SEMIANNUAL REPORT TO THE CONGRESS

FY 2009 – FIRST HALF

OFFICE OF THE INSPECTOR GENERAL
DENALI COMMISSION
ANCHORAGE, ALASKA
MEMORANDUM FOR FEDERAL CO-CHAIR CANNELOS

From: Mike Marsh, CPA, MPA, CFE, Esq.
      Inspector General

Subject: Semiannual report to agency head and Congress for first half of FY 2009

The discussion below constitutes the Office of Inspector General (OIG) report to the agency head
and Congress, as required by the Inspector General Act, for the first half of FY 2009. This is the
sixth such report for this function here at the Denali Commission.

OIG has had considerable inquiry from the agency head and other parties concerning the
FY 2008 financial audit. This report will thus offer readers the closure of a more detailed,
technical explanation of this particular activity.

This report further summarizes OIG accountability activities that have involved OMB, GAO,
congressional staff, and the Partnership for Intergovernmental Management and Accountability.

We also outline some unsettled financial reporting issues that will continue to hinder the
transparency and comparability of federal-state collaborations like Denali until refined by the
larger federal system.

GROWING PAINS OF THE ANNUAL FINANCIAL AUDIT

1. Respective Roles of OIG and the Contract Auditor

Federal statutes and OMB rules require small agencies like Denali to have an annual audit of
their financial statements by an independent CPA firm. For agencies that have an Office of
Inspector General (OIG), the OIG is responsible for selecting the audit firm and monitoring its
performance of the contract.

Oversight over Denali’s accounting systems is an important OIG responsibility. The annual audit
contract is a key opportunity for a small OIG like ours to leverage its very limited in-house
staffing. If the relationship is successful, the contractor’s expertise provides us with a valuable
outsider’s critique of Denali’s safeguards over how public money is spent in Alaska.
The core of the contractor’s purpose is to review the agency’s accounting records, and then issue the firm’s independent opinion as to whether management’s financial statements fairly reflect that audit evidence. However, all must remember that the contractor’s “independence” is the very essence of this service.

Thus, per various professional (and legal) “prime directives,” OIGs must be careful not to direct management how to author its financial statements — and not to direct the independent contractor what to write in its audit report. In other words, the OIG contracts for the audit firm’s independent professional judgment rather than for a particular result (opinion). Or, to think of it another way, independent auditors are quite different from lawyers who get paid on a contingency fee basis only when they produce the answer a client wants to see.

2. How OIG Hires the Contractor

Though any licensed CPA firm could theoretically perform the annual audit, the practice of Denali’s OIG has been to set the bar higher. We conduct this procurement using (1) the national GSA 5207 Schedule of qualified contractors, (2) an outside federal contract officer who evaluates bidder pricing for us and assures our compliance with the Federal Acquisition Regulation, and (3) OIG’s “blue-ribbon” panel\(^1\) of financial experts who review the proposals’ technical merits. While several different CPA firms have conducted Denali’s audit over the years, the selection process has so far always resulted in a Beltway-based contractor.

In short, Denali’s inspector general doesn’t simply pick a contractor. And he doesn’t personally decide what to pay them. The Federal Acquisition Regulation prescribes a process — and an independent contract officer makes sure we follow it.

Even within such procurement constraints, OIGs have considerable discretion in how they define the “statement of work” that the contractor is expected to accomplish. For FY 2008, we contracted for a more rigorous audit than Denali had received in the past. A more rigorous audit involves a contractor who assigns a larger and more diverse team of auditors — and obviously bids a higher price to compensate for this. The contractor for FY 2008 assigned a six-person team that included some specialists, and they asked Denali’s management many hard questions that at times overwhelmed its tiny accounting staff.

While the previous (cheaper) audits appeared to meet the legal minimums, there were several technical reasons to seek a more rigorous audit for FY 2008. First, OIG had concerns about whether management should present its financial statements, including the explanations of accounting treatment, with more elaboration that would make them clearer to public readers. Second, OIG wished reassurance that management had successfully adapted its financial reporting to the change to FASAB (versus FASB) accounting principles at the end of FY 2006. Third, OIG wished reassurance that management was properly recording its fragmented federal funding under FASAB’s accounting principles. Fourth, Denali suffered a catastrophic IT failure.

