29 percent for fiscal year 2003. This resulted in an under-recovery of about \$37,400 in indirect costs.
- The Director of Business and Administrative Services at the Department of Planning and Natural Resources told us that there was no signed indirect cost agreement for fiscal year 2003, and that she was notified of the new rates late. The Director also stated that the rates were too high and would hamper the administration of the programs. Therefore, the agency used its fiscal year 2002 indirect cost rate of 18.13 percent for its programs in fiscal year 2003 instead of its new rates of 39.52 percent for Fish and Wildlife programs and 21.11 percent for Environmental Protection programs. This resulted in an under-recovery of about \$236,269 in indirect costs. Also, the Department used a 7 percent rate for its Libraries, Archives and Museums program instead of the approved rates of 18.13 percent for fiscal year 2002 and 24.87 percents for fiscal year 2003. If the correct indirect cost rates had been applied in fiscal years 2002 and 2003, indirect cost reimbursements would have been \$13,083 greater.
- The Commissioner of the Department of Agriculture stated that the proposed 52.7 percent indirect cost rate was unreasonably high and would be detrimental to its grant programs. In that regard, a September 2003 letter from the grantor agency stated, “This [indirect cost] charge could result in a loss of U.S. Forest Service federal grant funds due to the fact that after the deduction there would be less than half of the funds available

for projects and program administration. It [indirect cost] will affect your ability to complete projects and without positive performance outcomes your competition for future funds will be extremely limited.” A V.I. Office of Management and Budget official told us that a follow-up meeting was held with the Commissioner in November 2003, and it was agreed that the approved indirect cost rate should be used for fiscal years 2004 and 2005. However, Agriculture did not request any reimbursement of indirect costs.

- The Department of Human Services used its fiscal year 2002 indirect cost rate of 26.31 percent instead of the correct rate of 27.65 percent for its food and nutrition service program in fiscal year 2003. If the correct indirect cost rate was applied, indirect cost reimbursements would have been \$778 greater.

Agencies Applied Indirect Cost Rates Incorrectly

To comply with the indirect cost section of the Compliance Agreement between the GVI and the U.S. Department of Education, the V.I. Office of Management and Budget contracted with an accounting firm to prepare a new comprehensive indirect cost allocation plan and related indirect cost rates for fiscal years 2003 through 2005. The accounting firm computed rates for program agencies using a base of net total direct costs⁸ instead of direct salaries and wages, as had been the past practice. We found, however, that program agencies continued the past practice of applying indirect cost rates to direct salaries and wages for fiscal year 2003. As direct salaries and wages are generally lower than net total direct costs, application of the rates to salaries and wages resulted in decreased indirect cost recoveries.

According to V.I. Office of Management and Budget officials, this error occurred because (1) fiscal year 2003 was a period of transition, (2) it would have been cumbersome to apply rates against net total direct costs, and (3) the Financial Management System was not set up to accommodate rates based on net total direct costs. Further, our audit disclosed that most Indirect Cost Negotiation Agreements did not become effective until late in fiscal year 2003 or early in fiscal year 2004, which was too late to begin applying rates to net total direct costs for fiscal year 2003. The V.I. Office of Management and Budget advised that it anticipated that indirect cost rates would be applied to net total direct costs for fiscal year 2004.

⁸ Net total direct costs are total direct costs less cost categories that are considered to be unallowable under Circular A-87 and the specific laws and regulations related to certain grant programs.

ACCOUNTING FOR AND USE OF INDIRECT COST REIMBURSEMENTS

Indirect Cost Reimbursements and Revenues into the Indirect Cost Fund Were Not Accurately Tracked

The GVI did not properly account for and use indirect cost reimbursements. Specifically, the amount of indirect costs deposited into the Indirect Cost Fund was not accurately tracked, Fund revenues were not used to support grant administration in the program agencies, and Fund revenues were used for unauthorized purposes or expenditures were not adequately supported.

