MEMORANDUM FOR: Karen E. Armes
Acting Regional Director, Region IX

FROM: Robert J. Lastrico
Western District Audit Manager

SUBJECT: Watsonville Community Hospital
Watsonville, California
Public Assistance Identification Number 087-90302
FEMA Disaster Number 845-DR-CA
Audit Report Number W-01-03

The Office of Inspector General audited public assistance funds awarded to the Watsonville Community Hospital, Watsonville, California (WCH). The objective of the audit was to determine whether WCH expended and accounted for FEMA funds according to Federal regulations and FEMA guidelines.

WCH received a public assistance award of $60.5 million from the California Office of Emergency Services (OES), a FEMA grantee, for debris removal, and repair and replacement of the hospital facility damaged by the Loma Prieta Earthquake that occurred on October 17, 1989. The award provided for 75 percent FEMA funding for 16 large and 25 small projects.¹

The audit covered the period October 1989 to November 1998 and included review of seven large projects with a FEMA grant award of $9.4 million. The audit excluded review of the Project 83396, an improved project grant award for $50.5 million. Because WCH did not generally maintain cost data by individual projects, we could not reconcile WCH expenditures to source documents for five of the seven projects. However, we did verify that the projects were completed, and, since WCH used an operating checking account (operating account)² to exclusively track project-related expenditures, we reviewed this account to identify costs claimed

¹ According to Federal regulations in effect at the time of the disaster, a large project was defined as a project costing $36,500 or more and a small project was defined as one costing less than $36,500.
² Funded exclusively with FEMA advances.
that were not eligible under any of the FEMA approved projects. The attached exhibit provides a schedule of the audited projects.

We performed the audit under the authority of the Inspector General Act of 1978, as amended, and according to generally accepted government auditing standards. In October 1998, WCH was sold to Community Health Systems, a for-profit organization, and the Pajaro Valley Community Health Trust (Trust) was established as the surviving private non-profit organization for the purpose of clearing the WCH Loma Prieta grants. The audit included a review of FEMA’s and OES’ records, tests of WCH’s accounting records retained by the Trust, a judgmental sample of project expenditures, and other auditing procedures we considered necessary under the circumstances.

RESULTS OF AUDIT

WCH did not remit to FEMA $1,037,385 of interest income earned on FEMA advances to WCH. In addition, WCH’s claim included $2,129,157 in questionable costs (FEMA’s share - $1,596,868). The questionable amounts pertained to costs not within the scope of the project, ineligible professional services costs, and unsupported and ineligible force account labor costs.

A. Interest Earned on Federal Advances. On December 30, 1993, FEMA approved an improved project to replace the old hospital facility with a completely new structure. For this purpose, FEMA advanced WCH $1.2 million between February 1990 and July 1992, and $28.4 million between May 1995 and October 1995. Of the $29.6 million in FEMA advances, WCH deposited $24.3 million in an interest bearing account and $5.3 million in a non-interest bearing operating account. WCH administered FEMA projects and paid most disaster recovery costs using the two accounts that consisted exclusively of FEMA funds. From bank statements we determined that, as of January 12, 1998, interest earned on FEMA advances totaled $1,037,385. As of that date, WCH no longer earned interest on any FEMA funds.

WCH did not remit to FEMA the $1,037,385 in interest earned on the $24.3 million advance. WCH records showed that at least two separate meetings occurred in 1996 and 1997 wherein hospital officials discussed the nature of the earned interest and were aware the funds were the property of the Federal Government. For example, on August 14, 1997, WCH Board Members and managers acknowledged that over $1 million of interest had been earned on FEMA advances. However, these officials approved a motion to use the funds for other purposes and did not take action to remit the interest to FEMA.

WCH’s 1998 and 1999 single audits\(^3\) reported that the interest due to the Federal Government was $525,000. The accountants who performed the audits determined this amount based on

\(^3\) A single audit in an audit of a non-Federal entity that expends a specific dollar amount of Federal awards during its fiscal year. These audits are required by Office of Management and Budget Circular Number A-133.
the project expenditures paid with other WCH funds while advanced FEMA funds remained invested in the interest bearing account. Over the investment period, the accountants decreased the principal balance of FEMA funds in the interest bearing account by project expenditures paid from other accounts. These audits resulted in a request that WCH remit $525,000 in interest earned on FEMA funds. In a letter dated October 2, 2001, WCH responded to this request by stating that an OIG audit was in progress and that WCH had initiated efforts to have the $525,000 interest debt forgiven.

