

STATE OF NORTH CAROLINA

DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES

RALEIGH, NORTH CAROLINA

STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2013

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES

RALEIGH, NORTH CAROLINA

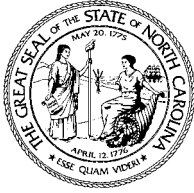
STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2013

ADMINISTRATIVE OFFICERS

JOHN E. SKVARLA, III, SECRETARY

REX H. WHALEY, CHIEF FINANCIAL OFFICER



Beth A. Wood, CPA
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Pat McCrory, Governor
Members of the North Carolina General Assembly
John E. Skvarla, III, Secretary
Department of Environment and Natural Resources

As part of our audit of the State of North Carolina's compliance with requirements applicable to its major federal programs, we have completed certain audit procedures at the Department of Environment and Natural Resources for the year ended June 30, 2013. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*. We conducted the audit 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 State Auditor expresses an opinion on the State's compliance with requirements applicable to its major federal programs in the State's *Single Audit Report*.

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



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**INDEPENDENT AUDITOR'S 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**

Mr. John E. Skvarla, III
and Management of the Department of Environment and Natural Resources

Report on 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, 2013, 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:

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

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.

Management's Responsibility

Management is responsible for compliance with laws, regulations, contracts, and grants applicable to federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the State of North Carolina's major federal programs based on our audit of the types of compliance requirements

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referred to above, which we issue in the State's *Single Audit Report*. 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. However, our audit does not provide a legal determination of the Department's compliance with those requirements.

Opinion on Each Major Federal Program

As stated above, our opinion on compliance for each of the State of North Carolina's major federal programs is included in the State's *Single Audit Report*.

Other Matters

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 OMB Circular A-133 and which are described in the Audit Findings and Responses section of this report.

Report on Internal Control Over Compliance

Management is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered internal control over compliance with the types of requirements that could have a direct and material effect on a major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program 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.

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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 material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, we consider the deficiencies described in findings 2 and 4 in the Audit Findings and Responses section of this report to be material weaknesses in internal control over compliance. Furthermore, we consider the deficiencies described in findings 1 and 3 in the Audit Findings and Responses section of this report to be significant deficiencies in internal control over compliance.

Purpose of Report on Internal Control Over Compliance

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this communication is not suitable for any other purpose.

Management's Responses to Audit Findings

Management's responses to the findings identified in our audit are included in the Audit Findings and Responses section of this report. The responses were not subjected to the

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auditing procedures applied in the audit of compliance or consideration of internal control over compliance, and accordingly, we express no opinion on them.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

March 14, 2014

AUDIT FINDINGS AND RESPONSES

Matters Related to Federal Compliance Objectives

CFDA 66.458 CAPITALIZATION GRANTS FOR CLEAN WATER STATE REVOLVING FUNDS

1. FEDERAL FUNDS EXPENDED AFTER THE PERIOD OF AVAILABILITY

The Department of Environment and Natural Resources did not comply with the period of availability requirements for the Capitalization Grant for Clean Water State Revolving Fund. Grant funds were expended during the liquidation period for obligations that were incurred after the period of availability.

40 CFR 31.23 requires that only allowable costs resulting from obligations incurred during the period of availability may be charged to the grant. Additionally, cost incurred in the 90-day liquidation period after the end of the funding period should only be for obligations incurred within the period of availability.

The budget period and project period for the American Recovery and Reinvestment Act (ARRA) Capitalization Grant for Clean Water State Revolving Fund ended October 30, 2012. The liquidation period was November 1, 2012 – January 31, 2013. Any federal funds that were expended during the liquidation period should have been for obligations that occurred on or before October 31, 2012.

Audit results revealed \$15,512 was expended during the liquidation period for personal services and indirect costs that occurred during the liquidation period. These costs are considered unallowable and will be questioned.

Federal Award Information: This finding affects funds administered under the American Recovery and Reinvestment Act federal award 2W-95421209 for the award period of March 16, 2009 - October 31, 2012.

Recommendation: The Department should implement procedures to ensure that federal funds expended during the liquidation period are for expenditures associated with obligations that occurred during the period of availability.