\(^1\) For instance, our FY 2009 selection panel included these individuals: (1) a retired GAO executive, (2) the accounting services manager from another federal agency, (3) a local CPA/PhD, and (4) OIG’s office administrator. All four have technical history with the Denali Commission and its challenges.
of its connectivity to the federal world in early 2008 (which should have been prevented). Fifth, like much of the federal system, Denali’s small in-house staff (<30 FTEs) is heavily leveraged through presumed monitoring of sub-awards by a much larger “shadow bureaucracy” of contractors and grantees over whom Denali has limited control.2

And, finally — and we realize that this is a sensitive topic — the congressional future of the Denali Commission is uncertain (authorization expired last year). If a more rigorous (and more expensive) review would uncover problems while management could still self-correct, that could be helpful feedback for Congress’ redesign of Denali’s enabling legislation. And it frankly seemed preferable to waiting for GAO to do an “autopsy” of Denali’s decade if Congress ultimately failed to continue the agency.

3. The Risk of a Rigorous Review

The auditor’s purpose is to review the agency’s accounting records and then offer the firm’s independent opinion as to whether the financial statements fairly reflect that audit evidence. The firms that audited fiscal years 2004 to 2007 found this to be the case, that is, they issued an “unqualified” opinion. We might analogize this roughly to a student getting a grade of “A” in the academic world.

Unfortunately, the firm that audited this past year (FY 2008) was unable to reach an opinion, that is, the firm “disclaimed” an opinion. And such a disclaimer can be considered like the undesirable result of a student getting an “incomplete.” (And an “adverse” opinion — which did not occur here — would translate as a failing grade.)

A “disclaimer” is obviously an undesirable result and should be a rarity in any agency’s history (an outlier or a “hiccup”). But, unlike Fortune 500 companies, audit disclaimers are not uncommon among young federal agencies like Denali that are growing up with more refined

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2 Denali’s contractors, its major grantees (which it calls its “program partners”), and the grantees’ sub-grantees no doubt collectively represent a workforce of hundreds that actually implement Denali’s projects around the state.
Denali has come a long way since it started a decade ago with two rooms, three employees, and an artistic logo of Mt. McKinley designed by a local volunteer (the CFO’s husband). The agency started with $20 million, a QuickBooks general ledger, and even a naive, short-lived assumption that its funding belongs in a local bank account (like city governments). In fact, early Denali correspondence reflects some initial uncertainty as to whether Denali was a true federal agency — or some other type of entity (resolved by Treasury).

4. Denali’s Disclaimer: Contributing Causes

Nevertheless, the audit firm is a contractor that works for OIG, and it is important for us to understand why the auditor was unable to reach an opinion on the accuracy of Denali’s FY 2008 financial statements. After reviewing the records (e.g., 800+ emails) of this remotely-conducted audit, OIG has concluded that the audit relationship was unsuccessful due to the constellation of 14 factors listed in Exhibit 1.

All of this occurred, of course, against Alaska’s recent backdrop of political integrity issues notorious in the Beltway. Readers should note, though, that the 15 factors of Exhibit 1 collectively signal an unsuccessful relationship between the audit firm and management, rather than allegations of missing money, hidden money, or public deception (à la Enron).

Over the course of this audit, OIG met 33 times with the contractor in hopes of resolving (or preventing) the problems. This was unusual for such a small federal contract, given that OIG’s limited role was to monitor the contract rather than to “re-audit” the contractor’s work. Six of these meetings involved the contract officer (also unusual for such a small federal contract).

