

# STATE OF NORTH CAROLINA

**NORTH CAROLINA RURAL ECONOMIC DEVELOPMENT CENTER, INC.**

**FINANCIAL RELATED AUDIT**

**STATE GRANT MANAGEMENT AND SUB-RECIPIENT MONITORING**

**JULY 2013**

**OFFICE OF THE STATE AUDITOR**

**BETH A. WOOD, CPA**

**STATE AUDITOR**

## **EXECUTIVE SUMMARY**

### **PURPOSE**

This audit report evaluates the North Carolina Rural Economic Development Center, Inc., (Rural Center) grant monitoring practices and evaluates how it managed administrative expenses charged to state grant funds.

### **BACKGROUND**

The Rural Center's mission is to develop, promote, and implement sound economic strategies to improve the quality of life of rural North Carolinians. The Rural Center serves North Carolina's 85 rural counties, with a special focus on individuals with low to moderate incomes and communities with limited resources.

### **KEY FINDINGS**

- Approximately \$20 million in interest earnings from undisbursed state funds is not available to the State.
- Job creation or other performance measures were not verified for at least five grants.
- Grant reporting requirements were not diligently enforced.
- Executive pay is not reasonable.

### **KEY RECOMMENDATIONS**

- The Rural Center and the Department of Commerce should request clarification from the General Assembly about the intended use of interest earnings from state funds.
- The Rural Center should independently verify all grantee provided information for accuracy and reliability.
- The Rural Center should notify grantees when they become noncompliant with grant contract terms, including reporting and performance requirements.
- The Rural Center should compensate its employees at a rate that is comparable to executives in similar positions at rural economic development agencies.

The key findings and recommendations in this summary are not inclusive of all the findings and recommendations in the report.





Beth A. Wood, CPA  
State Auditor

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## AUDITOR'S TRANSMITTAL

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July 17, 2013

The Honorable Pat McCrory, Governor  
The General Assembly of North Carolina  
Secretary Sharon Allred Decker, Department of Commerce  
Board of Directors, North Carolina Rural Economic Development Center, Inc.  
Billy Ray Hall, President, North Carolina Rural Economic Development Center, Inc.

This report presents the results of our financial related audit at the NC Rural Economic Development Center, Inc. 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 objective of our audit was to identify improvements needed in grant monitoring practices and management of state grant funds.

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.

*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 ways 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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## BACKGROUND

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As authorized by Article 5A of Chapter 147 of the North Carolina *General Statutes*, the Office of the State Auditor conducted a financial related audit at the N.C. Rural Economic Development Center, Inc. This audit was conducted as a result of the findings reported in the November 2012 audit titled *Department of Commerce – Fiscal Management Division, State Grant Funds Monitoring*.

That audit reported significant deficiencies in the Department of Commerce Fiscal Management Division's (Division) grant monitoring practices. For example, auditors noted the Division did not:

- Conduct continuous grantee risk assessments to identify, evaluate, and manage risks that may impact a grantee's ability to meet grant goals and objectives;
- Perform timely evaluations of grantees' achievement of grant objectives or performance of expected outcomes;
- Conduct on-site monitoring visits to verify whether grantees followed proper internal controls or to verify information provided by the grantees;
- Evaluate the monitoring procedures and activities of grantees that award state grant funds to other organizations (sub-recipients).
- Verify grantee expenditures reported by grantees for accuracy and reliability;
- Perform timely reviews of quarterly and annual reports submitted by grantees to determine if grant objectives are being met, if grant expenditures are reasonable, and if grantees are complying with all applicable laws, regulations, and contract terms.

Sufficient grant monitoring practices are necessary to ensure that grantees meet grant objectives and that grant expenditures are reasonable. Additionally, adequate grant monitoring practices reduce the risk that grant funds will not be used for their intended purposes.

Auditors selected the N.C. Rural Economic Development Center, Inc. (Rural Center), the Division's largest state grant recipient, to evaluate how state grant funds were managed by the Division.

The Rural Center was established in 1987 to address certain findings identified in a yearlong study conducted by the NC Commission on Jobs and Economic Growth. One finding identified a significant difference in economic prosperity between rural and urban North Carolina, with urban areas experiencing an economic boom while the rural economy remained stagnant or even declined.

The Rural Center's mission is to develop, promote, and implement sound economic strategies to improve the quality of life of rural North Carolinians. The Rural Center serves North Carolina's 85 rural counties, with a special focus on individuals with low to moderate incomes and communities with limited resources.

The Rural Center is required to monitor grant recipients in accordance with North Carolina *General Statute 143C-6-23*.

