

# STATE OF NORTH CAROLINA

**DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES**

**STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES**

**FOR THE YEAR ENDED JUNE 30, 2010**

**OFFICE OF THE STATE AUDITOR**

**BETH A. WOOD, CPA**

**STATE AUDITOR**

**DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES**

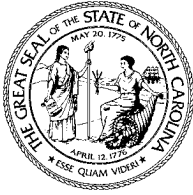
**STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES**

**FOR THE YEAR ENDED JUNE 30, 2010**

**OFFICE OF THE STATE AUDITOR**

**BETH A. WOOD, CPA**

**STATE AUDITOR**



Beth A. Wood, CPA  
State Auditor

STATE OF NORTH CAROLINA  
Office of the State Auditor

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
Internet <http://www.ncauditor.net>

---

**AUDITOR'S TRANSMITTAL**

---

The Honorable Beverly Eaves Perdue, Governor  
Members of the North Carolina General Assembly  
Mr. Dee A. Freeman, Secretary  
Department of Environment and Natural Resources

We have completed certain audit procedures at the Department of Environment and Natural Resources related to the State of North Carolina reporting entity as presented in the *Single Audit Report* for the year ended June 30, 2010. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

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 major federal programs. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

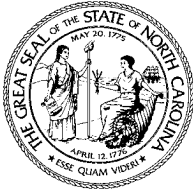
Our audit objective was to render an opinion on the State of North Carolina's, and not the Department's, administration of major federal programs. However, the report included herein is in relation to our audit scope at the Department and not to the State of North Carolina as a whole.

The audit findings referenced in the report are also evaluated to determine their impact on the State's internal control and the State's compliance with rules, regulations, contracts, and grants. If determined necessary in accordance with *Government Auditing Standards* or the OMB Circular A-133, these findings are reported in the State's *Single Audit Report*.

*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.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA  
State Auditor



Beth A. Wood, CPA  
State Auditor

STATE OF NORTH CAROLINA  
Office of the State Auditor

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
Internet <http://www.ncauditor.net>

**REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE A  
DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON  
INTERNAL CONTROL OVER COMPLIANCE  
IN ACCORDANCE WITH OMB CIRCULAR A-133**

---

Secretary Dee A. Freeman  
and Management of the Department of Environment and Natural Resources

Compliance

As part of our audit of the State of North Carolina's compliance with the types of requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of its major programs for the year ended June 30, 2010, we have performed audit procedures at the Department of Environment and Natural Resources. Our report on the State of North Carolina's compliance with requirements that could have a direct and material effect on each major program and on internal control over compliance in accordance with OMB Circular A-133 is included in the State's *Single Audit Report*. Our federal compliance audit scope at the Department of Environment and Natural Resources included the following:

- Capitalization Grants for Clean Water State Revolving Funds (CFDA 66.458)
- Capitalization Grants for Drinking Water State Revolving Funds (CFDA 66.468)

The audit results described below are in relation to our audit scope at the Department and not to the State of North Carolina as a whole.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Department's compliance with those requirements.

The results of our audit procedures at the Department of Environment and Natural Resources disclosed instances of noncompliance that are required to be reported in accordance with

**REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE A  
DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON  
INTERNAL CONTROL OVER COMPLIANCE  
IN ACCORDANCE WITH OMB CIRCULAR A-133 (CONTINUED)**

---

OMB Circular A-133 and which are described in findings 1, 2, and 3 in the Audit Findings and Responses section of this report.

Internal Control Over Compliance

Management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered internal control over compliance with the requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of internal control over compliance.

*A deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. *A material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. *A significant deficiency in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

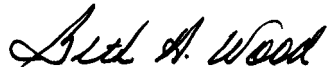
Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses, and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, we consider the deficiencies described in the findings in the Audit Findings and Responses section of this report to be significant deficiencies in internal control over compliance, as defined above.

Management's responses to the findings identified in our audit are included in the Audit Findings and Responses section of this report. We did not audit the responses, and accordingly, we express no opinion on them.

**REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE A  
DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON  
INTERNAL CONTROL OVER COMPLIANCE  
IN ACCORDANCE WITH OMB CIRCULAR A-133 (CONCLUDED)**

---

This report is intended solely for the information and use of management, Secretary Dee A. Freeman, others within the entity, the Governor, the General Assembly, and federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.



Beth A. Wood, CPA  
State Auditor

March 11, 2011

[ This Page Left Blank Intentionally ]

## **AUDIT FINDINGS AND RESPONSES**

---

### **Matters Related to Federal Compliance Objectives**

#### **1. SUBRECIPIENT MONITORING NEEDS IMPROVEMENT**

The Department of Environment and Natural Resources did not consistently perform adequate monitoring procedures to ensure subrecipients were in compliance with all applicable federal requirements. As a result, there is an increased risk that noncompliance with federal requirements could occur at the subrecipient level and not be detected by the Department.