At least 12 of these 33 meetings involved complaints by the audit firm that Denali’s management was being unresponsive to requests for the information needed to perform the audit. The following is typical of the contractor’s written complaints sent jointly to OIG and the CFO:

We continue to experience delays as reported in the past status reports. There has not been one issue brought up in the past that had been completely resolved. We continue to receive schedules or statements that were incorrect or incomplete that we have to spend time each time it is received reviewing and discussing with Denali.

OIG responded by conducting two internal reviews of this document exchange (“PBC”) relationship, concluding that the exchanges, though imperfect, overall seemed to be proceeding in a reasonable manner. And, early in the audit, another agency’s OIG shared with us customized software that we hoped would allow management and the auditor to comfortably coordinate their PBC exchanges across the continent.

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OIG also verified that the contractor had working remote access to Denali’s computerized accounting system — with physical connectivity started, and demonstrated, during the entrance conference in the contractor’s own office. But the electronic record shows little auditor accessing of this system during the first three months of the audit.

OIG took the auditor’s complaints to the agency head and his counsel. They reviewed the matter to their satisfaction and then reassured the finance staff of their confidence that Denali was responding reasonably to the auditor’s requests. Nevertheless, the need for OIG to function like a judicial “discovery master” is unusual.

5. Denali’s Disconnect: Unsuccessful OIG Interventions

OIG unsuccessfully tried a variety of interventions in hopes that the contractor would be able to reach an opinion on the financial statements. This included OIG’s insistence upon direct discussions among the agency head, his counsel, and the audit firm’s management. It included hours of direct mediation by the OMB branch chief, who conferred with her counterparts at FASAB, GAO, and Treasury over Denali’s disputes with the auditor.

The effort also included SAS 50 “second opinions” from consultants formally retained by OIG and management. It included input from the accounting experts on Denali’s financial management advisory committee. It included meetings between Denali’s CFO and her counterparts at the agencies that Congress instructs to fund Denali through assorted appropriations. It included the contract officer’s acquiescence in a 60-day extension of the reporting deadline with the concurrence of OIG, OMB, and the CFO.

And, last but not least, we much appreciated the consultations that we received from several other OIGs, including the one with oversight over the franchise fund that has long prepared Denali’s financial statements. Another OIG even shared its customized software for tracking “PBC” document exchanges (and trained us how to use it).

Despite all the interventions attempted by OIG and the Beltway, the most objective observation is probably that Denali’s management and the contractor had a mismatch in work styles and simply didn’t develop a successful working relationship.

6. Corrective Actions for the FY 2009 Audit

OIG has already implemented the following course corrections of its own for the FY 2009 audit: (1) a new audit firm with (2) a new contract officer and (3) a new onsite COTR who monitors the contract. To reinforce public confidence in the independence of the audit, OIG will continue its practice of retaining a contract officer from an agency different than the one used by the commission’s finance staff (because the latter’s procurements are obviously part of the audited transactions).

The agency head and his CFO have agreed to implement the following corrective action plan from their perspective:

- Starting FY 2010, Denali’s accounting will be performed by Treasury’s BPD franchise fund.
• Denali will continue to implement the DHHS grant tracking system (GrantSolutions) that the agency began implementing in FY 2008.

• Denali’s CFO will negotiate a written consensus with each federal funder (HRSA, DOL, RUS, FTA) as to the anticipated accounting treatment on Denali’s FY 2009 financial statements.

• Starting FY 2010, Denali will record funding received from other federal agencies using a new transaction code issued by Treasury to clarify Denali’s accounting.

• During FY 2009 audit fieldwork, Denali’s CFO will supplement her in-house staff with detailed staff from the BPD franchise fund.

• Starting FY 2009, Denali’s management will contract with the VA franchise fund to conduct a NIST certification of its IT system for purposes of FISMA reporting to OMB.

• Denali’s CFO will continue to arrange advanced in-house staff training from OMB, GAO, and the state government’s single audit coordinator.

• The agency head will continue his existing practice of inviting representatives from OMB, GAO, and Treasury to proactively brief his financial management advisory committee on technical issues subject to the audit.

