FEMA Should Recover $3.8 Million of Public Assistance Grant Funds Awarded to Kenergy Corporation, Henderson, Kentucky
MEMORANDUM FOR: Major P. (Phil) May
Regional Administrator, Region IV
Federal Emergency Management Agency

FROM: John V. Kelly
Assistant Inspector General
Office of Emergency Management Oversight

SUBJECT: FEMA Should Recover $3.8 Million of Public Assistance Grant Funds Awarded to Kenergy Corporation, Henderson, Kentucky
FEMA Disaster Number DR-1818-KY
Audit Report Number DA-13-20

We audited Public Assistance grant funds awarded to Kenergy Corporation (Kenergy), a not-for-profit electric utility cooperative located in Henderson, Kentucky (FIPS Code: 000-UKM5M-00). Our audit objective was to determine whether Kenergy accounted for and expended Federal Emergency Management Agency (FEMA) grant funds according to Federal regulations and FEMA guidelines.

Kenergy received a Public Assistance award totaling $31.2 million from the Kentucky Division of Emergency Management (State), a FEMA grantee, for damages resulting from a severe winter storm, which occurred in January 2009. The award provided 75 percent FEMA funding for debris removal activities, emergency protective measures, and permanent repairs to the electrical distribution system. The award consisted of three large projects and one small project.¹

We audited three large projects with awards totaling $31.2 million (see Exhibit, Schedule of Projects Audited). The audit covered the period from January 26, 2009, to July 9, 2012, during which Kenergy claimed $32.4 million under the projects reviewed. At the time of audit, work under the projects was complete and Kenergy had submitted final claims for project expenditures to the State.

We conducted this performance audit between July 2012 and March 2013 under the authority of the Inspector General Act of 1978, as amended, and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based upon our audit objective. We believe that

¹ Federal regulations in effect at the time of the ice storm set the large project threshold at $64,200.
OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

the evidence obtained provides a reasonable basis for our findings and conclusions based upon our audit objectives. To conduct this audit, we applied the statutes, regulations, and FEMA policies and guidelines in effect at the time of the disaster.

We judgmentally selected project costs (generally based on dollar value); interviewed FEMA, State, and Kenergy officials; reviewed Kenergy’s procurement policies and procedures; reviewed applicable Federal regulations and FEMA guidelines; and performed other procedures considered necessary to accomplish our audit objective. We did not assess the adequacy of Kenergy’s internal controls applicable to its grant activities because it was not necessary to accomplish our audit objective. However, we gained an understanding of Kenergy’s method of accounting for disaster-related costs and its policies and procedures for administering the activities provided for under the FEMA award.

RESULTS OF AUDIT

FEMA should recover $3,772,496 (Federal share $2,829,373) of grant funding awarded to Kenergy. Although Kenergy generally accounted for FEMA funds according to Federal regulations and FEMA guidelines, it did not comply with Federal procurement requirements when awarding contracts valued at $1,989,277 for permanent repairs to its electrical distribution system. In addition, Kenergy’s claim included $1,783,219 of questionable costs, which included:

- $1,023,446 for excessive equipment and contract costs;
- $406,985 for ineligible project charges;
- $23,813 for costs not adequately supported;
- $266,564 for costs that were non-disaster related;
- $42,306 for credits not applied; and
- $20,105 for costs covered by insurance.

Finding A: Contracting Procedures

Kenergy did not comply with Federal procurement regulations and FEMA guidelines when awarding two time-and-material contracts valued at $1,989,277 for permanent repairs to its electrical distribution system. Federal procurement regulations at 2 CFR 215 required Kenergy, among other things, to—

- Perform all procurement transactions in a manner to provide, to the maximum extent practical, open and free competition. (2 CFR 215.43)
• Take positive efforts to use small businesses, minority-owned firms, and women's business enterprises, whenever possible. (2 CFR 215.44(b))

• Perform some form of cost or price analysis for every procurement action and document such analysis in the procurement file. (2 CFR 215.45)

In addition, FEMA Public Assistance Guide (FEMA 322, October 2007, pp. 39–40) specifies that—

• Contracts must be of reasonable cost, generally must be competed, and must comply with Federal, State, and local procurement standards.

