



STATE OF NORTH CAROLINA

OFFICE OF STATE BUDGET AND MANAGEMENT

FINANCIAL RELATED AUDIT

JUNE 2012

OFFICE OF THE STATE AUDITOR

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STATE AUDITOR

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AUDITOR'S TRANSMITTAL

June 29, 2012

The Honorable Beverly Eaves Perdue, Governor
The General Assembly of North Carolina
Andy Willis, State Budget Director

This report presents the results of our financial related audit at the Office of State Budget and Management. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the performance audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under *Government Auditing Standards*. These items are described in the Audit Findings and Recommendations section of this report. We also noted another issue that is included in the Other Matters for Further Consideration section of this report. The Office of State Budget and Management's response to the findings is included in the Agency Response to Findings section.

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, reading "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

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BACKGROUND AND GENERAL OBJECTIVES

BACKGROUND

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a financial related audit at the Office of State Budget and Management. There were no special circumstances that caused us to conduct the audit, but rather it was performed as part of our effort to periodically examine and report on compliance with appropriate state laws.

A central role of state government is to provide citizens with public services. Grants are a key means to providing some of these services. Grants are financial assistance arrangements, where both governmental and non-governmental entities receive state and federal funds from state agencies to administer specific projects or programs in accordance with authorized purposes.

The Strategic Management Section of the Office of State Budget and Management administers the day to day operations and processes for overseeing the grants to non-governmental entities. In this context, non-governmental entities are non-state entities that receive state funds as grants from state agencies but exclude any non-state entities (counties, cities, and towns) subject to the audit and other reporting requirements of the Local Government Commission.

Administrative rules and statutes guide the oversight of grants to non-governmental entities in North Carolina. *North Carolina General Statute* 143C-6-23(d) requires the Office of State Budget and Management to adopt rules that ensure the uniform administration of state grants by all grantor state agencies and grantees. In the North Carolina Administrative Code, the Uniform Administration of State Grants establishes policies and procedures for disbursements of state grants and for state agency oversight, monitoring, and evaluation of grantees.

For state fiscal year 2011, non-governmental entities received approximately \$769 million in state and federal funds from state agencies. Non-governmental entities use these funds to administer numerous state and federal programs. As a result, there is a need for adequate oversight to ensure appropriate use of public funds.

GENERAL OBJECTIVES

The general objective of this financial related audit was to identify improvements needed in internal control over selected fiscal matters. The specific fiscal matters included in the audit are described in the Scope and Specific Objectives section of this report.

Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control

BACKGROUND AND GENERAL OBJECTIVES (CONCLUDED)

to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate. Our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

METHODOLOGY

METHODOLOGY

To accomplish our audit objectives, we gained an understanding of internal control over matters described in the Scope and Specific Objectives section of this report and evaluated the design of the internal control. We then performed further audit procedures consisting of tests of control effectiveness and/or substantive procedures that provide evidence about our audit objectives. Specifically, we performed procedures such as interviewing personnel, observing operations, reviewing policies, analyzing records, and examining documentation supporting controls.

As a basis for evaluating internal control, we applied the internal control guidance contained in professional auditing standards. As discussed in the standards, internal control consists of five interrelated components, which are (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

To determine if the Office of State Budget and Management's policies and procedures are adequate to ensure effective oversight of grant funds disbursed to non-governmental entities, we reviewed the applicable administrative rules and statutes.

We conducted this audit in accordance with generally accepted government auditing standards applicable to performance audits. 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 on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

SCOPE AND SPECIFIC OBJECTIVES

SCOPE AND SPECIFIC OBJECTIVES

Our audit scope included a review of the Office of the State Budget and Management's statutory responsibilities for the administrative oversight and reporting of state grant funds in accordance with the *North Carolina General Statutes Chapter 143C-6* for the period July 1, 2011 through December 31, 2011.