OIG considers these steps if implemented to be an adequate management response to the FY 2008 disclaimer. Regardless of management’s good intentions, Denali runs the risk of a second disclaimer if these corrective actions remain unimplemented.

GROWING PAINS OF UNSETTLED ACCOUNTING ISSUES

Though the disclaiming contractor is probably not feeling popular or appreciated at the moment, they are really just the messenger for some larger issues that the federal system needs to address.

The Denali Commission is one of seven congressional experiments with the inter-governmental entities known as “regional commissions.” Due to their hodgepodge of funding sources, these hybrids fit imperfectly under the traditional FASAB accounting principles for federal bureaucracies. For description, timing, and measurement of financing sources, they seem to lie somewhere in the borderlands between the FASAB principles and the GASB paradigm that applies to state and local governments. And the enabling statutes prescribe significant differences among the seven creations, with the Denali Commission apparently the most ambiguous of them all.5

4 Appalachian Regional Commission, Denali Commission, Delta Regional Authority, Northern Great Plains Regional Authority, and three newborns in the latest Farm Bill (P.L. 110-246).

5 Denali OIG’s earlier Semiannual Report to Congress (Nov. 2007) details the important differences between the original regional commission (Appalachian Regional Commission) and the second one (Denali Commission).
Such uncharted territory contributed to the difficulties that Denali experienced with its FY 2008 audit. Denali has in recent years received fragmented funding from Congress though other agencies’ appropriations that name Denali in the details. Inconsistencies and uncertainties in the accounting treatment appeared both between the sources and between Denali and the sending agencies. While Denali’s accounting treatment and that of a sending agency should theoretically “mirror” each other, this is not realistic in practice given the immateriality of the amounts to the sending cabinet-level departments. In other words, what’s material to the mouse is not material to the mammoth.

1. Authoritative Guidance from OMB

At first glance, these seem to be arcane classification debates that only an eyeshaded accountant could love. But these are also the details that derail in the inquiring mind of a rigorous auditor. More specifically, the uncertainties focused on (1) who had reporting responsibility for verifying use of the money (“parent” versus “child”), (2) whether Denali was doing business with the sending agencies (“exchanges”), and (3) whether congressional funding destined for Denali is simply known by many names.

Ideally, Denali and its federal funders would proactively agree in advance on the accounting status of what Denali receives. But this ideal was frustrated by language in the MOUs that was ambiguous, missing, or boilerplate.

Given the need for an authoritative technical resolution in the federal system, OIG concluded that OMB was the best home for this dispute. OMB has the statutory status (primary jurisdiction) as arbiter of whether an executive branch entity is correctly recording its transaction detail under the standard general ledger and correctly constructing its financial statements under OMB’s Circular A-136.

At OIG’s request, OMB settled the issue with a formal determination that the funding sources in question should be classified as “expenditure transfers from non-exchange transactions.”

In requesting OMB’s determination, OIG noted that the funding sources in dispute lack the following characteristics that appear at various key points in the FASAB standards: (1) pricing arrangements; (2) quid pro quo; (3) mutual economic benefit; (4) mutual sacrifice of value; (5) Economy Act arrangements; (6) user fees; (7) taxation; (8) account receivable at the source; (9) reimbursement to the source; (10) return of unused funding to the source; (11) monitoring by the source; (12) project-specific funding by the source; (13) feedback by the source; (14) recipient revolving fund; (15) franchise fund; (16) public enterprise fund; (17) “sales” of goods and services to a “customer;” (18) “cycle of business-type operations;” (19) “parent-child” relationship of oversight; (20) shifting between separate appropriations.

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4 See 31 U.S.C. §§ 504(a), 503(a)(2), 503(a)(6), 503(a)(11), 3515(d). We particularly note 31 U.S.C. § 503(a)(11), which authorizes OMB to “settle differences that arise among agencies regarding the implementation of financial management policies.”

We also referred OMB to the appropriation language of the sources at issue. None of the sending agencies really regard themselves as making a choice to send money on to Denali. They consider Congress to have made the choice, that is, the senders seem to implicitly consider themselves as nominal receivers, constructive agents, surrogates, proxies, or some such similar legal fiction.