The Comptroller General of the United States has consistently held that, except as otherwise provided by law, interest earned by a grantee on funds advanced by the United States under an assistance agreement pending their application to grant purposes belongs to the United States and that all such interest is required to be accounted for as funds of the United States. Further, according to Federal regulation 44 CFR 13.21(h)(2)(i), grantees and subgrantees are required to remit to FEMA the interest earned on advances at least quarterly. Consequently, we question the $1,037,385 in interest earned but not remitted to FEMA as required.

B. Costs Not Within Scope of the Project. Project 83349 was the product of a Memorandum of Understanding (MOU) that resulted from extensive negotiations between FEMA, OES, and WCH. This MOU provided $7.4 million in grant funding for six categories of costs covered in the MOU. WCH’s claim included $1,472,638 for expenditures that were not within the scope of Project 83349, consisting of $1,159,588 for equipment and related costs not authorized in the MOU and $313,050 for expenses not related to moving patients or equipment. Our review included a reconciliation of the amount awarded for the project by FEMA, plus any excess costs WCH represented as incurred for the project. We first evaluated the eligibility of the excess costs and then deducted from total project costs those expenditures not eligible for FEMA funding. Thus, the questioned costs identified below only pertain to the actual FEMA award.

- WCH’s claim included $239,843 for the purchase of equipment not authorized by FEMA. While the MOU only authorized the purchase of 21 headwalls, WCH acquired 80 headwalls, or 59 over the approved number at an additional cost of $239,843.

- WCH’s claim for medical equipment included $665,190 for vendor costs relating to the purchase and installation of cabling to provide connectivity to the various hospital systems (televisions, hospital information systems, telephones, etc.). The claim was not related to the purchase of new or replacement medical equipment, but pertained to cost allowed in another project category “Hospital Systems” (systems). The MOU provided

5 11 gas panel headwalls and 10 critical care headwalls
6 Damage Survey Report (DSR) 83349 - line item number 5 – “Additional Hospital Systems Equipment”
funding for systems to a maximum dollar amount and to specific cost items; the overall intent was to replace the systems in use on the date of the disaster, including code upgrades. However, WCH performed substantial improvements to the system resulting in costs exceeding the dollar limitations authorized in the MOU, and claimed the $665,190 incurred for systems connectivity as medical equipment.

- WCH’s claim included $254,555 for various medical and ancillary equipment not approved in the MOU, consisting of $80,591 for birthing beds with accessories, $31,972 for medical gas columns for operating rooms, and $141,992 for furniture, televisions, and appliances. While WCH documents on the project disclosed that WCH officials had determined that the birthing beds and the medical gas columns did not qualify for FEMA reimbursement, the items were included in the claim for reimbursement of medical equipment.

- WCH’s claim included $313,050 for force account labor costs not related to physically moving patients and equipment from the old hospital facility to the replacement location. Claimed costs included employees’ time spent attending meetings with FEMA, lobbyists, and community groups and performing tasks related to the general operations of the hospital. Additionally, WCH claimed expenses for Food/Nutrition Services staff members and vendors working to set up a food service system at the replacement hospital. WCH’s documents supporting the cost of moving patients and equipment also included expenditures related to the purchase of new furniture, cabinets, files, window treatments such as draperies, blinds, and valances for the new facility. Costs related to inventorying equipment never moved to the new facility were also charged to FEMA.

According to Federal regulation 44 CFR 206.223(a), an item of work must be required as the result of the major disaster event to be eligible for financial assistance. Since the MOU provided specific criteria for the acquisition of medical equipment in use on the date of the disaster and for costs associated with moving patients and equipment from the old hospital facility to the replacement location, we question WCH’s claim of $1,159,588 for medical equipment and $313,050 for moving costs not specially approved in the MOU.

C. Ineligible Professional Services. WCH’s claim included $484,996 in professional services costs not directly related to FEMA approved projects. We identified the ineligible cost during our review of WCH’s operating account used exclusively to track project-related expenditures. Since the operating account did not link expenditures to specific projects in all instances and WCH did not consistently maintain cost data by project, we used the projects’ approved scope to associate, where possible, the questionable costs to a specific project. We determined that the questioned costs included $54,555 for Project 93490 and $430,441 for all other projects.\(^7\)

\(^7\) Because WCH paid costs from its FEMA operating account, we could not identify ineligible expenses to a specific DSR.
• For Project 93490, WCH claimed $54,555 in project management costs not directly related to the project. The expenditures recorded in the operating account pertained to project management time spent to manage the development and sale of a non-disaster related property – the “Aptos City Property.” The primary scope of Project 93490 was to fund project management costs.