The specific audit objectives were to determine whether the Office of State Budget and Management has adequate controls to ensure compliance with its statutory requirements and adequate controls to ensure the completeness and accuracy of the reports submitted to the General Assembly.

RESULTS AND CONCLUSIONS

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The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under generally accepted government auditing standards. These items are described in the Audit Findings and Recommendations section of this report.

We also noted other matters for further consideration that are described in the Other Matters for Further Consideration section of this report.

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AUDIT FINDINGS AND RECOMMENDATIONS

1. ADMINISTRATIVE CODE AND POLICIES AND PROCEDURES NEED UPDATING

The Office of State Budget and Management (OSBM) did not update the sections of the North Carolina Administrative Code (NCAC) that establish reporting requirements for non-governmental entities¹ that receive, use, or expend state funds to reflect current responsibilities and requirements. In addition, OSBM did not establish formal policies and procedures to ensure adequate state agency oversight over disbursements of state grants as required by *North Carolina General Statute* 143C-6-23(d). The outdated NCAC and lack of formal policies and procedures increase the risk that granting agencies and grantees may not comply with current requirements and also may confuse interested parties regarding the requirements. Granting agencies provided approximately \$769 million² to grantees in state fiscal year 2011.

Effective July 1, 2009, the Office of State Auditor (OSA) was required to eliminate non-core functions, which included the non-governmental section of the office. All the responsibilities in Section .0500 of subchapter 03M of the NCAC, except for reviewing audit reports for grantees receiving \$500,000 or more in state funds were transferred to OSBM along with the Grants Information Center (GIC)³. Shortly thereafter, OSBM reviewed the existing NCAC to identify necessary updates to reflect the current responsibilities and also consulted with OSA regarding the changes. However, around the same time, the General Assembly's Program Evaluation Division (PED) initiated a study of the grant oversight process. The PED made several recommendations for improving the process that resulted in legislative proposals in the 2009-10 sessions, requiring numerous changes in the grants reporting requirements. Although several recommendations were made, none of the proposals passed.

As a result, OSBM decided to undertake a more substantive update to the rules. OSBM delayed taking action to incorporate any statutory changes in the revised rules until after the legislative session. Currently, a new statewide grants management system is being developed by the State Chief Information's Office. Since there is no specific timeline as to when the system will be fully developed, the rules update is on hold, leaving state agencies and their grantees without clear guidance and rules indefinitely.

North Carolina General Statute 143C-6-23(d) requires OSBM to adopt rules that ensure the uniform administration of state grants by all granting state agencies and grantees. The current rules in the NCAC are outdated and were established before the automation

¹ Non-governmental entities are non-state entities, such as non-profit and for-profit organizations, that receive state funds as grants from state agencies but do not include non-state entities, such as counties, cities, and towns, subject to the audit and other reporting requirements of the Local Government Commission.

² The \$769 million included both state funds and federal funds passed down from state agencies. State funds totaled approximately \$439 million.

³ GIC was a reporting system used by the state agencies to report their disbursements to grantees and also used by the grantees to report their actual expenditures.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

of many of the reports or processes. Since the rules are not current, it is unclear who has responsibility for many reporting requirements or even what reports are required. The risk of noncompliance increases when requirements are not clear.

Recommendation: OSBM should develop and/or update the policies and procedures and the NCAC regarding the administration of state grants to ensure adequate oversight of these grants. Also, OSBM should indicate on its website that the referenced NCAC is not current and should also provide provisional policies for the granting agencies' use until the NCAC is updated.

2. INAPPROPRIATE ACCESS TO THE NC GRANTS SYSTEM

OSBM did not appropriately restrict administrative access to the NC Grants system (formerly GIC) for its employees and other state agencies' employees. Administrative access gives employees the ability to add, update, alter, and/or delete data for any/all grantees or granting agencies. This unrestricted administrative access increases the risk that inappropriate changes to data could occur and not be detected timely.