At the time of our review, the Financial Management System automatically computed indirect costs based on the rates programmed into the System for the ten program agencies. The programmed rates were generally based on the approved indirect cost negotiation agreements. However, as already noted, these rates were not always used by program agencies, and some program agencies simply did not request indirect cost reimbursements. However, the Department of Finance used information in the Financial Management System to prepare quarterly reports on the status of the Indirect Cost Fund for the Governor, the Director of the V.I. Office of Management and Budget, and the Legislature. Consequently, amounts reflected in Indirect Cost Fund quarterly reports were not accurate. For example, the Department of Finance reported indirect cost revenues of \$4.8 million from Federal grantor agencies for the 3-month period ended September 30, 2003, but our audit disclosed that actual deposits into the Fund totaled only \$2.5 million. Nevertheless, these reports were used by the Legislature to make decisions related to appropriations from the Fund.

\$3.6 Million in Indirect Cost Reimbursements Was Not Equitably Allocated

The Virgin Islands Code⁹ states that monies deposited into the Indirect Cost Fund may be appropriated to support Federal program activities established within the various departments or agencies of the GVI receiving Federal grant assistance. We found that the Legislature properly appropriated \$3.2 million in fiscal year 2002 and \$3.8 million in fiscal year 2003 for salaries, operating expenses, and other purposes of four central service agencies. However, indirect cost reimbursements were not specifically appropriated to cover the internal grant administration costs of most program agencies – a deficiency that adversely impacted the administration of Federal programs by the program agencies and also resulted in the General Fund having to cover some of the administrative costs of the Federal programs.

We found that only the Departments of Education and Justice received funds from the Indirect Cost Fund to cover a portion of their grant administrative costs. A Department of Justice official told us it had been a struggle to get back its indirect cost monies.

⁹ 33 VIC § 3025(b)(5)

Also, officials of three program agencies told us that they could have used indirect cost reimbursements to pay shared and overhead costs of running their grant programs; and officials of four other program agencies said that since they have never been reimbursed for indirect costs, they have managed to run the programs without those additional monies.

In accordance with the Compliance Agreement between the GVI and the U.S. Department of Education, steps to determine indirect costs and distribute indirect cost reimbursements between the V.I. Department of Education and the central service agencies were to be fully implemented by October 1, 2002 (the beginning of fiscal year 2003). The V.I. Office of Management and Budget also used the procedures established for the Department of Education to compute central service agency components of indirect costs and the indirect cost rates for program agencies. However, it had not begun to routinely allocate indirect cost reimbursements between the program agencies and central service agencies using the established rates.

In September 2003, the Department of Finance developed a new Indirect Cost Fund account number and new expenditure and revenue cost center codes to allocate indirect costs between program agencies and central service agencies. Under this new process, program agencies would be required to prepare two Miscellaneous Disbursement Vouchers for each year (beginning with fiscal year 2004) using the new cost center codes to record the allocation of indirect cost reimbursements between the program agencies and the central service agencies.

However, program agency officials reported that, as of March 2004, they had not started using this new process and that their inquiries on the Financial Management System showed no activity for the new cost center codes. Further, we identified three program agencies which were not aware of the new process for allocation of indirect cost reimbursements. In April 2004, the V.I. Office of Management and Budget held meetings with program agency and Department of Finance officials to finalize plans for implementing the new process.

Subsequent to our February 10, 2005 exit conference, the V.I. Office of Management and Budget provided us with documentation showing that a training session, attended by more than 50 program agency and central service agency representatives, was held on April 20, 2004 to explain the new procedures that had been developed for processing indirect cost

Appropriations from the Indirect Cost Fund Were Made for Non-Grant Purposes

reimbursements. Management and Budget also provided us with a copy of the new procedures, which were formally issued on June 10, 2004. The procedures included detailed examples for calculating the allocation of indirect cost reimbursements between program agency and central service agency components and examples of completed forms needed to properly record the receipt and allocation of the indirect cost reimbursements.