• Noncompetitive proposals should be used only when the award of a contract is not feasible under small purchase procedures, sealed bids, or competitive proposals, and one of the following circumstances applies: (1) the item is available only from a single source, (2) there is an emergency requirement that will not permit a delay, (3) FEMA authorizes noncompetitive proposals, or (4) solicitation from a number of sources has been attempted and competition is determined to be inadequate.

• Time-and-material contracts must be carefully monitored and a cost ceiling or “not-to-exceed” provision must be included in the contract.

FEMA may grant exceptions to Federal procurement requirements to subgrantees on a case-by-case basis (2 CFR 215.4).

Under Project 1792, Kenergy awarded two noncompetitive time-and-material contracts valued at $1,989,277 for permanent repairs to its electrical distribution system damaged by the ice storm in January 2009. The contracts were awarded for work after February 18, 2009, when emergency electrical power had been restored to all of Kenergy’s customers. We concluded that the need to restore electric power constituted exigent circumstances that warranted the use of noncompetitive contracts through February 18, 2009, because lives and property were at risk. However, Kenergy should have openly competed permanent repair work after such date because exigent circumstances no longer existed to justify the use of noncompetitive contracts. In addition, Kenergy awarded the contracts without a cost ceiling or not-to-exceed clause and did not take positive efforts to use small businesses, minority-owned firms, and women’s business enterprises, when possible.

Full and open competition helps discourage and prevent favoritism, collusion, fraud, waste, and abuse. It also increases the probability of reasonable pricing from the most qualified contractors and allows the opportunity for minority firms, women’s business
enterprises, and labor surplus area firms to participate in federally funded work. For two contracts valued at $1,989,277, Kenergy did not openly compete the work, but instead requested information from several contractors that Kenergy officials believed were capable of doing the work. Based on the information received, they prequalified several contractors and sent requests for quotations to those contractors, awarding the contract work to the lowest bidders. The contract file documentation indicated that Kenergy performed a price analysis on the proposed prices. However, there was no evidence that Kenergy took positive steps to use small businesses, minority-owned firms, and women’s business enterprises. We also noted that the contractors did not use minority firms, women’s business enterprises, or labor surplus firms in the performance of the work.

We question $1,989,277 claimed for the contract work because Kenergy did not comply with Federal procurement regulations and, as a result, FEMA has little to no assurance that Kenergy received the best price for the work.

Kenergy Response. Kenergy officials disagreed with our finding. They said that two of the contracts in question were procured in accordance with U.S. Department of Agriculture Rural Utilities Service guidelines in advance of the disaster. They also maintained that time-and-material contracts were used while exigent circumstances existed for the restoration of power and that, as such, the contractors were properly procured. Kenergy officials also said that their employees monitored the time-and-equipment contractors to ensure that only disaster-related work was completed and that the work was correctly performed. Additionally, they said that FEMA officials examined the questioned contracts on multiple occasions and found no deficiencies. Finally, they said they did not take positive efforts to use minority-owned, women owned, or small businesses because of the emergency conditions that existed.

Office of Inspector General Response. Although Kenergy may have procured the contracts in question using guidelines provided by the Rural Utilities Service, those guidelines did not meet FEMA’s grant requirements. We also disagree that exigent circumstances existed to justify the use of the noncompetitive contracts. The costs we are questioning are for longer-term electrical repair work that Kenergy completed after it restored emergency power to its customers. In our view, Kenergy had sufficient time while performing the emergency work to complete a cost or price analysis and to solicit competitive bids for the permanent repair of its electrical distribution system using an expedited competitive process at the very minimum.
Finding B: Excessive Project Costs

Kenergy’s claim under Projects 1776 and 1792 included $1,023,446 of excessive equipment and contract costs, as follows:

- **Force Account Equipment.** Kenergy’s claim for force account equipment use was overstated by $964,756. Kenergy claimed $1,569,593 for equipment use under the FEMA projects based on the FEMA Schedule of Equipment Rates. However, Kenergy should have based its claim on actual equipment costs recorded in its accounting system, which would have resulted in total equipment costs of $604,837 or $964,756 less than the amount claimed.

