



STATE OF NORTH CAROLINA

DEPARTMENT OF PUBLIC INSTRUCTION

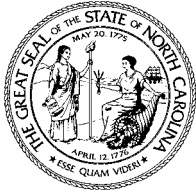
STATEWIDE FINANCIAL AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR



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March 31, 2006

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
The Honorable Dr. June St. Clair Atkinson, State Superintendent
Department of Public Instruction

We have completed certain audit procedures at the Department of Public Instruction related to the State of North Carolina reporting entity as presented in the *Comprehensive Annual Financial Report (CAFR)* and *Single Audit Report* for the year ended June 30, 2005. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

In the *CAFR*, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor presents the results of tests of internal control and compliance with laws, regulations, contracts and grants applicable to the State's financial statements and to its federal financial assistance programs. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, issued by the Comptroller General of the United States and the Single Audit Act as applicable. Our audit scope at the Department of Public Instruction included the following:

State of North Carolina's Financial Statements

General Fund

State of North Carolina's Administration of Federal Financial Assistance Programs

Child Nutrition Cluster:

- School Breakfast Program
- National School Lunch Program
- Special Milk Program for Children

Special Education Cluster:

- Special Education – Grants to States
- Special Education – Preschool Grants

Title 1 Grants to Local Education Agencies

Vocational Education – Basic Grants to States

Reading First State Grants

Our audit procedures at the Department of Public Instruction were less in scope than would be necessary to report on the financial statements that relate solely to the Department or its administration of federal programs. Therefore, we do not express such conclusions.

The results of our audit procedures yielded audit findings and recommendations for the Department related to the State's financial statements and federal financial assistance programs that may require disclosure in the aforementioned reports. These findings are included in the audit findings and recommendations section contained herein. Our recommendations for improvement and management's response follow each finding.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting or Federal Compliance Objectives

The following findings and recommendations were identified during the current audit and discuss conditions that represent significant deficiencies in internal control and/or noncompliance with laws, regulations, contracts or grants.

1. INTERNAL CONTROL WEAKNESSES OVER DETERMINATION OF ELIGIBILITY

Controls were not in place to ensure that the criteria used to determine eligible subrecipients in the Reading First State Grants program complied with the criteria in the State Plan. The State Plan stated that schools that had fewer than 20 students scoring below proficiency were excluded from eligibility. Our review of eligibility determinations revealed that 29 of 92 schools received funding even though they had fewer than 20 students scoring below proficiency. Eligibility determinations for these schools were calculated using a threshold of 10 or more students in a school scoring below grade level.

Since the Department did not adhere to the criteria in the approved State Plan, 29 schools were ineligible to receive funding. We were unable to determine the exact amount of funds expended by these schools during our audit period because this information was not readily available at the Department. However, this information should be at the individual schools. Therefore, we were unable to determine questioned cost. However, the projected questioned cost, based on proposed funding of \$11,426,005 to these schools, would likely exceed \$10,000.

Recommendation: The Department should strengthen controls to ensure that eligibility determinations are made in accordance with the approved criteria.

Agency's Response: We disagree with the finding that the DPI used incorrect criteria to determine eligible subrecipients in the Reading First State Grant program. DPI believes that it had prior approval to use the lower threshold of ten or more students in a school scoring below grade level to determine eligibility. We have asked the U.S. Department of Education for written confirmation of that approval.

2. CONTROLS NOT IN PLACE TO ENSURE COMPLIANCE WITH FEDERAL SUSPENSION AND DEBARMENT REQUIREMENTS

The Department did not have controls in place to ensure that the federal suspension and debarment requirements were met for the subrecipients in the Reading First State Grants program. The failure to comply with these requirements heightens the risk that the Department may contract with or provide funds to suspended or debarred subrecipients.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Our examination of 39 subrecipient files revealed that the Department did not verify that these subrecipients were not suspended or debarred. This verification may be accomplished by checking the Excluded Parties List System maintained by the General Services Administration, collecting a certification from the entity, or adding a clause or condition to the covered transaction with that entity.

Title 34 CFR section 85.300 requires verification for covered transactions to ensure that the recipients of federal funds are not suspended or debarred. All non-procurement transactions (for example, subawards to subrecipients) according to 34 CFR Section 85.210 are covered transactions.

Recommendation: The Department should establish and implement procedures to ensure compliance with current federal suspension and debarment regulations.