## **AUDIT SCOPE AND OBJECTIVES**

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The general objective of this financial related audit was to identify improvements needed in internal control over selected fiscal matters. 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. Errors or fraud may nevertheless occur and not be detected because of the inherent limitations of internal control. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or that compliance with policies and procedures may deteriorate. This audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

The audit scope covered the Rural Center's management of state grant funds disbursed during the period July 1, 2011, to June 30, 2012. Specifically, auditors evaluated the Rural Center's grant monitoring practices against state requirements and best practices. They also evaluated how the Rural Center managed reported administrative expenses charged to state grant funds.

The audit scope did not include an evaluation of the Rural Center's grant program effectiveness, nor did it include any verification of actual grant performance and identification of all possible conflict of interest arrangements.

The scope period included grant management and monitoring practices through January 31, 2013.



## METHODOLOGY

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To accomplish the audit objectives, auditors gained an understanding of internal control over matters described in the *Audit Scope and Objectives* section of this report and evaluated the design of the internal control. Auditors then performed further audit procedures consisting of tests of control effectiveness and substantive procedures that provide evidence about the audit objectives. Specifically, auditors interviewed personnel, observed operations, reviewed policies, analyzed grant monitoring records, and examined documentation supporting recorded transactions and balances, as considered necessary in the circumstances. Whenever sampling was used, auditors applied a non-statistical approach. As a result, the results cannot be projected to the population.

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

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.

## RESULTS AND CONCLUSIONS

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The results of the 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 Responses* section of this report. Management's responses are presented after each audit finding. Auditors did not audit the responses, and accordingly, express no opinion on them.

# AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES

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## 1. \$20 MILLION IN INTEREST EARNINGS NOT AVAILABLE TO THE STATE

The N.C. Rural Economic Development Center (Rural Center) earned approximately \$20 million in interest income from investing undisbursed state funds during the five-year period ending June 30, 2012. None of the interest earnings are available to the state.

State law required the Department of Commerce (Commerce) to distribute state grant funds long before those funds were needed to fund Rural Center grants. These early disbursements allowed the Rural Center to accumulate significant interest income while waiting for projects to be completed.

For example, the Rural Center received \$145.5 million in state funds in fiscal years 2008 and 2009 for the Clean Water Partners infrastructure program.<sup>1</sup> However, because the program funds multi-year projects, the Rural Center did not distribute these funds to its rural area grantees for several years. More than three years later at June 30, 2011, the Rural Center had not distributed approximately \$80.5 million (55.33%) of these funds. One year later at June 30, 2012, the Rural Center still had not distributed approximately \$55.9 million (38.39%) of these funds.

The Rural Center also received more than \$145.3 million in state funds for its Economic Infrastructure program since fiscal year 2005.<sup>3</sup> However, only \$86.9 million (59.83%) of these funds had been distributed as of June 30, 2012.

State law does not require the Rural Center to make the interest earned from investing state grants available to the State. This arrangement is in direct conflict with the objectives of the Statewide Cash Management Plan (Plan). The Plan tells state agencies that funds “deposited with the State Treasurer remain on deposit with the State Treasurer until final disbursement to the ultimate payee.”<sup>2</sup>

### **Rural Center Not Required to Pay the State Interest Earned on State Grant Funds**

The State Budget Act requires state agencies to give all interest earned from investing state funds to the State’s General Fund.<sup>3</sup> Additionally, the Plan requires state agencies to adopt cash management strategies “designed to maximize interest-bearing investment of cash.”<sup>4</sup>

Although the State Budget Act states that interest earned on all funds should be submitted to the State’s General Fund,<sup>5</sup> the Office of State Budget and Management believes this law only applies to funds deposited with the State Treasury. The Rural Center is not required to deposit its funds with the State Treasury and instead uses a private bank account.

Recent session laws did not dictate what the Rural Center should do with interest earned from investing state grant funds. Prior to fiscal year 2003, session laws allowed the Rural

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<sup>1</sup> The Clean Water Partners and Economic Infrastructure Programs fund multi-year projects to install and improve water and sewer infrastructure for rural areas of North Carolina.

<sup>2</sup> North Carolina *General Statute* 147-86.11

<sup>3</sup> North Carolina *General Statute* 143C-1-4a

<sup>4</sup> North Carolina *General Statute* 147-86.10

<sup>5</sup> North Carolina *General Statute* 143c-1-4a

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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Center to use up to 50% of interest earnings from state funds for administrative expenses, though it did not provide any direction about how the remaining interest income should be treated. Since fiscal year 2003, the law has been silent on what the Rural Center should do with interest income generated from investing state grant funds.

The Rural Center stated it uses the interest earnings to fund such things as program operations, executive salaries, and other administrative costs (See Finding 3).