NC Grants is an online reporting system where grantees file required reports electronically. Granting agencies use the system to track each grantee's reporting status. The granting agencies may monitor and may review submitted reports to determine compliance with state requirements.

OSBM granted administrative access to NC Grants to 14 employees. However, four of the employees had inappropriate access as described below:

- Three former OSBM employees had access to NC Grants at the time of our audit. The employees separated from the agency between November 2010 and December 2011. Even though OSBM terminated the employees' North Carolina Identity Management (NCID)⁴, it did not officially remove the separated employees' administrative access to NC Grant until we made inquiries about the access.
- One employee at OSBM continued to have administrative access to NC Grants. This employee was assigned to another position within the agency, which did not require access to the system. OSBM removed the employee's access when we made inquiries about the access.

Because of the limitations of the system and the complexity of the Department of Health and Human Services (DHHS), OSBM gave administrative access rights (administrative access gives employees the ability to add, update, alter, and/or delete data for any/all grantees or granting agencies) to NC Grants to four employees at the DHHS Controller's Office. After our inquiries, OSBM removed the access for one of these employees.

⁴ NCID controls access to secure online resources for many NC government agencies.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

However, the remaining three employees still have access to NC Grants and the ability to access and change grantee reports from all granting agencies in state government.

The *Statewide Information Security Manual* requires agencies to establish appropriate controls on access to information systems to allow only those authorized to access the data residing on those systems. The *Statewide Information Security Manual* also requires access to be immediately terminated upon leaving employment. Maintaining proper access controls over computer systems helps to protect the confidentiality and integrity of information by preventing alteration of data and unauthorized use.

Recommendation: OSBM should strengthen its access security procedures. Specifically, OSBM should periodically review employee access to ensure access is restricted to authorized users. In addition, OSBM should immediately revoke separated employees' access.

3. INFORMATION ON SUSPENSION LIST NOT IN COMPLIANCE WITH STATUTE

The Suspension of Funding List (Suspension List) does not meet the requirements of the general statutes and is not effective in ensuring the appropriate use of the list. Deficiencies with the Suspension List were noted as follows:

- *North Carolina General Statute* 143C-6-23(h) states that not later than May 1, 2007, and by May 1 of every succeeding year, OSBM shall report to the Joint Legislative Commission on Governmental Operations and the Fiscal Research Division on all grantees or subgrantees that failed to comply with reporting requirements with respect to grant funds received in the prior fiscal year. OSBM posts a Suspension List weekly as its method of communication of the required information. However, the weekly list is current as of the posting date only and does not provide the noncompliance information for the fiscal year as required by statute.
- Some grantees cannot legally have their funding suspended since they are receiving funds from federal programs that are exempt from the suspension rule. We reviewed 602 grantees on the Suspension List as of the fourth week of December 2011 and found that over one-third of the grantees on the Suspension List received funding from federal grants exempt from the suspension rule. However, there was no indication on the Suspension Lists informing granting agencies or users of the list that these funds cannot be suspended. The usefulness of the report is reduced when many grantees on the Suspension List have grant programs whose funds cannot be suspended.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

- The Suspension List consists of automatic and manually suspended grantees. An automatic suspended grantee is a grantee that failed to submit reports in NC Grants by its reporting deadline. NC Grants automatically removes grantees from the Suspension List when the required reports are submitted. A manually suspended grantee is a grantee suspended by the granting agency for any reason other than failure to submit online reports. For these manually suspended grantees, the granting agency ensures the suspended grantees have corrected the noncompliance issues before requesting OSBM to remove them from the Suspension List.

We reviewed the manually suspended grantees posted on the July 11, 2011 and March 5, 2012 Suspension Lists. We found that OSBM removed 15 grantees from the Suspension List during the period. However, OSBM did not provide any documentation authorizing the removal of four grantees. We contacted the granting agencies about the removal of these grantees from the Suspension List and confirmed that they had requested OSBM to remove these grantees.