Kenergy records actual costs for equipment use in its accounting system when equipment is used. These costs contain all the cost elements included in the FEMA equipment rates for operation of the equipment such as fuel, insurance, maintenance, depreciation, etc. We noted that Kenergy used the recorded equipment costs to support equipment use in requests for construction work financing from the U.S. Department of Agriculture, Rural Utilities Service. However, when calculating its claim for equipment use under the FEMA projects, Kenergy used the FEMA equipment rates, which resulted in Kenergy being reimbursed $964,756 more than its actual costs of operating the equipment.

Federal regulation 44 CFR 206.228(a)(ii) states that where local guidelines are used to establish equipment rates, reimbursement will be based on those rates or rates in a Schedule of Equipment Rates published by FEMA, whichever is lower. Furthermore, 2 CFR 230, Appendix A, A.2.c. requires that a cost be consistent with policies and procedures that apply uniformly to both federally financed and other activities of the organization. Therefore, we question the $964,756 of excessive equipment charges ($3,377 under Project 1776 and $961,379 under Project 1792).

**Kenergy Response.** Kenergy officials disagreed that the excess costs should be disallowed. They said that they received guidance from FEMA officials and relied on the FEMA Public Assistance Guide (FEMA 322), which states that if an entity does not have established rates that it uses in its normal day-to-day operations, the entity may use the FEMA Schedule of Equipment rates. They also said that Kenergy does not have established rates. Finally, they said that they discussed their accounting practices and not having established equipment rates with FEMA project officers and that the officers made the determination that the FEMA equipment rates should be used.

**OIG Response.** Although Kenergy may not have developed individual rates for equipment, it would not be reasonable for FEMA to reimburse a subgrantee
nearly a million dollars in excess of their actual documented costs. Federal regulations (2 CFR 230, Appendix A, A.3.d) state that when considering reasonableness, consideration should be given to significant deviations from established policies of the organization that unjustifiably increase the cost of the award. Therefore, our position remains unchanged.

- **Contract Costs.** Kenenergy's claim under Project 1792 included $58,690 of excessive contract costs for permanent electrical repair work. The contractor billed Kenenergy a total of $67,975, consisting of $57,490 for 4,160 hours of truck usage and $10,485 for 4,112 hours of chainsaw usage. However, contractor activity logs and timesheets showed that the actual hours of use for the trucks and chainsaws was 542 hours and 704 hours, respectively. Therefore, we question excessive contract costs of $58,690 as shown in table 1.

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Hours Billed</th>
<th>Actual Hours Used</th>
<th>Difference (Hours)</th>
<th>Amount Billed</th>
<th>Correct Billing Amount</th>
<th>Amount Questioned</th>
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</thead>
<tbody>
<tr>
<td>Trucks</td>
<td>4,160</td>
<td>542</td>
<td>3,618</td>
<td>$57,490</td>
<td>$7,490</td>
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</tr>
<tr>
<td>Chainsaws</td>
<td>4,112</td>
<td>704</td>
<td>3,408</td>
<td>$10,485</td>
<td>1,795</td>
<td>8,690</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>$67,975</strong></td>
<td><strong>$9,285</strong></td>
<td><strong>$58,690</strong></td>
</tr>
</tbody>
</table>

Kenergy officials could not explain the reason for the overbilling. After bringing this matter to their attention, Kenergy officials contacted the contractor who said they would research the billings and issue a credit to Kenenergy.