### **Cash Management Best Practices are Interest Neutral**

The State could benefit by following the interest neutral federal cash management best practices.

Federal best practices for cash management do not allow states to receive federal funds before they are needed and keep any interest income earned from investing those federal funds. In fact, the Joint State/Federal Cash Management Reform Task Force was created in 1983 to specifically address this issue.

The Task Force's first objective was to endorse an overall concept of "no winners or losers during funds exchange for joint state/federal programs."<sup>6</sup>

In other words, fund exchanges from the federal to state governments should be interest neutral. The federal government should not forfeit an opportunity to generate interest earnings from its own money, and states should not be allowed to keep interest income earned from investing idle federal funds.

To achieve this goal, the federal government implemented the Cash Management Improvement Act of 1990 (CMIA).<sup>7</sup> The CMIA includes several requirements for States receiving federal funds. For example, states receiving federal funding for programs must:

- Minimize the amount of time between when the state receives federal funding and ultimately distributes those funds for program purposes;<sup>8</sup>
- Only draw-down the minimum amount of federal funding required to meet the state's actual and immediate cash needs;<sup>9</sup>
- Pay the United States any interest earned on investing federal funds.<sup>10</sup>

However, with regards to transactions with nonprofit entities, the State does not generally follow cash management best practices such as those followed by the federal

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<sup>6</sup> "Background and History of CMIA," United States Department of the Treasury- Financial Management Service website <http://www.fms.treas.gov/cmia/background.html>

<sup>7</sup> Code of Federal Regulations Title 31 – Money and Finance: Treasury, Part 205 – Rules and Procedures for Efficient Federal-State Funds Transfers

<sup>8</sup> 31 CFR 205.11(a)

<sup>9</sup> 31 CFR 205.11(b)

<sup>10</sup> 31 CFR 205.15

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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government. Federal cash management practices prevent states from obtaining federal funds before they are needed and earning interest on those funds. State cash management practices allow nonprofit entities to obtain state funds before they are needed and earn interest on those funds.

### ***Recommendation:***

The Rural Center and Commerce should request clarification from the General Assembly about the intended use of interest earnings from all funds.

The General Assembly should consider changing the cash management requirements in the State Budget Act to reflect the objectives of the Statewide Cash Management Plan.

### ***Agency Response:***

We do agree that expectations for use of these earnings should be made clear by the General Assembly. Following enactment of the State Appropriations Act for 2014, the center will request written clarification from the Fiscal Research Division of the General Assembly regarding use of interest earned on funds appropriated under this act from the time those funds are received until they are expended. The center will then work with the Department of Commerce to develop language that reflects the General Assembly's intended usage of these earnings for inclusion in the contract executed for the center's 2014 funding. The President and Vice President of Finance and Administration will be responsible for taking these actions.

## **2. INADEQUATE GRANTEE MONITORING**

The N.C. Rural Economic Development Center (Rural Center) did not adequately monitor grants to ensure that grantees were meeting grant objectives and that grant expenditures were reasonable. Specifically, the Rural Center did not:

- Verify grant performance information reported by grantees;
- Take timely and appropriate action against grantees that did not comply with grant reporting requirements;
- Sufficiently document grantee risk assessments.

As a result, there is an increased risk that more than \$58.8 million in grant funds spent in fiscal year 2012 were not used for their intended purpose.

### **Grant Performance Information Not Verified**

The Rural Center did not perform adequate grant performance evaluations. Specifically, the Rural Center did not verify grant performance information submitted by grantees.

During a review of 48 grant monitoring files, auditors identified five (13.16%) out of 38 instances where the Rural Center did not independently verify the performance information

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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reported by grantees.<sup>11</sup> For example, as of the date of our review, the Rural Center had not verified;

- The creation of 100 jobs in the City of Marion as required by an \$882,808 grant award. The grant period terminated almost 18 months ago on October 31, 2011;
- The creation of 82 jobs in Halifax County as required in the \$814,000 grant award. The grant period terminated more than seven months earlier;
- The number of jobs created in Harnett County in exchange for a \$1 million grant award. The grant period terminated more than five months earlier.

The National State Auditors Association states that awarding agencies should review and verify the data submitted for accuracy and reliability, and document the verification work done and its results.<sup>12</sup> Doing so ensures grant objectives are met and that tax dollars are being spent wisely and achieving the desired results.

### **Timely Action Not Taken for Grantee Noncompliance**

The Rural Center did not take timely and appropriate action against grantees that did not comply with the progress and final reporting requirements of the grant agreements despite having grant agreements that allowed several actions if the grantee did not comply with grant contract terms.