Agency's Response: We agree with the finding. DPI has subsequently requested suspension and debarment statements from its subrecipients in the Reading First State Grant program, and all but three of the suspension and debarment statements have been received at this time.

3. STATE COMPLIANCE SUPPLEMENTS NOT PREPARED IN THE PRESCRIBED FORMAT

The State Compliance Supplement prepared for the Reading First State Grants program did not include the information necessary for independent auditors to conduct the single audit for the Local Education Authorities (LEAs). The Department completed the "short form" version of the compliance supplement instead of the version that includes guidance for the CPAs to audit these programs.

North Carolina General Statute 159-34(c) requires state departments and agencies that provide funds to local governments and public authorities to provide the Local Government Commission with documents in a prescribed format describing standards of compliance and suggested audit procedures sufficient to give adequate direction to independent auditors retained to conduct a single audit. The Local Government Commission requires a compliance supplement containing standards of compliance and suggested audit procedures whenever the amount subgranted to any one local government or public authority is \$100,000 or more. The Department subgranted \$20.9 million to the LEAs during the audit period.

Since the compliance supplement was not adequate and the Department did not perform any other fiscal monitoring of these funds, there is an increased risk that the subrecipients expended grant funds for unallowed activities.

OMB Circular A-133 requires subrecipients expending \$500,000 or more in federal awards during the subrecipient's fiscal year to be audited. In addition, pass-through entities should be responsible for monitoring the subrecipient activities to provide reasonable assurance that a subrecipient administers federal awards in compliance with federal requirements.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Recommendation: The Department should establish procedures to ensure that the State Compliance Supplement is prepared in the prescribed format for all programs, provides adequate direction to independent auditors regarding federal and state requirements, and provides any other information to enable independent auditors to audit the federal/State program.

Agency's Response: We agree with the finding. In order to assure that compliance supplements are provided in the format required for new programs, DPI has added a step to its process for setting up new federal programs. The new step will provide our Monitoring and Compliance Section with important information and a checklist for reference each year when compliance supplements are updated.

4. FUNDS REALLOCATED AFTER PERIOD OF AVAILABILITY

The Department reallocated unexpended funds in violation of the federal regulations in the Reading First State Grants program. Unexpended grant funds from the 2002-2003 award year of \$234,431 were reallocated from one subrecipient to another in January 2005, which was after the period of availability. As a result, we will question these costs.

The OMB Circular A-133 Compliance Supplement states that State Education Agencies or other grantees are not to reallocate grant funds from one subrecipient to another after the period of availability. Also, 34 CFR Section 80.23(b) requires that a grantee liquidate all obligations incurred under the award no later than 90 days after the end of the funding to coincide with the submission of the annual Financial Status Report. The federal agency may extend this deadline at the request of the grantee.

The Department contends that reallocation of allotments from one subrecipient to another is appropriate as long as the expenditures have been incurred before the period of availability has ended. If this was an acceptable interpretation of the federal requirement, costs would still be questioned since the subrecipient that received the reallocation of funds had not expended enough funds to cover the additional allocation at December 31, 2004.

Recommendation: The Department should ensure that all funds are expended within the period of availability. The Department should consult with the federal government on the proper interpretation of this requirement.

Agency's Response: We disagree with the finding that the reallocation adjustments were made after the period of availability. We do not reallocate funds and increase a Local Education Agency's (LEA) overall availability to spend more than what is originally allocated (carryover plus new grant year allocation). We do make adjustments to coincide with the federal approved first-in, first-out (FIFO) method for utilization of federal funds. The DPI Allotment Section does not reallocate grant funds by increasing an LEA's overall allocation, but the DPI makes an adjustment (journal entry) between grant years to appropriately associate expenditures that were incurred during the oldest

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

applicable grant available period. This action appropriately assigns expenditures to assure 100% utilization of the oldest available grant funds. This action is authorized by the Federal Government.

The funding has already been drawn down from the Federal Government, based on their authorization per FIFO and we are making the adjustment to the allotment to reflect federal grant year funds that cover actual expenditures during the period of availability. To do this, we identify LEAs that have expended all of their prior year funds and are using the current year funding still within the prior grant available period. We refer to that as the FIFO method. In years past, we have had programs where LEAs had not expended enough funds during the period of availability under our FIFO method and thus, reverted funds back to the Federal Government.