The Virgin Islands Code¹⁰ stresses that the Indirect Cost Fund be used for the purpose of improving Federal grants administration and management and increasing the Virgin Islands' participation in Federal grant-in-aid programs. However, we found that the Legislature sometimes appropriated monies from the Fund for purposes that were not related to these areas.

In October 1998 (Act No. 6254), the Legislature appropriated \$318,000 from the Indirect Cost Fund for purposes such as (1) Department of Public Works operation and maintenance coordinator, St. John landfill closure re-analysis study, and wastewater collection recording system; (2) Office of Management and Budget economic program; (3) Roy L. Schneider Hospital institutional consultant; (4) Department of Finance needs assessment for Treasury Division; and (5) Department of Education inventory and survey of public school facilities.

At our February 10, 2005 exit conference, V.I. Office of Management and Budget officials stated that some of the appropriated amounts listed above were related to the administration of Federal grants. However, as of May 2, 2005, they had not provided us with documentation to support that assertion.

In January 2002, the Office of Inspector General, U.S. Department of Interior, wrote to the Governor and the Legislature informing them of the consensus reached by Federal grantor agency representatives at a joint Federal/Virgin Islands conference held in the Virgin Islands during December 2001. During this conference, extensive discussions were held regarding the Government-wide procedures for computation, distribution, and use of indirect cost reimbursements from Federal grant programs. The letter stated, in part:

¹⁰ 33 VIC § 3025(b)(4) states, "The Indirect Cost Fund shall be utilized for the purpose of improving Federal grants administration and management in the Territory and increasing Virgin Islands' participation in Federal grant-in-aid programs, including but not limited to, grant budget and accounting assistance, grant proposal development, grant management training, special studies and acquisition, accounting or reporting of Federal grant programs, and for other purposes."

Based on the definition of indirect costs included in Attachment E of the Office of Management and Budget Circular A-87, the indirect cost reimbursements deposited into the Indirect Cost Fund should be used solely to support the costs associated with administering the respective grant programs. Specifically, we do not believe that appropriations should be made from the Fund for non-grant expenditures, such as the \$318,000 appropriation made by Act No. 6254. We believe that the Fund should be used to reimburse the central service agencies for the costs associated with such Government-wide grant administrative functions as grant oversight, single audits, and financial accounting and to reimburse the individual grant recipient agencies for internal costs associated with administering the grant programs.

Despite this policy statement, in December 2002 (Act No. 6571), the Legislature appropriated \$3.6 million from the Indirect Cost Fund to finance negotiated union contracts for firefighters. The Governor, however, vetoed this appropriation, stating that he was not in favor of “raiding the Indirect Cost Fund to support non-federal salary increases for which this Government lacks resources because it jeopardizes all federal programs.” The Governor urged the Legislature to seek an alternative source of funding.

In a related test, we reviewed fiscal year 2002 and 2003 appropriations of \$7.9 million and expenditures of \$4.9 million for four central service agencies to determine if indirect cost monies were used in accordance with applicable local laws and regulations. We concluded that expenditures were generally for authorized purposes, except for \$2,480 that was not supported and \$8,400 that was outside the scope of grant management, as follows:

- The V.I. Office of Management and Budget could not provide supporting documents for \$2,480 spent for cleaning services and utilities.
- The Division of Personnel spent \$1,000 to publish the names of employees of the year for 2002, \$6,400 to host public service ceremonies on St. Thomas and St. Croix, \$600 for Christmas party items, and \$400 for meals during pre-arbitration and financial meetings.

The language included in the Virgin Islands Code pertaining to the acceptable uses of the Indirect Cost Fund – specifically the catchall phrase “and for other purposes” – allows the Indirect Cost Fund to be used for purposes unrelated to Federal grant programs.

Reimbursements to the Indirect Cost Fund are needed to (1) assist the central service agencies that provide vital services such as grant oversight, single audits, and financial accounting and (2) reimburse the program agencies for internal costs associated with administering grant programs. We believe the indirect cost reimbursements received from Federal grant programs and deposited into the Indirect Cost Fund should be used only for these purposes.