2. Authoritative Guidance from the Comptroller General (GAO)

While OMB was the solution for the above accounting dispute, it was the originator of another. Approximately two years ago, OMB referred a perceived violation of the Antideficiency Act for OIG’s investigation. OMB alleged that Denali’s finance staff had issued a $400,000 grant that overspent its apportioned appropriation.

This dispute focused on another arcane (but important) accounting issue, that is, the precise point in a grant’s processing that triggers the “obligation” of the funds appropriated by Congress. While statutes indicated OMB as the arbiter of the previously-discussed issue, another statute prescribes the Comptroller General (GAO) as the authority concerning appropriation laws.

After OMB’s complaint, the matter was reviewed by Denali’s counsel, CFO, OIG, and contract accountant (the VA franchise fund). All four concluded that no ADA violation had occurred, but OMB disagreed and insisted that the agency head nevertheless report an ADA violation to Congress.

OIG ultimately requested a formal determinations from the Comptroller General, which was published last October (GAO # B-316372, Oct. 21, 2008). In discussing the facts, the Comptroller General noted that the problem began with an error by the state government as grantee:

In August 2005, Commission staff sent a Financial Assistance Award document to the Alaska Department for signature. The Alaska Department misplaced the award document and, consequently, never returned it to the Commission. After following up with the department in October 2005, Commission staff transmitted a second award document to the department, dated December 2, 2005.

The Comptroller General decided that “[w]hen the Commission transmitted the Financial Assistance Award to the Alaska Department in August, the language of the award form recognized an obligation at that time.” No ADA violation occurred because the agency had adequate apportioned funds of an appropriation to cover the obligation at that point. Nevertheless, the Comptroller General cautioned the agency head as follows:

8 For example, see P.L. 110-161, 121 Stat. 2157 (DOL) (“$6,875,00 for the Denali Commission”); P.L. 110-161, 121 Stat. 2171 (DHHS) (“$39,283,000 shall be provided to the Denali Commission as a direct lump payment”); P.L. 110-161, 121 Stat. 2398 (FTA) (“Denali Commission, Alaska, $5,000,000”). And 7 U.S.C. § 918a(a)(2) authorizes the Secretary of Agriculture, “acting through the Rural Utilities Service,” to “make grants and loans to the Denali Commission . . . to acquire, construct, extend, upgrade, and otherwise improve energy generation, transmission, or distribution facilities” for communities with high energy costs.

The Commission should examine its policies and procedures to ensure that is recording its grant obligations properly, in accordance with 31 U.S.C. § 1501, and that it has appropriate controls in place to ensure that it has an apportionment at the time of obligation. Without appropriate controls, the Commission has no assurance that it complied with the Antideficiency Act as it incurred grant obligations.

At OIG’s request, the GAO attorney that authored this decision has met with both Denali’s management and its financial management advisory committee. The CFO has now completed a regimen of GAO appropriation law training taught by this same attorney. And, next month, the managing attorney for the GAO appropriation law unit is scheduled to teach this course for more of the commission’s staff and other federal employees in Anchorage.

OIG considers the Comptroller General’s determination and the subsequent steps taken by agency management to constitute an adequate response to the recording error that triggered OMB’s original referral of a possible ADA violation.

3. The Unsettled Frontier: Timing Idiosyncrasies of Denali’s Operations

However, the guidance that OIG sought from OMB and GAO does not settle the even more distinctive question as to when Denali should record (recognize) federal funding from other agencies in its accounting records. The general FASAB rule for federal agencies is the classic recognition on an accrual basis (versus actual cash receipt). However, there are some distinctive nuances in statute and practice that have caused Denali’s management to define the triggering “economic consequences” in a very conservative manner reminiscent of the GASB “modified accrual” used by state and local governments.

On one hand, Denali’s adaptation of FASAB signals the need for the seven regional commissions to have more customized guidance concerning the accounting treatment that will be most transparent to the public in the long run.