Agency Response: Department agrees with the finding. Corrective action is in progress. Overall, our allowable expenses within the grant period exceeded our draws, and we did incur other expenses within the grant period from which a draw could be made; however, the \$15,512 noted did fall within the liquidation period. The Department is creating standard operating procedures to prevent any future occurrences. Since this finding relates specifically to ARRA funding that is no longer available, this issue will not reoccur.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

2. MONITORING OF SUBRECIPIENT CASH MANAGEMENT NEEDS IMPROVEMENT

The Department of Environment and Natural Resources did not monitor subrecipients of the Capitalization Grant for Clean Water State Revolving Funds to ensure that funds were expended in accordance with the cash management requirements communicated in the Offer and Acceptance Document. As a result, there is an increased risk that subrecipients are not complying with the cash management requirements resulting in excess cash held by subrecipients and lost interest earnings to the State.

The Offer and Acceptance (Binding Commitment) document, Section 2 – Assurances, requires the subrecipient to expend all of the requisitioned loan/grant proceeds for the purpose of paying costs of projects within three banking days of receipt of such funds from the State. However, the Department did not monitor subrecipients to verify that funds were expended within the required three days. During the audit period, 17 subrecipients received \$36,462,111 in Capitalization Grants for Clean Water State Revolving Funds.

OMB Circular A-133 requires that subrecipients be monitored to provide reasonable assurance that the subrecipient administers federal awards in compliance with laws, regulations and provision of contracts or grants agreements. In addition, 40 CFR 31.20(b)(7) requires the State to monitor cash drawdowns by its subrecipients to ensure that they conform substantially to the same standards as the State.

This finding has been reported for four consecutive years.

Federal Award Information: This finding affects CFDA 66.458 Capitalization Grants for Clean Water Revolving Funds and federal awards CS-37000110 for the award period of 10/01/2010 – 09/30/2012; CS-37000111 for the award period of 10/01/2011 – 09/30/2014 and CS-37000112 for the award period of 08/01/2012 – 12/31/2014. This finding also affects funds administered under the American Recovery and Reinvestment Act federal award 2W-95421209 for the award period of March 16, 2009 – October 30, 2012.

Recommendation: The Department should strengthen subrecipient monitoring by implementing procedures to ensure that cash management requirements are met.

Agency Response: Department agrees with the finding. Corrective action has been implemented. DENR Internal Audit staff are currently in the process of monitoring recipients of the Clean Water State Revolving Fund and Drinking Water State Revolving Fund.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

CFDA 66.468 Capitalization Grants for Drinking Water State Revolving Funds

3. FEDERAL FUNDS USED FOR AN UNALLOWABLE ACTIVITY

The Department of Environment and Natural Resources inappropriately transferred federal funds into the State Revolving Fund. As a result federal funds were used for an unallowable activity. In addition, the Department did not comply with federal cash management requirements to minimize the time elapsing between the transfer of funds from the U.S. Treasury and their disbursement for program purposes.

The Department uses the Capitalization Grant for Drinking Water State Revolving Fund (DWSRF) to make loans to local governments for approved projects. Repayment of these loans by the local government is appropriately deposited into the State Revolving Fund.

During the 2013 fiscal year, the Department drew down \$1,652,657 in available funds from the American Recovery and Reinvestment Act DWSRF Capitalization Grant and treated the drawdown as repayment for three loans projects that had been previously financed with funds from the 2008 DWSRF Capitalization Grant. The ARRA funds were deposited directly into the State Revolving Fund where they would not be subject to federal compliance requirements.

Additionally, the funds were not disbursed timely which may result in interest owed to the federal government for holding funds in the State account.

DWSRF Capitalization Grants should only be expended for allowable activities as prescribed in 40 CFR sections 35.3520 and 35.3525. In addition, 31 CFR 205.33 requires the State to minimize the time elapsing between the drawdown of federal funds from the federal government and their disbursement for federal program purposes.

Federal Award Information: This finding affects funds administered under the American Recovery and Reinvestment Act federal award 2F-95423309 for the award period of April 1, 2009 and September 30, 2013.

Recommendation: The Department should improve procedures to ensure that federal funds are only used for allowable activities and that federal funds are drawn and disbursed timely in accordance with cash management requirements. Also, the Department should transfer the ARRA funds from the State Revolving Fund to the federal capitalization grant to be loaned out as federal funds and subject to federal compliance requirements.