We examined a sample of 15 files for subrecipient projects funded by the American Recovery and Reinvestment Act (ARRA) for the Drinking Water State Revolving Fund and noted the following deficiencies:

- For two projects, the certification forms denoting compliance with ARRA Buy American provisions were not obtained from the subrecipients as prescribed by Department policy. As a result, there was no evidence that the Department ensured the subrecipients and their contractors certified compliance with the Buy American provisions.
- For two projects, the forms certifying compliance with federal suspension and debarment requirements were not obtained from subrecipients as prescribed by Department policy. As a result, there was no evidence that the Department verified that these subrecipients were not entering into transactions with suspended or debarred entities.

During our review of the Department's on-site monitoring inspections, we noted the following deficiencies for the Drinking Water State Revolving Loan Fund:

- Two of the 15 American Recovery and Reinvestment Act (ARRA) projects in our test were not monitored for compliance with the Davis-Bacon Act. As a result, the Department did not ensure that the subrecipients paid prevailing wages, obtained certified payrolls, conducted employee interviews for all contracts, or posted the wage determinations at the construction site.
- The Department's procedures do not include monitoring the subrecipients for compliance with cash management requirements. As a result, the Department did not ensure that the subrecipients' cash draws were actual reimbursements or that advanced funds were promptly disbursed.

In addition, we noted the following deficiencies in the on-site monitoring inspections of the Clean Water State Revolving Fund Loan Fund:

- Four of the 12 ARRA subrecipients in our test were not monitored for compliance with the Davis-Bacon Act or Buy American provisions. In addition,



## AUDIT FINDINGS AND RESPONSES (CONTINUED)

---

noncompliance with the Davis-Bacon Act at the subrecipient level was previously reported in a fiscal control audit of the Department's during-the-award monitoring of ARRA subrecipients. The Department did not ensure that the subrecipients paid prevailing wages, obtained certified payrolls, conducted employee interviews for all contracts, posted the wage determinations at the construction site, or used manufactured goods produced in the United States.

- The Department's procedures do not include monitoring the subrecipients for compliance with cash management requirements. As a result, the Department did not ensure that the subrecipients' cash draws were actual reimbursements or that advanced funds were promptly disbursed.

According to the *OMB Circular A-133 Compliance Supplement*, subrecipients should be monitored to provide reasonable assurance that the subrecipient administers Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

*Federal Award Information:* This finding affects CFDA 66.458 Capitalization Grants for Clean Water State Revolving Funds ARRA award 2W-95421209 for the award period March 16, 2009 - October 30, 2012; and CFDA 66.468 Capitalization Grants for Drinking Water State Revolving Funds award FS-98533808 for the award period July 1, 2009 - September 13, 2014 and ARRA award 2F-95423309 for the award period April 1, 2009 - March 31, 2012.

*Recommendation:* The Department should enhance internal controls to ensure that all applicable federal compliance requirements are included in their subrecipient monitoring procedures and that adequate documentation of completed monitoring procedures is maintained.

*Agency Response:* Department agrees with the finding. Both the Clean Water and Drinking Water programs have improved their project review process to ensure that all projects are in compliance with the ARRA Buy American provisions and Davis-Bacon Act provisions.

All contracts have been reviewed to ensure compliance with federal suspension and debarment requirements. Checking the federal debarment list is now a routine procedure in the contracting process.

To ensure that we are in compliance with federal cash management requirements, we are developing procedures for project staff to confirm compliance during project reviews. We will also develop "compliance supplements" addressing this issue for independent auditors performing single audits of these local governments.

### 2. PUBLIC NOTICE FOR CATEGORICAL EXCLUSIONS NOT PROVIDED

The Department of Environment and Natural Resources did not provide notice to the public of categorical exclusions issued from the environmental reviews of proposed

## AUDIT FINDINGS AND RESPONSES (CONTINUED)

---

projects to be funded by the Drinking Water State Revolving Loan Funds. Title 40 CFR section 35.3580(c)(4) requires States to provide public notice when a categorical exclusion is issued or rescinded.

The Department performs environmental reviews for each proposed project to assess the project's environmental impact. A category of actions that do not individually or cumulatively have a significant effect on the human environment is referred to as a categorical exclusion, and neither an environmental assessment nor an environmental impact statement is required in these circumstances.

The Department performs environmental reviews based on the State Environmental Review Procedures (SERP) document that has been approved by the U.S. Environmental Protection Agency (EPA). Due to revisions in the federal regulations issued by the EPA, the Department made changes to their SERP document and intended to drop the requirement to provide public notification of categorical exclusions that were issued, but the intended changes were not made in the document submitted to and approved by the EPA. Without EPA approval, the Department implemented a new procedure and stopped providing notice of categorical exclusions to the public. As a result, during the 2010 fiscal year 85 out of 90 new projects received a categorical exclusion and the appropriate notice was not provided to the public.

*Federal Award Information:* This finding affects CFDA 66.468 Capitalization Grants for the Drinking Water State Revolving Fund award FS-98433808 for the award period July 1, 2009 - September 13, 2014 and ARRA award 2F-95423309 for the award period April 1, 2009 - September 30, 2012.