CONCLUSION

Agencies of the GVI which operate Federal grant programs should, to the extent permitted by Federal law, regulation, and agreements, recover and retain their appropriate share of indirect costs to help effectively operate grant-funded programs. This is not happening in the Virgin Islands. Based on our audit, we concluded that agencies of the GVI do not fully recognize the complexities of estimating, budgeting, and recovering indirect costs. Further, the requirement to deposit indirect cost reimbursements into the Indirect Cost Fund serves as a disincentive, in our opinion, for program agencies to optimize indirect cost reimbursements because the Legislature has not given the appropriate share of the deposits back to the program agencies.

We believe that the GVI lacks a comprehensive strategy to administer indirect costs. Such a strategy should include:

- An analysis of all Federal grants and contracts regularly awarded to the GVI to identify any limitations on indirect cost recoveries, to identify instances where application of the full indirect cost rate will be detrimental to the delivery of direct program services, and to identify instances where application of the full indirect cost rates will hinder the GVI’s ability to compete for grant awards;
- An estimate, based on the above analysis, of the amount of recoverable indirect costs and the development of agency budgets and grant proposals that include accurate forecasts of the cost of grant administration to be financed with indirect and direct costs to be recovered under the grants and with GVI funds;

- The provision of ongoing refresher training to agency management and key staff on the computation, recovery, and use of indirect costs; and
- The revision of the Virgin Islands Code (33 VIC §3025) to provide that the portion of program agency payments into the Indirect Cost Fund that are applicable to their internal grant administrative costs are transferred to the program agencies to cover such costs.

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RECOMMENDATIONS

TO THE GOVERNOR OF THE VIRGIN ISLANDS

We recommend that the Governor of the Virgin Islands:

1. Develop and implement a comprehensive strategy to administer indirect costs, as outlined in the Conclusion section of this report.

In the interim, we also recommend that the Governor of the Virgin Islands ensure that:

2. The Office of Management and Budget continues to monitor the program agencies to ensure that they budget for indirect cost reimbursements, complete the negotiation process for indirect cost agreements, and use only current, approved indirect cost rates.

3. The Office of Management and Budget takes the necessary steps to comply with the requirement that indirect cost rates are applied to net total direct costs as stated in the Summary of Proposed Indirect Cost Rates and Indirect Cost Negotiation Agreements.

4. The Department of Finance takes the steps necessary to require that future indirect cost reimbursements are recorded to the correct revenue codes on Statements of Remittance for accurate reporting on Indirect Cost Fund quarterly reports to the Governor, the Office of Management and Budget, and the Legislature.

5. The Office of Management and Budget locates and provides to us the supporting documents for \$2,480 in expenditures from the Indirect Cost Fund.

6. Program agencies and central service agencies comply with the Virgin Islands Code provisions for the appropriate uses of the Indirect Cost Fund for the purpose of enhancing the administration of grant programs.

TO THE LEGISLATURE OF THE VIRGIN ISLANDS

We further recommend that the Legislature of the Virgin Islands:

7. Appropriate, in accordance with the Virgin Islands Code, monies from the Indirect Cost Fund only for purposes that improve the administration and management of Federal grant programs.

8. Consider removing the phrase “and for other purposes” from the policy statement for use of the Indirect Cost Fund that is contained in the Virgin Islands Code.

AUDITEE RESPONSE

The May 9, 2005, response (Appendix 4) from the Virgin Islands Office of Management and Budget concurred with the findings and recommendations and provided detailed information on actions which have been taken to improve and standardize the indirect cost allocation process within the Government of the Virgin Islands. Based on the response, we classified Recommendations 1, 2, 3, 4, and 6 as resolved and implemented. Because the response did not address Recommendation 5, we classified that recommendation as unresolved. Additionally, because we did not receive a response from the Legislature of the Virgin Islands, we also classified Recommendations 7 and 8 as unresolved. Appendix 5 describes the documentation that the Government of the Virgin Islands should provide in order to close out Recommendations 5, 7, and 8.