Agency Response: Department agrees with the finding. Corrective action has been implemented. While there were other allowable charges that could have drawn from ARRA funding, all transactions involving the \$1,652,657 from the Drinking Water State Revolving Fund have been reversed. Since this finding relates specifically to ARRA funding that is no longer available, this issue will not reoccur.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

4. SUBRECIPIENT MONITORING NEEDS IMPROVEMENT

The Department of Environment and Natural Resources did not have adequate monitoring procedures in place for subrecipients of the Capitalization Grant for Drinking Water State Revolving Fund (DWSRF). As a result, there is an increased risk that subrecipients may not administer federal awards in compliance with laws, regulations and provision of contracts or grants agreements and performance goals may not be met.

The Department did not follow its monitoring plan, did not monitor subrecipients for cash management requirements and did not verify suspension and debarment certifications. The following details the audit results:

- The Department did not perform subrecipient site visits in accordance with its monitoring plan. The Department's monitoring plan required that a site visit be performed when projects were 10%, 50% and 90% complete. Audit results disclosed that 24 of the 42 subrecipients that had open projects during the audit year did not receive site visits in accordance with the monitoring plan.
- The Department did not monitor subrecipients to ensure that funds were expended in accordance with the cash management requirement communicated in the Offer and Acceptance document. The Offer and Acceptance (Binding Commitment) document, Section 2 – Assurances, requires the subrecipient to expend all of the requisitioned loan/grant proceeds for the purpose of paying costs of projects within three banking days of receipt of such funds from the State. As a result, there is an increased risk that subrecipients are not complying with the cash management requirements resulting in excess cash held by subrecipients and lost interest earnings to the State. During the audit period, 44 subrecipients received \$22,979,540 in Capitalization Grants for Drinking Water State Revolving Funds.
- The Department did not ensure that subrecipients did not contract with parties that were suspended or debarred. As part of the monitoring process Department engineers are required to check that all contractors and subcontractors submit a certification that they are not suspended or debarred. The auditor tested eight of the 40 new loan projects approved during the audit period and identified one instance (12.5% error rate) where the contractor did not submit the required suspension and debarment certification. The total value of the loan project noted as an error was \$725,170 with current year federal expenditures of \$292,789. Insufficient verification of suspension and debarment certification increases the risk that the Department would reimburse the subrecipient for unallowable costs paid to suspended or debarred parties. Based on auditor review of the State and Federal debarment listings, the contractor in question was not suspended or debarred.

OMB Circular A-133 requires that subrecipients be monitored to provide reasonable assurance that the subrecipient administers federal awards in compliance with laws, regulations and provision of contracts or grants agreements. In addition, 40 CFR 31.40

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

requires that grantees must monitor subrecipients to assure compliance with applicable federal requirements and 40 CFR 31.20(b)(7) specifically requires monitoring for conformance with cash management requirements.

Certain aspects of this finding have been reported for four consecutive years.

Federal Award Information: This finding affects federal awards FS-98433807 for the award period of July 1, 2008 – September 30, 2013; FS-98433808 for the award period of July 1, 2009 – September 13, 2014; FS-98433809 for the award period of July 1, 2010 – September 13, 2015 and FS-98433810 for the award period of July 1, 2011 – September 30, 2016. This finding also affects funds administered under the American Recovery and Reinvestment federal award 2F-95423309 for the award period of April 1, 2009 – September 30, 2013.

Recommendation: The Department should have an adequate monitoring plan in place to ensure that subrecipients administer federal awards in compliance with laws, regulations and provisions of contracts or grants agreements.

The Department should strengthen subrecipient monitoring procedures to ensure subrecipients expend funds within three-days of receipt in compliance with cash management requirements.

The Department should verify that subrecipients require contractors and subcontracts to certify that they are not suspended or debarred.

Agency Response: Department agrees with the finding. Corrective action has been implemented. A) The monitoring plan was intended to provide guidance to division staff rather than a requirement; however, this was not clearly indicated in the plan. The monitoring plan has been updated to more clearly define the inspection protocol. B) DENR Internal Audit staff are currently in the process of monitoring recipients of the Clean Water State Revolving Fund and Drinking Water State Revolving Fund. C) Although contractors were being monitored for suspensions or debarments, the Department did not previously check for this certification regarding engineers. The “Owner DBE Checklist” has now been updated to require this certification.

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