But this is also part of the larger difficulty of explaining to the traditional federal world what regional commissions really do. It misses the forest for the trees to label these rare creatures as mere “conduits,” funding “wholesalers,” or “pass-through” grantors. In fact, such simplifications raise the question as to what value these commissions really add to the process (whether they’re more than just another bureaucratic layer).

While OIG isn’t Denali’s defender or “cheerleader,” we think it’s safe to say that the two most senior regional commissions (Appalachian, Denali) seem to view themselves as offering a public process (venue, forum, planning, coordination) in which the ultimate issuance of grants is just one by-product. These hybrid entities seem to be more of a collaborative “barn-raising”10 in which they try to marshal (“leverage”) other entities’ funding as well as distribute their own.11

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10 Though the benefiting farmer always appreciates the barn, it’s just a by-product of a community process in the lore of rural America.

11 On the other hand, the contributions of the marshaled will often not be reflected for the public on a regional commission’s own financial statements.
Such an amorphous role is a tough pill for any traditional auditor to swallow, but the reality is qualitatively verifiable by the collection of collaborators listed for over 1,000 projects on Denali’s online public database (www.denali.gov).

The economic consequence (or public service, or program, or benefit) may thus occur when the process begins, that is, well before a grant is awarded — if that’s even the way the forum decides to address an issue. Waiting until a grantee takes the cash from Denali would arguably overlook the economic substance of what the agency provides to the public.

Denali’s role as a key Alaskan problem-solving forum is institutionalized in its statute that, unfortunately, injects yet another complication into meaningful recognition of its funding stream. Every fiscal year starts by convening the statutorily-prescribed panel of statewide leaders to draft a “work plan” that frames the best use of available funding. The plan is adopted by the agency head after publication in the Federal Register.

But assessment of the available funding is a delicate dance of uncertainty for the CFO, since she has historically had to juggle OMB’s proposed budget with the more generous appropriation that has traditionally arrived after the inevitable six months of limbo under a continuing resolution. While all agencies labor under such uncertainty, Denali’s need to integrate the mandatory work plan with actual funding is a further factor that supports the agency’s adaptation of FASAB to fit the circumstances. The need to promptly pay bills during the limited ice-free construction season in “bush” Alaska is a key determinant of whether this plan can be successfully implemented. Delay of construction until the next season may increase the cost of a facility by a fifth.

And the actual availability of Denali’s fragmented appropriations presents another uncertainty. Depending on the source, the “proxy” agency’s presence can vary from invisible, to a “speed bump,” to an indefinite, high-maintenance contingency.

In short, the collective impact of various funding uncertainties, a distinctive statute, and an uncommon inter-governmental entity argue in favor of some adaptation of the strict accrual timing that FASAB prescribes for the traditional line agencies.

This inspector general has been a representative over the past year to the OMB/AGA Partnership for Intergovernmental Management and Accountability. Though this group focuses on the accountability of federal grants, OIG was unsuccessful in urging the group’s leadership to initiate a project that might refine OMB’s accounting guidance for the seven regional commissions. Recent issues concerning federal economic stimulus understandably overshadowed my request.

OIG REPORTING TO CONGRESSIONAL COMMITTEES

The hallmark of the inspector general function is its dual reporting relationship to the agency head and to Congress.

For instance, section 2 of the Inspector General Act directs OIGs to keep “Congress fully and
currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action.” And section 4(a)(2) directs OIGs to “review existing and proposed legislation and regulations relating to programs and operations . . .”

In December, OIG responded to a request from the House Committee on Oversight and Government Reform for Denali’s progress in responding to the recommendations we’ve made in specific project reviews and in our semiannual reports to Congress. OIG responded to the committee’s inquiry with the data in Exhibit 2.

Over the past six months, the inspector general has traveled to Washington, DC and met with staff for two oversight committees and two authorizing committees. The inspector general briefed committee staff on the challenges of monitoring federal spending in Alaska and the potential legislative solutions.

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