Effective internal control requires that changes to the Suspension List are properly authorized and that supporting documentation is maintained.

Recommendation: OSBM should make the following changes and enhancements to the Suspension List:

- Ensure the Joint Legislative Commission on Governmental Operations and the Fiscal Research Division are receiving the required report containing grantees or subgrantees that failed to comply with reporting requirements with respect to grant funds received in the entire prior fiscal year.
- Revise the Suspension List to identify the grantees required to receive federal funds regardless of their failure to meet reporting requirements.
- Maintain supporting documentation authorizing the removal of grantees from the Suspension List.

OTHER MATTERS FOR FURTHER CONSIDERATION

Under current guidance, non-governmental entities that expend \$500,000 or more in state funds are only requested to have a “Yellow Book”⁵ audit performed by a CPA. Using these standards, there is no requirement that the auditor determine that the state funds were spent in accordance with the intended purpose or that other requirements were complied with unless the noncompliance would have a direct and material effect on the financial statements. It is possible that no compliance tests would be performed on the state funds under these standards.

On the other hand, local governments⁶ and public authorities that expend \$500,000 or more in state financial assistance must have a single audit performed in accordance with OMB Circular A-133 (single audit). When performing a single audit, the auditor will determine whether the auditee has complied with laws and regulations that would have a direct and material effect on each major program.

Because of the differences in the requirements, state funds disbursed to local governments and public authorities are subject to more scrutiny than state funds disbursed to non-governmental entities.

We examined a sample of 60 non-governmental entities’ audit reports received for the 2010 fiscal year and found the following:

- Ten of the 60 audits were performed in accordance with Yellow Book standards. The total expenditures for these entities was \$172,388,415.
- Fifty of the 60 audits were performed in accordance with federal single audit standards. The total expenditures for these entities was \$168,510,199.

Based on the results of our test, 51% of total expenditures in our test were not subject to the federal single audit standards. Some state funds may have been included in the audit of federal programs; however, it is likely that many state-funded programs are not audited for compliance. This increases the risk that noncompliance with program requirements could have occurred and not be detected.

Recommendation: The General Assembly should look at the impact of the double standards for audits for local governments and non-governmental entities and determine the risk of having such a high dollar amount of state funds that may not be subject to a compliance audit.

⁵ The “Yellow Book” contains Government Auditing Standards issued by the Comptroller General of the United States. Financial statement audits conducted in accordance with the Yellow Book are similar to an audit conducted only in accordance with auditing standards generally accepted in the United States of America. However, in a Yellow Book audit, there is also a published report on internal control and compliance related to financial reporting, and auditors much comply with a few other supplemental standards.

⁶ Includes counties, cities and towns

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AGENCY RESPONSE TO FINDINGS



**STATE OF NORTH CAROLINA
OFFICE OF STATE BUDGET AND MANAGEMENT**

BEVERLY EAVES PERDUE
GOVERNOR

ANDY WILLIS
STATE BUDGET DIRECTOR

June 28, 2012

The Honorable Beth Wood, State Auditor
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Raleigh, NC 27601

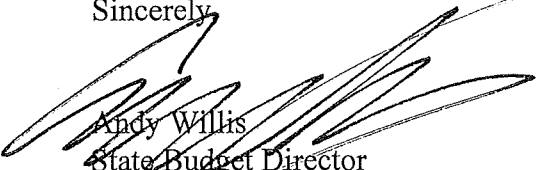
Dear Ms. Wood:

Thank you for the opportunity to respond to the findings outlined in your June 22, 2012, letter regarding the audit of OSBM's oversight of grants to non-state entities. As discussed at the initiation of this audit, under existing statute and rules, granting agencies have primary responsibility for monitoring grantees to ensure compliance with the contractual terms and rules for individual grants. OSBM has the authority to establish rules and policies, but ultimately the onus is on the agencies to ensure compliance with those requirements. Additionally, as we have also discussed, the existing state-level reporting system, which was transferred to OSBM from the Office of the State Auditor in 2009, was not designed with the functionality needed to support state level monitoring or auditing functions. It was basically designed to automate the state-level reporting process and cannot be easily modified to provide the information or tools necessary to meet the growing demand for better monitoring and oversight.