In the grant monitoring file review noted above, auditors identified 28 grantees (58.33%) that had not submitted all progress and final reports to the Rural Center in a timely manner. Of those 28 grantees not meeting all reporting requirements:

- No grantee (0%) was given written notice indicating it was out of compliance;
- No grantee (0%) was required to return grant funds to the Rural Center;
- Four grantees (14.29%) continued to receive grant payments, even though they had not submitted required progress and final reports;
- Eight grantees (28.57%) did not have timely executed contract amendments to change the terms of the grant.

The Rural Center should take timely and appropriate actions against grantees that are not in compliance with grant contract requirements for two reasons: 1) best practices suggest it, and 2) the NC Administrative Code requires it.

First, the National State Auditor's Association (NSAA) states that an effective grant monitoring process includes notifying the grantee when it is not in compliance or has not

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<sup>11</sup> Ten of the grants were open. Verification of job creation is not performed until the end of the grant.

<sup>12</sup> "Best Practices in Carrying Out State Economic Development Efforts – A National State Auditors Association Best Practices Document." National State Auditors Association. 2004. Page 5.

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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achieved the intended grant results. The awarding agency should take appropriate steps to ensure the grantee understands what is expected and when.<sup>13</sup>

The NSAA also states that an agency should take timely and appropriate actions against grantees that fail to meet grant requirements, including:

- Changing the terms of the grant agreement;
- Withholding additional payments until the grantee has met certain requirements or achieved certain goals;
- Recouping grant payments that have been distributed.<sup>14</sup>

Second, the NC Administrative Code<sup>15</sup> requires any agency that receives or disburses state funds to hold grantees accountable for how those funds are spent. Granting agencies are required to monitor grantee compliance with all terms of a contract. Upon determination of noncompliance, the granting agency must give grantees 60 days written notice to come into compliance. After the 60-day period, the granting agency shall:

- Terminate the contract and take action to retrieve unexpended funds or unauthorized expenditures;
- Suspend payments pending negotiation of a plan of corrective action; or
- Offset future payments with the amount improperly spent.

### **Insufficient Documentation of Grantee Risk Assessments**

The Rural Center did not sufficiently document how it identified, evaluated, and managed risks that could impact a grantee's ability to meet the goals and objectives set by grant awards. Without a documented risk assessment, the Rural Center can only provide limited assurance that its sub-recipient grantees are receiving the appropriate level of monitoring.

During the grant monitoring file review described above, auditors noted:

- 30 grantees (62.5%) did not have a documented risk assessment;
- 10 grantees' (20.8%) most recent documented risk assessment was in 2009, more than four years ago;
- 1 grantee's (2.08%) most recent documented risk assessment was in 2003, more than 10 years ago.

Federal guidance identifies risk assessments as tools for developing effective monitoring plans. The federal Office of Management and Budget states that management should identify risks that could prevent agencies from meeting its goals and objectives and analyze

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<sup>13</sup> "Best Practices in Carrying Out State Economic Development Efforts – A National State Auditors Association Best Practices Document." National State Auditors Association. 2004. Page 5.

<sup>14</sup> "Best Practices in Carrying Out State Economic Development Efforts – A National State Auditors Association Best Practices Document." National State Auditors Association. 2004. Pages 5-6.

<sup>15</sup> The grant contract between the Rural Center and the Department of Commerce requires the Rural Center to comply with Title 09, Section 03M of the NC Administrative Code.

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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those risks for their potential effector impact on the agency.<sup>16</sup> The Office of the Inspector General of the US Department of Justice suggests that granting agencies have an effective risk assessment model in order to provide proper monitoring of grantees.<sup>17</sup>

### **Rural Center Said It Lacks Grant Monitoring Resources**

The Rural Center stated it did not adequately monitor grants because it did not have sufficient personnel and lacked the money to hire additional monitors.

The Rural Center stated that it views its grantees as partners in a collaborative effort to improve economic development outcomes and quality of life in rural communities across the State. In doing so, the Rural Center tries to work with grantees instead of enforcing grant conditions and terms.

### **Inadequate Monitoring Resulted In Limited Accountability**

The Rural Center's failure to adequately apply monitoring procedures resulted in an inability to hold its sub-recipient grantees accountable for how taxpayer dollars were spent. There is an increased risk that more than \$58.8 million in grant funds spent in fiscal year 2012 were not used for their intended purpose.

#### ***Recommendation:***

The Rural Center should document and enforce policies and procedures to independently verify all grantee provided information for accuracy and reliability.

The Rural Center should notify grantees in a timely manner when they become noncompliant with grant contract terms, including reporting and performance requirements.

The Rural Center should exercise penalty provisions, such as withholding future disbursement and recouping already disbursed funds, when grantees are noncompliant with grant contract terms.