**Finding C: Ineligible Project Charges**

Kenenergy's claim included $406,985 of ineligible labor, materials, and contract costs as follows:

- **Force Account Labor Costs.** Kenenergy's claim included $358,380 of ineligible labor costs. Kenenergy claimed $2,646,180 for force account labor consisting of $597,415 and $2,048,765, respectively, under Projects 1776 and 1792. Under emergency protective measures Project 1776, Kenenergy's claim included labor charges for regular-time for permanently employed personnel. However, straight or regular-time salaries and benefits for emergency work is not eligible for FEMA funding (44 CFR 206.228(a)(2)). After discussing this matter with Kenenergy officials, they reviewed their claim and determined that the fringe benefits calculation was also in error. Therefore, they recalculated their total claim for labor costs and determined that the correct amount should have been $2,287,800 or $358,380 less than the amount claimed. We reviewed the revised claim and agree with the revised amount. Therefore, we question the $358,380
of ineligible labor costs claimed ($301,732 under Project 1776 and $56,648 under Project 1792).

**Kenergy Response.** Kenergy officials said that their request for reimbursement of labor costs was consistent with the FEMA guidance they received and their established compensation policy. They also said that they discussed and reviewed their prolonged outage policy with the FEMA inspector and that the inspector wrote in the narrative section of the project worksheet “applicant’s documentation for claimed costs have been reviewed by a FEMA Project Specialist and found to be eligible, accurate, and reasonable.”

**OIG Response.** As stated in the finding, straight or regular-time salaries and benefits of an applicant’s permanently employed personnel are not eligible costs for emergency work. We also noted that Kenergy’s project files included documentation from FEMA advising them that straight or regular-time labor was not eligible. Therefore, our position remains unchanged.

- **Material Costs.** Kenergy’s claim for material under Project 1792 included $47,454 of ineligible charges for transformers. This occurred because Kenergy replaced 293 small transformers (10 KVA and smaller) with 15 KVA transformers, although there are no Federal, State, or local codes or standards requiring the upgrade. Kenergy officials said it is their policy to replace the smaller transformers with a 15 KVA transformer because the smaller transformers are harder to obtain and the larger transformers perform better in their current larger system. However, Federal regulation 44 CFR 206.226(d)(3) states that for an upgrade to be eligible for FEMA reimbursement, it must be reasonable, in writing, and formally adopted and implemented by the State or local government on or before the disaster declaration date or be a legal Federal requirement applicable to the type of restoration. We determined that the average cost of a 15 KVA transformer is $707.34 and the average cost of a 10 KVA is $545.38, or $161.96 less than the 15 KVA. Therefore, we question the ineligible material charges of $47,454 ($161.96 times 293 transformers).

**Kenergy Response.** Kenergy officials acknowledged that the damaged transformers were replaced with transformers of greater KVA size and that there were no codes or standards that required Kenergy to install a certain size transformer in a give application. However, they maintained that the costs are eligible and reasonable. They said that they used long-standing Kenergy design criteria based on the industry’s best practices and load requirements when replacing the smaller-size transformer (3, 5, 7.5, and 10 KVA) with a 15 KVA. They also said that the use of the smaller-size transformers would have caused significant delays and prolonged the risk to lives and property.
**OIG Response.** Kenergy did not provide us with documentation that the upgrades were required by codes or standards. It may be Kenergy’s usual practice to replace these transformers with larger ones, but it did not present us with any evidence that this is an industry best practice or that FEMA authorized the cost of the upgrade. Therefore, our position remains unchanged.

- Under Project 1776, Kenergy claimed $1,151 for costs incurred by a contractor to wash and clean his equipment after he returned to his home location. However, the contract provisions did not authorize the costs. Therefore, we question the $1,151.

**Finding D: Supporting Documentation**

Kenergy’s claim included $23,813 of unsupported costs. Federal regulation (2 CFR 230, Appendix A, A.2.g) states that a cost must be adequately documented to be allowable under Federal awards. Kenergy did not have adequate documentation to support its claim for $23,813 of mutual aid costs under Project 1776. The contractor’s invoice for labor and equipment hours and miscellaneous charges was not supported by timesheets or work logs for us to validate that the hours billed for labor and equipment were accurate and reasonable. Therefore, we question the $23,813.