• WCH claimed $430,441 for professional service costs not directly relate to the scope of any project. The majority of the expenditures recorded in the operating account represented payments to consultants for lobbying services and for services on a bond issue. WCH project documents included information showing WCH officials were aware that the lobbying costs were not eligible for FEMA funding.

According to Federal regulation 44 CFR 13.20 (b), WCH is required to maintain accounting records that identify how FEMA funds are used. In addition, according to Federal regulation 44 CFR 206.223(a), only costs that can be directly tied to the performance of eligible work are eligible for funding. Consequently, we question the $484,996 in professional services costs claimed by WCH because such costs were not approved in the scope of the projects.

D. Unsupported Force Account Labor. WCH’s claim included $159,190 in unsupported force account labor costs for Projects 83349 and 93936. The claim was not supported with sufficient documentation to prove that the tasks performed were eligible for FEMA reimbursement.

• For Project 83349, WCH charged $146,975 for unsupported project management costs related to the purchase of equipment for the replacement hospital. The costs were not supported with payroll records or approved in the scope of the project. WCH officials stated they judgmentally allocated 25 percent of the total management cost to the project. Project records showed that the task of purchasing equipment for the new facility was actually performed by a vendor for the majority of the time period in question.

• For Project 93936, WCH charged $12,215 in force account labor costs that were not supported with payroll records. While time sheets and labor record listings were available for some employees, those records were inconclusive as to whether or not the employees actually performed disaster-related work.

According to Federal regulation 44 CFR 13.20 (b), WCH is required to maintain accounting records that identify how FEMA funds are used. In addition OMB Circular A-122, Attachment B, paragraph 7.b, requires that compensation paid for force account labor be eligible for reimbursement and be supported with adequate documentation. Consequently, we question the $159,190 in force account labor costs not adequately supported.
E. Ineligible Force Account Labor Costs. WCH’s claim for Project 93936 included $12,333 in ineligible force account labor costs, consisting of fringe benefits and costs either not related to the disaster or resulting from accounting errors.

- WCH claimed $5,145 for ineligible force account fringe benefit labor costs. These benefit costs were attributed to short-hour and part-time employees whom, by union contract, received an adjusted salary rate in lieu of benefits. WCH did not adjust the FEMA claim to reflect actual benefits paid.

- WCH claimed $5,495 for non-disaster related labor costs. The costs related to employees who did not perform disaster work, including employees whose work was described on time sheets as “routine paper work,” and an employee whose time sheet indicated that the person was not working during the period claimed.

- WCH claimed $1,693 for payroll accounting errors that resulted from duplicate entries for hours worked and the application of the wrong hourly rate.

According to Federal regulation 44 CFR 206.223(a)(1), for an item of work to be eligible for FEMA funding, it must be disaster related. According to Attachment B, paragraph 7f of Office of Management and Budget (OMB) Circular A-122, “Cost Principles for Non-Profit Organizations,” fringe benefits are allowable provided such benefits are granted in accordance with established organization policies and are reimbursable to the extent the benefits accrue to the individual or group of employees whose salaries and wages are chargeable to the awards. Based on the above criteria, we question the $12,333 in ineligible force account labor costs claimed by WCH.

**RECOMMENDATION**

We recommend that, in coordination with OES, the Regional Director:

1. Recover $1,037,385 of interest earned by WCH from FEMA grant advances.

2. Disallow $1,698,716, representing questioned costs of $1,619,613 for Project 83349, $54,555 for Project 93490, and $24,548 for Project 93936.

3. Disallow an additional $430,441 of ineligible professional services costs paid from WCH’s FEMA-funded operating account but not identified to specific project numbers.
DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOW-UP

We discussed our audit results with OES and WCH officials on April 30, 2002. We also discussed the results of our audit with Region IX officials on April 10, 2002, and August 21, 2002.

Pursuant to FEMA Instruction 1270.1, please advise this office by December 16, 2002, of actions taken to implement our recommendation. Should you have any questions concerning this report, please contact me at (510) 627-7011. Key contributors to this assignment were Humberto Melara and Curtis Johnson.
## Schedule of Projects

**Watsonville Community Hospital**  
**FEMA Disaster Number 845-DR-CA**

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1 This note identifies the seven projects that were audited.  
2 Because WCH did not generally maintain cost data by individual projects, we could not reconcile WCH expenditures to source documents for five of the seven projects. Therefore, alternate auditing procedures were used for these projects.  
3 Ineligible professional services costs not identified to specific project numbers; however, each was paid from WCH’s FEMA funded operating account.