The Rural Center should document and enforce policies and procedures to perform and document continuous grantee risk assessments.

***Auditor Response:*** See Appendix

***Agency Response:*** See Appendix

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<sup>16</sup> Executive Office of the President, Office of Management and "Budget, "OMB Circular A-123, Management's Responsibility for Internal Control." Page 7. Revised December 21, 2004.

<sup>17</sup> United States Department of Justice, Office of the Inspector General, "Improving the Grant Management Process," Page 4. February 2009.



## AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES

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### 3. ADMINISTRATIVE EXPENDITURES NOT IN COMPLIANCE WITH GRANT CONTRACT

The N.C. Rural Economic Development Center (Rural Center) charged unallowable expenses, such as salary and other administrative expenses, to the State in violation of its grant agreement with the Department of Commerce (Commerce). As a result, Commerce could require the Rural Center to repay any state funds that were used for these questioned costs.

#### **Executive Compensation is Not Reasonable**

The Rural Center charged executive compensation to the grant that was not reasonable when compared to salaries paid for similar positions at other rural development agencies in North Carolina, or even the United States. In fact, salaries paid to the Rural Center's president and vice-presidents were significantly higher than salaries paid for similar positions in local and national labor markets.

For example, the Rural Center president was paid \$221,070 per year for an annual salary and car allowance during fiscal year 2012.<sup>18</sup> This is \$96,394 (77.31%) more than the Secretary of Commerce, whose agency provided the primary funding for the Rural Center. Based on the findings of a national nonprofit compensation report,<sup>19</sup> the Rural Center president was paid \$72,909 more (49.21%) than economic development CEOs and Executive Directors in North Carolina. Furthermore, when compared to the highest national average compensation in the United States, the Rural Center president was paid \$49,025 more (28.50%) than other CEOs of rural development nonprofit entities.<sup>20</sup>

Additionally, salaries paid to the Rural Center's vice-presidents' ranged from \$120,000 to \$130,000. These salaries were more than \$20,000 higher (20%) than comparable salaries for similar positions in the Southeast region of the United States with similar sized budgets.

Terms of the state grant agreement between the Rural Center and Commerce state that only reasonable compensation costs can be charged to the grant.<sup>21</sup> Reasonable compensation costs are defined in the grant contract as being "comparable to that paid for similar work in the labor markets in which the organization competes for the kind of employees involved."<sup>22</sup>

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<sup>18</sup> This salary listed does not include annual severance pay awards that the Rural Center has placed into an account for the president since 2003. Annual severance pay awards ranged from \$10,000 to \$40,000. The account balance was \$241,856 as of June 30, 2012. This salary listed also excludes retirement plan contributions. The Rural Center's contribution to the president's retirement plan during fiscal year 2012 equaled \$24,319. Auditors excluded these amounts from the salary comparison with other economic development directors because auditors could not determine the amounts of similar payments that other directors may have received.

<sup>19</sup> "GuideStar Compensation Report, 11<sup>th</sup> Edition – September 2011." Compensation for NC Community Improvement, Capacity Building: Economic Development CEO/Executive Directors 75<sup>th</sup> Percentile. Page 216.

<sup>20</sup> "GuideStar Compensation Report, 11<sup>th</sup> Edition – September 2011." Compensation by NTEE Centile Group for Community Improvement, Capacity Building: Rural Development Average. Page 72.

<sup>21</sup> The grant contract between the Rural Center and the Department of Commerce requires the Rural Center to comply with the Cost Principles for Non-Profit Organizations as prescribed in the Office of Management and Budget Circular No. A-122.

<sup>22</sup> Office of Management and Budget Circular No. A-122, Attachment B, Paragraph 8.c.(2). Revised May 10, 2004.

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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The unreasonable executive compensation may have resulted from a flawed analysis of a compensation study used to identify compensation for nonprofit executives. The Board of Directors approved the president's salary based on an analysis performed by the Rural Center's staff and external auditors to identify comparable CEO compensation.

However, the research included compensation for all nonprofit organizations, regardless of the industry and the organization's source of funding. The Office of the State Auditor's compensation comparison was restricted to executives of rural economic development agencies in North Carolina and the United States.

### **Anniversary Luncheon Costs are Not Allowed**

The Rural Center charged \$7,025 in food and entertainment costs for its 25<sup>th</sup> Anniversary Luncheon social to the state grant. Expenditures included specialized pens, a professional photographer, flowers, and a catered lunch for employees, past and present board members, and other invited guests.

The Rural Center cannot charge food and entertainment costs to the state grant. The grant requires the Rural Center to comply with the federal cost principles found in the federal Office of Management Budget circular A-122. Those cost principles state,

“Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable.”<sup>23</sup>

Consequently, the Rural Center was not allowed to charge the anniversary luncheon costs to the grant.