*Recommendation:* The Department should strengthen internal controls to ensure that it complies with all procedures approved by the EPA.

*Agency Response:* While verbal approval from EPA exists for North Carolina's SERP, the fully executed document has not been received back from EPA. Public review sections are proposed for deletion because public notification is not required for Federally-issued CEs under 40 CFR 6.204. Similar requirements in 40 CFR 6.203(b) and (c) apply only to EAs and EISs respectively. As the public review is no longer federally required, the state requirement in the SERP is being dropped. In response to the auditor's recommendation, the PWS Section has been scanning and posting the CE's on line, and will continue to do so until the executed revised SERP is received back from EPA.

### 3. SOURCE OF ARRA FUNDS NOT COMMUNICATED TO SUBRECIPIENTS

The Department of Environment and Natural Resources did not communicate the federal award number and Catalog of Federal Domestic Assistance (CFDA) number to each subrecipient of American Recovery and Reinvestment Act (ARRA) funds at the time of the ARRA award and at the time ARRA funds were disbursed. As a result, the Department did not comply with federal requirements specific to ARRA funds. This increases the risk that subrecipients will not properly identify the award and CFDA

## AUDIT FINDINGS AND RESPONSES (CONTINUED)

---

number for the ARRA awards and expenditures in their Schedule of Expenditures of Federal Awards and Data Collection Form.

The Department's ARRA awards to subrecipients identify the award as ARRA and it identifies the amount of the ARRA funds; however, the federal award number and the CFDA number were not communicated in the agreement. In addition, at the time of disbursement the Department sends notifications to subrecipients that identify the award as ARRA and identify the amount of ARRA funds disbursed, but the notifications do not include communication of the federal award number or CFDA number.

The *OMB Circular A-133 Compliance Supplement* requires that the State separately identify to each subrecipient, and document at the time of the subaward and disbursement of funds, the Federal award number, CFDA number, and the amount of ARRA funds. It also states that the Department should require its subrecipients to provide similar identification in their Schedule of Expenditures of Federal Awards and Data Collection Form.

*Federal Award Information:* This finding affects CFDA 66.458 Capitalization Grants for Clean Water State Revolving Funds ARRA award 2W-95421209 for the award period March 16, 2009 - October 30, 2012 and CFDA 66.468 Capitalization Grants for Drinking Water State Revolving Funds ARRA award 2F-95423309 for the award period April 1, 2009 - March 31, 2012.

*Recommendation:* The Department should establish procedures to communicate the federal award number and CFDA number to subrecipients at the time of award and disbursement of ARRA funds.

*Agency Response:* As of September 17, 2010 the Federal grant award numbers and CFDA numbers for both the Clean Water and Drinking Water State Revolving Loan programs have also been included on all ARRA payments.

#### 4. BINDING COMMITMENTS THRESHOLD NOT PROPERLY TRACKED

For capitalization grants funded by the Drinking Water State Revolving Funds, the Department of Environment and Natural Resources did not have adequate controls in place to ensure compliance with federal requirements intended to ensure that the State utilizes grant funds in a timely manner. Although actual noncompliance was not found, the absence of proper controls increases the risk of noncompliance with the federal regulations.

Federal regulations require that the current year's cumulative binding commitments be at least 120 percent of the cumulative grant received in the prior year and that the commitments be made within a specified timeframe. A binding commitment is a legal obligation by the State to a local recipient that defines the terms for assistance. Due to the increased volume of activity funded by the American Recovery and Reinvestment Act during the current fiscal year, the Department abandoned their previous control

## AUDIT FINDINGS AND RESPONSES (CONCLUDED)

---

procedures that were in place to ensure actual commitments were made in accordance with federal regulations.

The *OMB Circular A-133 Compliance Supplement* requires entities receiving federal awards to establish and maintain control systems designed to ensure compliance with federal regulations.

*Federal Award Information:* This finding affects CFDA 66.468 Capitalization Grants for the Drinking Water State Revolving Fund award FS-98433808 for the award period July 1, 2009 - September 13, 2014.

*Recommendation:* The Department should establish adequate internal controls to minimize the risk of noncompliance with federal regulations related to the timely obligation of grant funds.

*Agency Response:* Tracking of the 120 percent requirement has been done historically, but was neglected during ARRA in order to meet very strict requirements and very short deadlines. We have reviewed the commitments and determined that the 120 percent requirement was met. Binding commitments will be reported quarterly by the PWS Section to the DEH finance office for tracking.

[ This Page Left Blank Intentionally ]

## ORDERING INFORMATION

---

Audit reports issued by the Office of the State Auditor can be obtained from the web site at [www.ncauditor.net](http://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:

Office of the State Auditor  
State of North Carolina  
2 South Salisbury Street  
20601 Mail Service Center  
Raleigh, North Carolina 27699-0601

Telephone: 919/807-7500

Facsimile: 919/807-7647