**Finding E: Non-Disaster-Related Charges**

Kenergy’s claim under Project 1792 included $266,564 for materials ($253,739 for transformers and $12,825 for utility poles) that were used for non-disaster-related repairs. Federal regulation 44 CFR 206.223(1) states that an item of work must be required as the result of a major disaster event to be eligible for FEMA financial assistance.

The excess claim of $253,739 for transformers occurred because Kenergy based its claim on invoices for transformers purchased after the disaster. However, we identified $253,739 of costs applicable to transformers not used for disaster purposes. The excess claim of $12,825 for utility poles occurred because Kenergy did not adjust the inventory for poles used on a non-disaster work order and inadvertently included those costs in their claim. Kenergy later adjusted the inventory, but did not credit the FEMA project. We question the $266,564 of non-disaster-related charges charged to the project.
Finding F: Unapplied Credits

Kenergy overstated its claim under several projects because it did not reduce project costs for $42,306 of credits received on fuel and material costs and proceeds from sales of scrap. Federal regulation 2 CFR 230, Appendix A, A.1 states that the total cost of an award is the sum of allowable direct and allocable indirect costs less any applicable credits. According to 2 CFR 230, Appendix A, A.5.a, the term applicable credits are those receipts, or reduction of expenditures which operate to offset or reduce expense items that are allocable to awards as direct/indirect costs. We question the $42,306, as follows:

- **Fuel Credits.** Kenergy received credits totaling $23,956 for fuel costs from its contractors, but did not reduce the FEMA claims under three large projects. Therefore, we question the $23,956, as shown in table 2.

  Table 2. Fuel Credits Not Applied

<table>
<thead>
<tr>
<th>Project Number</th>
<th>Amount Questioned</th>
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<tr>
<td>1769</td>
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<tr>
<td>1776</td>
<td>3,256</td>
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<td>1792</td>
<td>1,823</td>
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<td>Total</td>
<td>$23,956</td>
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- **Material Credits.** Kenergy received credits totaling $14,136 for material costs from its suppliers, but did not reduce the FEMA claims under two large projects. Kenergy purchased materials for $66,341 and charged Project 1776 the entire amount. However, Kenergy did not reduce the claim by a $7,401 credit received for returned materials. Therefore, we question the $7,401.

  Also, Kenergy is a member of a utility supply cooperative that manufactures and distributes transformers, conductors, and other equipment to the utility industry. The cooperative is required to pay a patronage credit each year to its members based on total annual purchases. In 2009, Kenergy received a credit of $13,497 based on annual purchases of $4,033,903. Kenergy claimed $2,012,111 of such purchases under Project 1792, which represents 49.9 percent of the total purchases. Therefore, Kenergy should have reduced its FEMA claim under the project by $6,735 ($13,497 × 49.9 percent). We question the $6,735.

- **Scrap Sales.** Kenergy received $4,214 from the sale of scrap wires and junk transformers, but did not reduce the FEMA claims under Project 1792. This
consisted of $2,929 from the sale of scrap wire and $1,285 from the sale of junk transformers. Therefore, we question the $4,214.

**Finding G: Losses Covered by Insurance**

Kenergy’s claim under Project 1792 included $20,105 of projects costs (cleanup of oil spills from failed transformers and re-paving of a parking lot) that were covered by insurance. Section 312 (a) of the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*, as amended, states that no entity will receive assistance for any loss for which financial assistance has already been received from any other program, insurance, or any other source. This occurred because Kenergy did not include four invoices totaling $20,105 for the disaster-related work on their original insurance claim. We contacted officials with Kenergy’s insurance company, and they agreed that the costs were insurable and should have been included in the claim. They also agreed to reimburse Kenergy for the insured losses. Therefore, we question the $20,105 claimed for losses covered by insurance.

**Finding H: Grant Management**

Given the nature and extent of ineligible costs identified in our review, we believe that the State could have done a better job of reviewing Kenergy’s contracting methods and project costs submitted for reimbursement. According to 2 CFR 215.51, the grantee is responsible for managing and monitoring each project supported by the award to ensure compliance with applicable Federal requirements. Therefore, we recommend that FEMA remind the State of its grant management responsibilities for monitoring and reviewing costs claimed by subgrantees.