### **State Can Require Repayment of Questioned Costs**

Commerce can require the Rural Center to repay any questioned costs charged to the state or federal pass-through grants.

However, the Rural Center said it used other funds to cover its administration costs. The Rural Center stated that about \$1.3 million in state grant funds were used to fund approximately \$2.3 million in “Center Administration, Technical Assistance, and Oversight Costs” charged to the state grant.

Unaudited information provided by the Rural Center indicated all but about \$81,000 (4%) of revenues used to fund its administration costs were derived directly or indirectly from State and federal sources. Specifically:

- About \$1.4 million (60%) was direct appropriations from the State;
- About \$540,000 (23%) was from interest earned by investing undisbursed grant funds (See Finding 1);
- About \$300,000 (13%) was administrative funding from the federal government.

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<sup>23</sup> Office of Management and Budget Circular No. A-122, Attachment B, Paragraph 14. Revised May 10, 2004.

## **AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES**

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In contrast, the Rural Center's audited June 30, 2012, financial statements state that all of the \$2.3 million expenditures for the "Center Administration, Technical Assistance and Oversight" account were charged to the direct award received from Commerce.

To avoid subsequent challenges of allowable and unallowable costs, federal guidance suggests nonprofit entities obtain a written agreement from the awarding agency before incurring any special or unusual costs.<sup>24</sup>

***Recommendation:***

The Rural Center should compensate its employees at a rate that is comparable to executives in similar positions at rural economic development agencies.

The Rural Center should obtain written approval from Commerce of the reasonableness of compensation paid to Rural Center executives.

The Rural Center should develop policies and procedures that ensure that all state funds are expended for reasonable and necessary costs for the performance of grant awards.

***Auditor Response:*** See Appendix

***Agency Response:*** See Appendix

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<sup>24</sup> Office of Management and Budget Circular No. A-122, Attachment A, Paragraph A.6. Revised May 10, 2004.

## APPENDIX

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### **Auditor's Response**

We are required to provide additional explanation when an agency's response could potentially cloud an issue, mislead the reader, or inappropriately minimize the importance of our findings.

Generally Accepted Government Auditing Standards state,

When the audited entity's comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditor's recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement.

To ensure the availability of complete and accurate information and in accordance with Generally Accepted Government Auditing Standards, we offer the following clarifications.

#### **Verification of Grant Performance Information**

The Rural Center's response misleads the reader into believing the Rural Center independently verified that job creation requirements had been met during the audit period for two grantees identified in the report.

The Rural Center did not.

As noted in the report, as of the date of our review, the Rural Center had not verified grant performance information for five (13.16%) out of 38 grantees whose contracts had been terminated for six to 18 months.

After our review, the Rural Center told auditors it had subsequently verified job creation information for two of those five grantees. However, auditors did not review those verifications and, therefore, make no comment on them.

Additionally, the Rural Center's response misleads the reader into believing no grant performance verification was due for the third grantee identified in the audit.

The Rural Center is incorrect.

As noted in the report, the Rural Center negotiated contract terms stating the grantee must submit a final report by October 31, 2012. As of the date of our review in February 2013, four months after the final report was due, the grantee still had not submitted the final report.

#### **No Grant Payments Without Current Progress Reports**

The Rural Center's response misleads the reader into believing the Rural Center ensured that grantee reporting requirements were met before any grant funds were distributed to grantees.

## APPENDIX

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The Rural Center did not.

As noted in the report, auditors identified four (14.29%) instances where grantees continued to receive grant payments without having a current progress or final report on file with the Rural Center.

### **Adequacy of Risk Assessments**

The Rural Center's response misleads the reader into believing the Rural Center is able to determine if adequate grantee risk assessments were performed.

The Rural Center cannot.

As noted in both the report and in the Rural Center's response, the Rural Center did not document how it identified, evaluated, and managed risks that could impact a grantee's ability to meet the goals and objectives set by grant awards. The only reliance Rural Center management has that risk assessments were performed is the word of its grant monitors.

### **Evaluation of Comparable Executive Compensation**

The Rural Center's response misleads the reader into believing it compared the president's salary to the salary paid to executives at other non-profits performing similar types and scope of work as the Rural Center.

The Rural Center did not.

The salary comparison the Rural Center used included organizations that do business in foreign countries and across state lines. However, the Rural Center's customer base is limited to the 85 counties identified as rural areas in North Carolina.

The salary comparison the Rural Center used included organizations that receive private funding from donations, investors, and business-type activities. In contrast, the Rural Center receives approximately 80% - 85% of its funding from state appropriations.