APPENDIX 1 - MONETARY IMPACT

FINDING AREA

Potential
Unrealized
Revenues

Under-Recovery of
Indirect Costs

\$696,530 *

* The amount represents Federal funds.

APPENDIX 2 – FEDERAL GRANT AWARDS AND INDIRECT COST REIMBURSEMENTS

Program Agency	FY 2002 Federal Grant Awards	Number of Grant Programs	FY 2002 Indirect Costs Reimbursed
Office of Adjutant General	\$561,176	1	\$46,999
Department of Education	15,942,877	26	156,071
Department of Health	20,349,538	20	337,505
Department of Human Services	17,371,919	8	381,761
Department of Justice	3,263,306	1	0
Department of Labor	7,288,023	13	289,279
Dept. of Planning and Natural Resources	15,332,065	34	445,629
Police Department	7,784,672	9	0
Totals	\$87,893,576	112	\$1,657,244

Program Agency	FY 2003 Federal Grant Awards	Number of Grant Programs	FY 2003 Indirect Costs Reimbursed
Office of Adjutant General	\$632,810	1	\$54,492
Department of Agriculture	165,000	1	0
Department of Education	19,830,243	29	450,131
Office of the Governor	42,000	1	5,140
Department of Health	20,780,001	23	745,673
Department of Human Services	18,627,745	8	363,774
Department of Justice	3,110,821	1	124,121
Department of Labor	6,496,237	14	235,408
Department of Planning and Natural Resources	14,956,432	34	525,321
Police Department	8,398,151	6	6,688
Totals	\$93,039,440	118	\$2,510,748

APPENDIX 3 – INDIRECT COST RATES

Program Agency and Rate Type (Rates Applicable to Fiscal Years 2003 to 2005)	Program Agency Rate	Central Service Agency Rate	Overall Combined Rate
Department of Education:			
Restricted Rate	4.82%	2.43%	7.25%
Unrestricted Rate	12.33%	2.65%	14.98%
Department of Health:			
Medical Care	5.15%	0.92%	6.07%
Emergency Services	12.93%	2.31%	15.24%
Health, Planning, Research	46.26%	8.27%	54.53%
Preventive Health	19.99%	3.58%	23.57%
Department of Human Services:			
Pre-School Services	10.68%	2.99%	13.67%
Food Stamps	21.03%	5.88%	26.91%
All Other Programs	21.60%	6.05%	27.65%
Department of Police:			
Law Enforcement/Victim Witness	1.77%	0.57%	2.34%
Highway Safety/Vehicle Registration	20.60%	6.67%	27.27%
All Other Programs	12.09%	3.91%	16.00%
Department of Planning and Natural Resources:			
Fish and Wildlife	27.74%	11.78%	39.52%
Environmental Protection	14.82%	6.29%	21.11%
All Other Programs	17.46%	7.41%	24.87%
Department of Justice:			
Paternity and Child Support	6.37%	4.37%	10.74%
All Other Programs	9.84%	6.75%	16.59%
Department of Agriculture:			
All Programs	33.85%	18.85%	52.70%
Department of Labor:			
Central Office	8.34%	12.34%	20.68%
Division of Training Programs	4.04%	5.98%	10.02%
V.I. Employment Security Agency	3.51%	5.19%	8.70%
Office of Adjutant General:			
V.I. Emergency Management Agency	10.73%	14.56%	25.29%
All Other Program	35.67%	48.38%	84.05%

APPENDIX 4 - RESPONSE TO DRAFT REPORT



GOVERNMENT OF
THE UNITED STATES VIRGIN ISLANDS

OFFICE OF MANAGEMENT AND BUDGET

41 NORRE GADE
EMANCIPATION GARDEN STATION, 2ND FLOOR
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May 9, 2005

Mr. Arnold van Beverhoudt,
Manager
Department of Interior
Office of the Inspector General
Federal Building
St. Thomas, Virgin Islands 00802

Dear Mr. van Beverhoudt:

Attached hereto is the Government of the Virgin Islands' response to the proposed findings and recommendations of the audit on the "*(1) - Under Recovery of Indirect Costs.*" I hope that this adequately addresses all of the concerns raised and that the final audit will reflect these responses and/or changes to the audit findings, as appropriate.