**State Response.** State officials disagreed with finding. They said that they had taken several steps before and after the disaster to educate, guide, and instruct subgrantees on proper contracting requirements. They also said we did not review their subgrantee monitoring procedures and, therefore, have no understanding of the procedures they use to review costs submitted by subgrantees. Further, they said that FEMA had written the projects when the work was 100 percent complete and had determined at such time the eligibility of the contract costs and it was not the State’s role to second-guess FEMA’s decisions. Finally, they said that they retain 10 percent of the value of each periodic reimbursement to a subgrantee to offset any deobligations that might result from a final inspection.

**OIG Response.** Although we did not specifically review the State’s subgrantee monitoring procedures, we believe that the contracting deficiencies and ineligible costs identified in our review are indicators that better monitoring and review of costs submitted by subgrantees is needed. The FEMA-State Agreement stipulates that the
RECOMMENDATIONS

We recommend that the Regional Administrator, FEMA Region IV:

**Recommendation #1:** Disallow $1,989,277 (Federal share $1,491,958) of ineligible costs claimed for contracts unless FEMA grants Kenergy an exception for all or part of the costs as provided for in 2 CFR 215.4 and Section 705(c) of the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*, as amended, and determines that the costs are reasonable (finding A).

**Recommendation #2:** Instruct the State to remind subgrantees of their requirement to comply with Federal procurement regulations and FEMA guidelines when acquiring goods and services under a FEMA award (finding A).

**Recommendation #3:** Disallow $1,023,446 (Federal share $767,585) of excessive project costs (finding B).

**Recommendation #4:** Disallow $406,985 (Federal share $305,239) of ineligible costs (finding C).

**Recommendation #5:** Disallow $23,813 (Federal share $21,239) of unsupported costs, unless Kenergy provides additional documentation to support the costs questioned (finding D).

**Recommendation #6:** Disallow $266,564 (Federal share $199,923) of non-disaster project costs (finding E).

**Recommendation #7:** Disallow $42,306 (Federal share $31,730) of unapplied credits (finding F).

**Recommendation #8:** Disallow $20,105 (Federal share $15,079) of costs covered by insurance (finding G).

**Recommendation #9:** Reemphasize to the State of its responsibility to adequately review costs claimed by subgrantees for adherence to Federal regulations and FEMA guidelines (finding H).
DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOWUP

We discussed the audit results with Kenergy, State, and FEMA officials during our audit. We also provided a written summary of our findings and recommendations in advance to these officials and discussed them at the exit conference held on March 13, 2013. Kenergy and State officials’ comments, where appropriate, are included in the body of this report.

Within 90 days of the date of this memorandum, please provide our office with a written response that includes your (1) agreement or disagreement, (2) corrective action plan, and (3) target completion date for each recommendation. Also, please include responsible parties and any other supporting documentation necessary to inform us about the current status of the recommendation. Until we receive and evaluate your response, the recommendations are considered open and unresolved.

Consistent with our responsibility under the Inspector General Act, we are providing copies of our report to appropriate congressional committees with oversight and appropriation responsibility over the Department of Homeland Security. We will post the report on our website for public dissemination.

Major contributors to this report are David Kimble, Eastern Region Audit Director; Felipe Pubillones, Audit Manager; Mary Stoneham, Auditor-in-charge; and Angelica Esquerdo, Auditor.

Please call me with any questions at (202) 254-4100, or your staff may contact David Kimble, Eastern Region Audit Director, at (404) 832-6702.
## Schedule of Projects Audited

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<th>Project Number</th>
<th>Project Scope</th>
<th>Category Of Work</th>
<th>Amount Awarded</th>
<th>Amount Questioned</th>
<th>Federal Share</th>
<th>Finding</th>
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<td><strong>$31,202,984</strong></td>
<td><strong>$3,772,496</strong></td>
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Appendix

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State Auditor, Kentucky

**Subgrantee**

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