The salary comparison the Rural Center used included salaries paid by organizations in areas like Washington, DC and New York, NY where the cost of living exceeds the Raleigh, NC area by 40% - 60%.

### **Response Does Not Adequately Address the Auditor's Recommendations**

The Rural Center's response did not adequately address the recommendations and audit findings that the Rural Center charged unallowable expenses to the State in violation of its grant agreement with Department of Commerce. Specifically, the Rural Center's response did not indicate if it agreed or disagreed with the findings and recommendations.

Additionally, the response did not include a corrective action plan to explain how the Rural Center would prevent the future use of any state grant funds towards unreasonable and/or

## APPENDIX

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unnecessary expenses. Instead, the Rural Center comments suggest it will keep doing what it has been doing.

### **Using Non-state Revenue to pay for Disallowed Costs**

The Rural Center's response misleads the reader into believing it had "demonstrated that revenue from non-state sources were available and were used to fund at least 40% of "Center Administration, Technical Assistance, and Oversight Costs."

The Rural Center did not.

As noted in the report, unaudited information provided by the Rural Center indicated that 4% of the Rural Center's revenue came directly from non-governmental sources. All other revenue resources came directly from the federal government for administrative funding (13%), direct appropriations from the State (60%), and indirect state funding from interest earned on invested state grant funds (23%).

The Rural Center considers the \$20 million in interest it earned over the last five years from investing state grant funds is non-state revenue. As such, the Rural Center used these earnings to fund unreasonable or unnecessary costs identified in this report. The amount of non-state revenue available to the Rural Center is dependent upon clarification from the General Assembly on the intended use of interest earned from investing state grant funds.

The Governor, Legislators, and the citizens of North Carolina should consider the clarification provided above when using this report to evaluate Rural Center's operation and holding government managers accountable for their programs.

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Valeria L. Lee  
Chair

Billy Ray Hall  
President

July 12, 2013

The Honorable Beth A. Wood, State Auditor  
Office of the State Auditor  
2 South Salisbury Street  
20601 Mail Service Center  
Raleigh, North Carolina 27699-0601

Dear Ms. Wood:

We appreciate the professionalism shown by the staff of the State Auditor's Office during this audit of the center's grant monitoring practices and its management of administrative expenses. The center has a proud twenty-six year history of serving the rural people and communities of North Carolina while maintaining the highest degree of ethical and fiscal integrity. We welcome the opportunity to examine and improve our operating policies and procedures to ensure that we continue to perform in accordance with the highest standards.

**Interest Earnings**

The center has consistently invested state funds in a fiscally responsible manner and has applied the earnings to a range of uses to serve rural communities. Earnings from funding appropriated in 2008 and 2009 for the Clean Water Partners grant program, \$10.2 million of the \$20.0 million cited, have been segregated and retained for use in administering those grant funds and supporting cost overruns associated with these clean water projects. Other earnings from undisbursed portions of recurring appropriations have been used to operate mandated programs not fully funded by administrative appropriations, conduct research into issues impacting the ability of rural residents to share in the state's prosperity, provide leadership training to prepare local leaders to manage economic change and provide critical technical assistance to rural communities.

We do agree that expectations for use of these earnings should be made clear by the General Assembly. Following enactment of the State Appropriations Act for 2014, the center will request written clarification from the Fiscal Research Division of the General Assembly regarding use of interest earned on funds appropriated under this act from the time those funds are received until they are expended. The center will then work with the Department of Commerce to develop language that reflects the General Assembly's intended usage of these earnings for inclusion in the contract executed for

North Carolina

Rural Economic

Development Center, Inc.

4021 Carya Drive

Raleigh, NC 27610

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the center's 2014 funding. The President and Vice President of Finance and Administration will be responsible for taking these actions.

## **Grantee Monitoring**

### **Performance Verification**

The center's current policies do require collection of data to support grantee claims that grant performance measures required in job generating programs have been met. Information to support these claims is routinely obtained and evaluated. Some variation, however, has been allowed in which forms are acceptable and what constitutes independent verification.

The time period for verification of jobs begins when those jobs are created following the completion of construction and ends when those jobs have been in existence for the prescribed period of time. It is the center's intent to maintain a contractual relationship with each grantee following completion of construction until all job creation requirements have been met. In two of the examples given as instances where the center did not independently verify performance, the center had verified the required job creation, but did not obtain documentation supporting that verification during the contract period. In the third example, infrastructure construction was complete, but the contract term had lapsed as of the audit date, even though the time horizon for creating the required jobs remains open.