The Office of Management and Budget, with the cooperation and assistance of the Department of Finance, has made tremendous strides in rectifying the problems associated with implementation of Indirect Cost pursuant to OMB Circular A-87. Implementation of corrective actions and enhancements will be on an on-going basis, but I know that the transition to using "net direct cost" was smoother than anticipated because of the changes implemented in FY 2004.

Should you have any further questions, please contact Mr. Clement "Cain" Magras, Associate Director, Federal Grants Management Unit at (340) 774-0750, extension 252.

Sincerely,

A handwritten signature in blue ink that reads "Ira R. Mills".

Ira R. Mills
Director

IRM/CF/CM/rtr
Indirectcostauditresponse

Attachment

*(1)– Under-Recovery of Indirect Cost Audit
Proposed Findings and Recommendations*

OFFICE OF THE INSPECTOR GENERAL

GOVERNMENT OF THE VIRGIN ISLANDS

RESPONSE

The Virgin Islands Office of Management and Budget (VIOMB) concurs with the auditors general conclusion that the Government of the Virgin Islands (GVI) under-recovered indirect costs, but those funds that were not recovered remained with the individual programs to enhance the delivery of services and the quality of the program provided. Additionally, it must be noted that the Office of the Inspector General (OIG) focused its audit on a period during which the administration of Indirect Cost was undergoing revisions by the Government of the Virgin Islands during Fiscal Year 2002 and Fiscal Year 2003.

This response will focus on the programs identified in the audit, and offer explanations for the situations cited, but more importantly it will address corrective actions taken since Fiscal Year 2003 that were implemented and are currently in place.

- The Medical Assistance and Child Health Insurance Program(s) have consistently been under-funded in the Virgin Islands by the Federal Government. As a result, the Government of the Virgin Islands made a decision to allow Indirect Costs to remain in the program to allow more individuals to be served. This arrangement continued until Fiscal Year 2004 when a modified rate was negotiated with the U. S. Department of Health and Human Services (DHHS). The modified rate took into consideration the fact that the East End Health Clinic and the Ingeborg Nesbitt Clinic (Frederiksted Health Clinic), had been severed from the Virgin Islands Department of Health and were being operated by private non-profit (PNPs) organizations. This change altered the base on which the rate had originally been calculated and required an adjustment by the local government.
- Historically, the Virgin Islands has not charged indirect cost to Human Services programs because these are programs that serve the under-privileged and disabled populations of the Virgin Islands. A decision was made to forego indirect cost so that more funds would be available to serve the public. Additionally, the particular program (the National and Community Service Program, better known as the AmeriCorps Program) cited in this audit report is funded through the Virgin Islands Department of Human Services but is run by Lutheran Social Services. All of the program funds are used to pay stipends which are considered to be "pass through" funds and are exempt from Indirect Cost.