Our responses to your specific findings are attached. However, we also wanted to take this opportunity to highlight other efforts underway that are related to this office. Specifically, OSBM has been working with the State Chief Information Officer and the Department of Transportation on a plan to implement an enterprise-level grants management system based on the existing grants management system that DOT has already implemented. It is our goal to ensure this system provides analytic and reporting tools to support improved monitoring, oversight and auditing capabilities. Simultaneously, we are undertaking an extensive review of the rules to ensure functionality in the new system aligns with desired improvements in the reporting process. We look forward to working with you on that effort to ensure this new system effectively meets the needs and interests of the State, and its taxpayers.

As stated, I look forward to our continued work on improving our overall systems that will allow for an improved statewide grant system. If you have any questions or concerns about this response, please do not hesitate to contact me at (919) 807-4717.

Sincerely,


Andy Willis
State Budget Director

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AGENCY RESPONSE TO FINDINGS (CONCLUDED)

Response to Findings

1. Administrative Code and Policies and Procedures Need Updating

OSBM concurs that the Administrative Code needs updating. The changes required to codify the transfer of responsibilities from the State Auditor to OSBM are fairly limited. OSBM delayed putting these changes through the rules process because we believe that a more substantive update is needed. This effort has started and stopped multiple times due to proposed legislation and other drivers that would impact some of the changes being considered.

As recommended by the Auditor, OSBM will add information on our website clarifying that the Administrative Code is not updated and that the responsibility for the reporting process has transferred to OSBM. We will also consider a limited update to the rules in the interim until we can complete the process for the more substantive changes we want to put in place.

2. Inappropriate Access to the NCGrants System

OSBM concurs and will add procedures to periodically review users with administrative access rights to ensure access is still warranted. In addition, OSBM removed those NCIDs from the database for the purpose of consistent record keeping but there was never a risk these individuals could access the NCGrants system since OSBM was aware their NCID were deactivated. Access to NCGrants is only functional if the NCID is valid – a deactivated NCID is not valid. The appearance of these NCIDs in the NCGrants database was residual, but these former employees did not have access to the system once their NCIDs were terminated.

3. Information on Suspension List Not Compliant with Statute

OSBM concurs with the first issue that the report required by 143C-6-23(h) was not formally sent to the Joint Legislative Commission on Governmental Operations and the Fiscal Research Division for May 2011. However, the information was publicly available on OSBM's website on a weekly basis. For May 2012, OSBM did submit the formal report to the Joint Legislative Commission on Governmental Operations and the Fiscal Research Division. The report included an Excel workbook containing each week's Suspension of Funding List for the entire year, so it did include all noncompliant grantees for the fiscal year as required by the statute. As done in this year and subsequent years, OSBM will comply with the reporting requirements as requested.

In regards to the second issue, OSBM believes the Suspension of Funding List is useful as currently produced and complies with all statutory requirements. However, since the Auditor believes further clarification is needed, OSBM suggests adding clarifying language to the memorandum accompanying the list to identify which Federal programs are exempt from suspension.

To further clarify, the Administrative Code requires that all grant funds from all agency grant programs be suspended and that no agency enter into any new grant agreements with entities on the Suspension of Funding List. There are, however, certain federal programs that do not allow states to withhold grant funds. If a grantee fails to submit state reports for that program, the grantee must still appear on the Suspension of Funding List as payments from any other grant awarded to that grantee must be immediately suspended, and no agency can enter into a new agreements with that entity.

OSBM concurs with the third issue and has updated its internal procedures to require that granting agencies request placement on and removal from the manual suspension list via email to allow for a clear audit trail which validates changes to the list.

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