### **Grantee Noncompliance**

For each grant award, the center enters into a performance contract that requires the grantee to submit progress and final reports in accordance with a prescribed schedule. The center has not been able to devote the resources required to issue written notices for each instance of noncompliance with a reporting requirement and instead focused staff priority on ensuring that a current progress report has been received before each disbursement of grant funds. Many of the local governments and other organizations the center work with are challenged by limited staff capacity, and the center tries to work with these organizations toward improving their ability to comply with grant terms without penalizing them unduly.

### **Grantee Risk Assessments**

When reviewing and making grant awards and administering those awards, center staff continually assess the risk that a grantee may fail to comply with grant requirements or that the grant activities may not result in the desired outcome. Factors considered during the assessments include the size and type of grant, the amount of oversight provided by other entities, past history with a grantee, the type of expenditures involved and grantee capacity. While those risks are assessed continually by center staff during the term of each grant and monitoring levels are adjusted in response, these activities have not been documented in a consistent manner.

### **Grants Management and Monitoring Plan**

The center has a written Grants Management and Monitoring Plan that prescribes a general framework of policies and procedures governing grant program design, application review and approval, grants

management and grants monitoring. This framework reflects the center's interpretation of all available state guidance for administration of state grant funds. Significant work has been done during the development of this plan to document grants management processes and to develop specific tools for use in evaluating inherent risk, but work remains to be done to formally document all of the specific policies the center employs to monitor grantee performance. Additional work will also be done to incorporate best practices in grants monitoring that are not prescribed by the state, but have been used during this audit to evaluate the center's performance. The center is working to complete this documentation and fully implement the completed plan by January 1, 2014. When completed, this plan will incorporate all grantee monitoring recommendations included in this report.

Specifically, the center will incorporate written policies providing the following:

- Definition of acceptable forms of documentation to support job creation and specific procedures for verifying such documentation
- Required methods and timelines for notifying grantees when they become noncompliant with grant terms, and specific requirements for imposing available penalties in the event of noncompliance
- Specific guidelines for the use of the center's risk assessment tools

Finalization of this plan will involve the participation of each of the center vice presidents as well as all grants management and monitoring staff. The Vice President of Finance and Administration will be responsible for completing this plan under the supervision of the center's President. The plan will be submitted to the Board of Directors for final approval.

### **Administrative Procedures**

#### **Executive Compensation**

Compensation paid to the center president and vice presidents is evaluated annually. Compensation levels are compared to results from a national nonprofit compensation report, giving consideration to the type and scope of work undertaken by comparable organizations. Compensation levels are then further evaluated in light of educational attainment and work experience, and the costs to acquire similar personnel in the markets where the center would compete for talent.

The center will continue to perform an annual evaluation of its methodology for determining the reasonableness of compensation for its management employees and will formally document its assumptions and conclusions. Following review and evaluation of this information, the Compensation Committee will recommend the President's annual compensation package to the Board of Directors for final approval. Following enactment of the State Appropriations Act for 2014, the center will work with the Department of Commerce to determine an approved amount of management employee salary cost to be charged to the contract executed for the center's 2014 funding. Effective July 1, 2012 state law prohibits the center from charging more than \$120,000 of the salary for any individual to State funds.

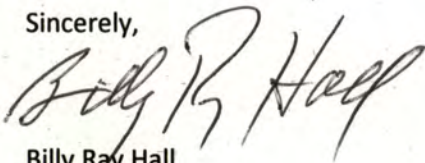
The center has complied and will continue to comply with that provision. The President and Vice President of Finance and Administration will be responsible for implementation of these actions.

### **Anniversary Luncheon**

It was the intent of the center that costs for its 25<sup>th</sup> Anniversary Luncheon be paid with non-state funding sources. The center has demonstrated that revenue from non-state sources were available and were used to fund at least 40% of "Center Administration, Technical Assistance, and Oversight Costs." The expenses in question were reported in this expense category.

Effective with financial statements prepared for the year ended June 30, 2013, modifications have been made in accounting procedures which allow for segregation of any unallowable costs and ensure that any such costs are charged to appropriate funding sources. The President and Vice President of Finance and Administration will be responsible for implementation of these actions.

Sincerely,

A handwritten signature in cursive script that reads "Billy Ray Hall". The signature is written in black ink and is positioned to the right of the word "Sincerely,".

Billy Ray Hall  
President

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## ORDERING INFORMATION

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Copies of this report may be obtained by contacting the:

Office of the State Auditor  
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Telephone: 919-807-7500

Facsimile: 919-807-7647

Internet: <http://www.ncauditor.net>

To report alleged incidents of fraud, waste or abuse in state government contact the:

Office of the State Auditor Fraud Hotline: 1-800-730-8477

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For additional information contact:

Bill Holmes  
Director of External Affairs  
919-807-7513

This audit required 1,915 audit hours at a cost of \$122,675.