- The Virgin Islands Office of Management and Budget concurs with the finding regarding the Virgin Islands Department of Agriculture (VIDOA). The Virgin Islands Office of Management and Budget has met on several occasions with the Commissioner of Agriculture (VIDOA) and his staff and have held several training sessions on Indirect Cost to rectify this matter. Since Fiscal Year 2004 the Virgin Islands Department of Agriculture has been charging Indirect Cost to all of its programs at an agreed-upon rate which incorporates the full Central Service rate and a modified Departmental rate. This was done at the request of the Virgin Islands Department of Agriculture. Also, because of the limited funds available for the "Bont Tick Program" and after discussion with United States Department of Agriculture officials in Puerto Rico, this program was exempted from Indirect Cost (Attachment A).
- In accordance with Attachment B, the Virgin Islands National Guard, which is funded by the United States Department of Defense, is exempt from all Indirect Costs.
- The Virgin Islands Territorial Emergency Management Agency (VITEMA) has consistently complained about high rates. However, VITEMA failed to point out that up until the end of Fiscal Year 2003 the Indirect Cost rate was only being charged to personnel services and fringe benefits. As a result, for many programs whose personnel costs are 50% or less of the grant, a lower rate was in effect being charged. Since full implementation of the Indirect Cost rates against total Direct Costs (Fiscal Year 2004) with redistribution of the Departmental rate to the department, VITEMA's Central Service rate is only 14.56%. The Departmental rate of 10.73% is retained by VITEMA for program or administrative costs.
- The Director of Business and Administrative Services of the Virgin Islands Department of Planning and Natural Resources (VIDPNR) was erroneously informed. There are signed agreements for a Central Service Indirect Cost rate with the Virgin Islands Office of Management and Budget (VIOMB) and for Departmental rates with all Department and Agency Heads affected, including DPNR. Further, all agreements have been reviewed and approved by the Department of the Interior's National Business Center. The Indirect Cost rates that were reduced were the Departmental rates, not the Central Service rates. In addition, it should be noted that the under-recovery of Indirect Cost from the Virgin Islands Department of Planning and Natural Resources' Fish and Wildlife Division was due to the fact that most of the programs under Fish and Wildlife carry "restricted rates" of 3%. All rates (restricted and unrestricted) have been adjusted and the correct rates are being charged to all Fiscal Year 2004 and 2005 programs (Attachment C).
- See 3rd bullet point re: V.I. Department of Agriculture (above).
- The Virgin Islands Department of Human Services has adjusted all rates for Fiscal Year 2004 and Fiscal Year 2005, except for the Social Services Consolidated

Block Grant (SSCBG), which has been granted a special reduced flat rate allowance (not exceeding the calculated rate) by VIOMB as negotiated with Commissioner Halbert. This program which serves the disabled, aged, and underprivileged in our community must stretch every dollar to maximize benefits and services to its clientele. The Government of the Virgin Islands is aware of the rates developed, but attempts to remain flexible by minimizing the funds allocated as Indirect Costs to allow for better delivery of services to these federally funded programs.

- The Government of the Virgin Islands (GVI) has always contracted with an accounting firm to prepare its Indirect Cost Allocation Plan. Professional development of the rates was not a result of the Compliance Agreement. In Fiscal Year 2003, the Government of the Virgin Islands was not prepared to fully convert its system to using net total direct costs as the base for computing Indirect Cost. All departments and agencies for whom rates had been prepared were instructed by OMB to continue assessing the NEW RATES against payroll. During FY 2003 several training meetings were held and new policies and procedures were developed and promulgated for full implementation in Fiscal Year 2004. There was no error made but rather a recognition that full implementation prior to Fiscal Year 2004 would have resulted in a financial fiasco and created more confusion. The decision was to make a seamless transition for Fiscal Year 2004, once all departments and agencies had been properly trained, and federal agencies had been alerted as to the potential impact on federal grants.

Recommendations:

The Office of Management and Budget concurs with the recommendations made and have already begun implementing them. Specifically, OMB has implemented a comprehensive strategy to administer Indirect Costs which includes:

Initiation of a survey of agencies and departments administering federal programs to determine if any federal programs have limitations, caps or restrictions on Indirect Cost recovery. It was through this procedure that VIOMB was able to identify the Virgin Islands National Guard (VING), the Fish and Wildlife (DPNR) and "COPS" (VIPD) cap on Indirect Costs (Attachment D). Additionally, expedited assessments of other programs are being conducted on an individual basis, upon request of Department Heads, to identify situations where application of the full rate could hinder the Government of the Virgin Islands' ability to compete for discretionary awards.