5. CONTROLS NEED IMPROVEMENT OVER PURCHASING

Controls were not in place to ensure that the Department complied with State regulations for the procurement of contractual services in the Reading First State Grants program. Our analysis of invoices and purchase orders revealed the following.

- The Department paid a total of \$21,750 for a personal service contract without having a formal contract. The vendor performed financial related services for the Department and submitted twelve monthly invoices, ranging from \$300 to \$4,800 during the fiscal year;
- The Department paid a total of \$13,030 to one vendor who had submitted a proposal to conduct workshops and consulting services for the program. The Department did not seek competitive bids for this project and did not create a contract for the services. We will question this cost because of the following;
 - a) Four invoices were split and four purchase orders were created keeping the total below the \$5,000 threshold that would have required the Department to seek competitive bids;
 - b) Three of the invoices noted above, in the amounts of \$3,250, \$3,250 and \$1,580, were entered into the procurement system 25 minutes apart on December 2, 2004;
 - c) The final invoice for \$4,950 submitted by this vendor provided no detail of the services performed, but the Department stated that the consulting services billed on that invoice were related to the proposal;
 - d) The vendor was the spouse of the administrative assistant for the program.
- The Department paid a total of \$11,013 to one vendor for services without having a contract that specified the services to be provided.

The lack of contracts for the purchase of services may cause the Department to pay for services never rendered or may cause a misunderstanding in the services to be provided.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Possible conflict of interest in purchasing could foster favoritism and cast doubts on the integrity and impartiality of the purchasing process.

Title 34 CFR section 80.36 requires a state to follow the same policies and procedures for procuring services under a grant as it uses for procurements from its non-federal funds. Also, it states that an employee, officer or agent of the grantee or subgrantee should not participate in the award or administration of a contract supported by federal funds if a conflict of interest, real or apparent, would be involved. In addition, such a conflict would arise when: (1) the employee, officer or agent, (2) any member of his immediate family, (3) his or her partner or (4) an organization which employs, or is about to employ, any of the above, has a financial or other interest in the firm selected for award.

The *State of North Carolina Agency Purchasing Manual* requires the awards of contracts for commodities and contractual services. The manual also requires state agencies to seek competitive bids for purchases over \$5,000 unless competition is waived for certain conditions, such as personal services.

Recommendation: The Department should ensure that its personnel, especially those who are responsible for making procurement decisions, are aware of and comply with all federal and state purchasing rules and regulations.

Agency's Response: We agree with the finding. The Reading First State Grant program staff will receive additional training and guidance on procurement policies and procedures to ensure awareness and compliance with all federal and state purchasing rules and regulations. The additional training will include special emphasis on competitive bidding requirements and avoidance of conflicts of interest. The Purchasing and Contracts Section has already enhanced its processes and controls over contracts in amounts under the current benchmark of \$5,000 for seeking competitive bids. The enhanced processes and controls include vendor searches on selected samples of procurements under \$5,000, follow-up on multiple procurements with the same vendor, and increased staff development training in policies and procedures for the procurement of services. The Purchasing and Contracts Section provided training sessions in December 2005, and January 2006, and will provide future training on a quarterly basis. An internal financial analyst will perform a review to determine the effectiveness of the enhanced processes and staff development training.

6. CHILD NUTRITION CLAIMS PAYMENT SYSTEM AUDIT TRAIL NEEDS IMPROVING

The Child Nutrition Claims Payment System used in the Child Nutrition Cluster did not provide an adequate audit trail to document all claim adjustments processed for the Local Education Agencies (LEAs) during the year. The design of the system causes it to overwrite original claims (and any previous adjusting claims) with the latest claim adjustment submitted by the LEA. All that remains on the system is the latest version of the claim submitted. There is no system retention of original claims, rates or any subsequent adjustments.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

The absence of a viable audit trail to document all claims adjustments processed in the system increases the risk that the Department would not detect improper claim payments to LEAs.

Federal regulation 7 CFR parts 210, 215 and 220 require state agencies to establish a financial management system to maintain records to include but are not limited to, documenting all claims paid with federal program funds.

Recommendation: Changes should be made to the Child Nutrition Claims Payment System to ensure there is a viable audit trail to document all claim transactions processed in the system.

Agency's Response: We agree with the finding. Although there is no evidence that any final claims have been improperly paid, a viable audit trail should be maintained on any previous versions of a claim. DPI expects to purchase a new Child Nutrition System, and begin processing claims on the new system on October 1, 2006. An acceptable audit trail of all claim transactions is a major requirement for the new system.

7. INTERNAL CONTROLS OVER MAINTENANCE OF EFFORT NEED STRENGTHENING

Although the Department met the maintenance of effort compliance requirement for the Special Education - Grants to States and Special Education - Preschool Grants programs, the Department did not have adequate internal controls in place to ensure compliance with this requirement. Title 34 CFR section 300.154 states that a state may not reduce the amount of state financial support for special education and related services for children with disabilities below the amount of state financial support provided for the preceding fiscal year. Even though the budget is reviewed when initially set up, there was no evidence that the Department reviewed expenditures to ensure compliance with this requirement. Unless the Department has adequate controls to provide reasonable assurance that the compliance requirement was met, there is an increased risk that the Department may not meet this requirement in the future.

OMB Circular A-133 states that an auditee must maintain internal control over federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Department personnel stated that they were unaware of the compliance requirement.

Recommendation: The Department should strengthen internal controls to ensure that the required maintenance of effort compliance requirement is continually met and maintained in accordance with federal regulations.

Agency's Response: We agree with the finding. Effective immediately, the budget analyst assigned to this grant will monitor the State expenditures for administration on a quarterly basis to ensure the maintenance of effort compliance requirement is met. Moreover, to ensure that all budget analysts are familiar with the federal requirements for

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

their assigned grants, they will review the fiscal requirements pertaining to State Education Agencies in the appropriate compliance supplements.

8. FAILURE TO COMPLY WITH FEDERAL SUSPENSION AND DEBARMENT REQUIREMENT

The Department failed to comply with federal suspension and debarment requirements for one of 11 procurement contracts in the Vocational Education - Basic Grants to States program. The failure to comply with these requirements heightens the risk that the Department may contract with or provide funds to suspended or debarred contractors.

Title 34 CFR section 85.300 requires verification for covered transactions to ensure that the recipients of federal funds are not suspended or debarred.

This verification may be accomplished by checking the Excluded Parties List System maintained by the General Services Administration, collecting a certification from the entity, or adding a clause or condition to the covered transaction with that entity. All contracts that are expected to equal or exceed \$25,000 according to 34 CFR section 85.220 are covered transactions.

Recommendation: The Department should follow its prescribed procedures to ensure compliance with current federal suspension and debarment requirements.

Agency's Response: We agree with the finding. DPI complies with the suspension and debarment requirement by affixing a certification statement to all of its contracts in amounts over \$5,000. However, this statement was inadvertently left off of the DPI contract format for personal services contracts that are classified as employees for IRS tax withholding purposes. This oversight has been corrected, and the required certification statement will be attached to all future contracts in this classification.

9. UNALLOWABLE COSTS CHARGED TO READING FIRST STATE GRANTS PROGRAM

The Department's review procedures were not sufficient to ensure that expenditures charged to the Reading First State Grants program were allowable and that they were in compliance with state travel policies. Our review of 41 disbursements revealed the following:

- One disbursement of \$1,908 was improperly charged to the program even though it benefited another program;
- One employee was erroneously reimbursed for dinner. The travel times listed on the travel voucher indicated that the employee was only eligible for lunch. Therefore, the employee claimed \$6 in error;
- One employee was reimbursed twice for a parking charge of \$10.

Since projected questioned costs would likely exceed \$10,000, we will question \$1,924, the amount of disbursements in our test which were not allowable.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

OMB Circular A-87 requires costs to be supported by appropriate documentation to be allowable under a grant program, and costs should represent actual charges. Also, *North Carolina General Statute 138-6* contains statutory regulation regarding employee travel. Allowances may not be claimed while in travel status unless the departure or arrival to one's duty stations extends the employee's workday for the appropriate length of time.

Unless adequate reviews are performed the risk of paying for unallowable costs increases.

Recommendation: The Department should adhere to all federal regulations and state prescribed policies and procedures when processing cash disbursements. Review procedures should be strengthened and reiterated to appropriate personnel.

Agency's Response: We agree with the finding. The \$1,908 inadvertently coded to the Reading First State Grant program will be refunded to the program, and charged to the correct program. In addition, to reduce the risk of paying unallowable travel costs in the future, the DPI travel reimbursement staff will strengthen their review procedures, and conduct semi-annual training sessions for all DPI employees. In addition, the travel reimbursement policies and procedures have been reiterated to the Reading First State Grant program staff.

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of audit reports may be obtained by contacting the:

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