The Office of Management and Budget (OMB), as part of its annual budgetary process, develops an estimate of total Indirect Cost, which may be recovered, in order to facilitate budgeting the projected expenditure of Central Service funds for the next fiscal year. Since Fiscal Year 2004, each department has also been required to develop a budget for anticipated collections of "Departmental" Indirect Cost funds. These budgets are reviewed by OMB to ensure that funds are being spent to promote better grants management and/or delivery of services to federally funded projects. Additionally, some

of these departmental funds are being earmarked to pay for services such as utilities and custodial services, not paid as a direct cost, in areas being used for federal programs.

The Office of Management and Budget has conducted several training sessions on Indirect Cost for Agency Heads and Program Directors over the past years. The results have been a better understanding of how to distinguish Direct vs. Indirect costs, how rates were calculated, and how funds can be used. In addition, the Office of Management and Budget and the Department of Finance participated in an audio teleconference on Indirect Cost conducted by Robert M. Lloyd of Thompson Interactive. The Office of Management and Budget is committed to continued education and training and has required that the successful bidder for development of the Fiscal Year 2006-2008 Indirect Cost Allocation Plan also include training as one of the deliverables under the contract.

(1) Revisions to the V.I. Code can only be done by the Legislature of the Virgin Islands; however, and the recommendation made by the Office of the Inspector General does not require legislative action. As of the date of this response, individual cost centers have been established to capture all Departmental Indirect Cost funds. All funds collected and attributable to the cost of operating the Central Service agencies are recorded in a separate and distinct account apart from departmental accounts.

(2) The Office of Management and Budget has initiated a new budget review process which requires, on an on-going basis (year round), that all budgets for federal programs be reviewed by Sr. Grants Analysts and Associate Directors of the Federal Grants Management Unit (FGMU), prior to being processed by the Budget Administration section of VIOMB. This review ensures that the programs are: (a) are using the correct Indirect Cost rates as approved, and (b) accurately calculating Indirect Cost for budgetary and other purposes. All Indirect Cost rates for Fiscal Years 2003-2005 have been properly negotiated and agreed to by the cognizant agency Department of Interior (DOI) via its National Business Center (NBC) in California.

(3) As stated earlier, full implementation of the new policy was effectuated on October 1, 2003 (Fiscal Year 2004), and all rates are being applied to net total direct cost, where not otherwise restricted.

(4) The Office of Management and Budget and the Department of Finance (DOF) have been communicating, collaborating and coordinating regarding Indirect Cost, in general, and the new Fiscal Year 2004 procedures, in particular. The Department of Finance (Chief, Revenue Audit Activity/Reconciliation, Accounting Director and CMIA Coordinator) is presently setting up revenue options codes in the Financial Management System for each department, so that the indirect cost reimbursements will be reflected correctly in the future. Upon completion of the project by June 15, 2005 all departments will be advised accordingly.

(5) As stated earlier, effective October 1, 2003 (Fiscal Year 2004) the Office of Management and Budget and the Department of Finance took the necessary steps to properly distribute Departmental Indirect Costs between departments and in some cases

between divisions in some departments. This was accomplished by establishing distinct revenue and expenditure accounts within the Financial Management System (FMS) for proper segregation of funds (Attachment E). At the same time, different accounts were set up for the Department of Education, as well as for Central Service Indirect Cost funds. This information was shared with Agency Heads as well as Program Directors and Fiscal Officers. The Office of Management and Budget and the Department of Finance continues to work closely together with departments and agencies to ensure the continuity of enhancements and improvements for this on-going Indirect Cost endeavor. Facilitating what is in the best interest of the Territorial federally-administered programs is the anticipated end-results with departments and agencies.

Dated May 9, 2005

APPENDIX 5 - STATUS OF RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
1, 2, 3, 4, and 6	Resolved and Implemented.	No further action required.
5, 7, and 8	Unresolved.	Provide a response that expresses concurrence or nonconcurrence with each recommendation. If concurrence is indicated, provide a plan of action that includes target dates and the titles of the officials responsible for implementing corrective action. If nonconcurrence is indicated, provide the reason for nonconcurrence and a plan of action that includes alternative corrective action and target dates for addressing the underlying deficiencies.