



John Keel, CPA
State Auditor

A Report on

**State of Texas Compliance with
Federal Requirements for the
Capitalization Grants for Drinking
Water State Revolving Funds
Program for the Fiscal Year
Ended August 31, 2010**

February 2011

Report No. 11-024



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SAO Report No. 11-024
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Overall Conclusion

The State of Texas complied in all material respects with the federal requirements for the Capitalization Grants for Drinking Water State Revolving Funds Program (Drinking Water Program) in fiscal year 2010.

As a condition of receiving federal funding, U.S. Office of Management and Budget (OMB) Circular A-133 requires non-federal entities that expend at least \$500,000 in federal awards in a fiscal year to obtain annual audits. Those audits test compliance with federal requirements in 14 areas, such as allowable costs, cash management, and monitoring of non-state entities when the State passes federal funds through to those entities (subrecipients). In addition, each program may outline special tests specific to the program that auditors are required to perform. The Single Audit for the State of Texas included (1) all high-risk federal programs for which the State expended more than \$85,612,909 in federal funds during fiscal year 2010 and (2) other selected federal programs.

From September 1, 2009, through August 31, 2010, the State of Texas expended \$56.9 billion in federal funds for federal programs and clusters of programs. The State Auditor's Office audited compliance with requirements for the Drinking Water Program at the Water Development Board (Board), which spent \$101,814,422 in federal Drinking Water Program funds during fiscal year 2010.

The Capitalization Grants for Drinking Water State Revolving Funds Program

The Capitalization Grants for Drinking Water State Revolving Funds Program (Drinking Water Program) provides states with a long-term source of financing to cover the costs of drinking water infrastructure.

The U.S. Environmental Protection Agency provides funding to the Water Development Board (Board), which then provides loans or grants to local entities to finance drinking water infrastructure development projects. Repayments on those loans are made to the Drinking Water State Revolving Fund to finance additional projects.

This audit was conducted in accordance with Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133.

For more information regarding this report, please contact James Timberlake, Audit Manager, or John Keel, State Auditor, at (512) 936-9500.

Auditors identified no material findings and two findings classified as significant deficiencies and non-compliance for the Drinking Water Program (see text box for definitions of finding classifications).

Key Points

The Board complied with federal requirements for most areas tested.

For most areas tested, the Board complied with OMB Circular A-133 requirements. While auditors identified some issues, the Board materially complied with all requirements tested.

The Board did not always correctly report information regarding American Recovery and Reinvestment Act (Recovery Act) funds that it spent during fiscal year 2010.

Due to the lack of a review process, the Board underreported its Recovery Act expenditures for the quarter ending June 30, 2010, by \$624,493.

The Board did not always ensure that its subrecipients, or non-state entities to which it passed federal funds, complied with federal requirements.

The Board did not verify that 6 (24 percent) of 25 subrecipients tested that had received Recovery Act funds had registered with the Central Contractor Registration (CCR) as required. The CCR is the primary vendor database for the federal government.

The Board also did not ensure that 2 (12 percent) of 17 subrecipients tested had complied with requirements to obtain an OMB Circular A-133 audit or certify that an audit was not required.

Auditors followed-up on two findings at the Board from the prior fiscal year related to the Capitalization Grants for Clean Water State Revolving Funds Program. The Board fully implemented the recommendations for both findings.

Summary of Management's Response

Management generally concurred with the audit findings. Specific management responses and corrective action plans are presented immediately following each finding in this report.

Finding Classifications

Control weaknesses are classified as either significant deficiencies or material weaknesses:

- A **significant deficiency** indicates that control weaknesses existed, but those weaknesses would not likely result in material non-compliance with the compliance area.
- A **material weakness** indicates that significant control weaknesses were identified that could potentially result in material non-compliance with the compliance area.

Similarly, compliance findings are classified as either non-compliance or material non-compliance, where material non-compliance indicates a more serious reportable issue.

Summary of Information Technology Review

The audit work included a review of general and application controls for key information technology systems related to the Drinking Water Program at the Board. Auditors did not identify any reportable control weaknesses related to the information technology systems reviewed.

Summary of Objectives, Scope, and Methodology

With respect to the Drinking Water Program, the objectives of this audit were to (1) obtain an understanding of internal controls, assess control risk, and perform tests of controls unless the controls were deemed to be ineffective and (2) provide an opinion on whether the State complied with the provisions of laws, regulations, and contracts or grants that have a direct and material effect on the Drinking Water Program.

The audit scope covered federal funds the State spent for the Drinking Water Program from September 1, 2009, through August 31, 2010. Audit work included control and compliance work at the Board.

The audit methodology included developing an understanding of controls over each compliance area that was material to the Drinking Water Program. Auditors conducted tests of compliance and of the controls identified for each compliance area and performed analytical procedures when appropriate.

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Independent Auditor's Report

*State of Texas Compliance with
Federal Requirements for the
Capitalization Grants for Drinking
Water State Revolving Funds Program
for the Fiscal Year Ended
August 31, 2010*

Report on Compliance with Requirements that Could Have a Direct and Material Effect on the Capitalization Grants for Drinking Water State Revolving Funds Program and on Internal Control Over Compliance in Accordance with U.S. Office of Management and Budget Circular A-133

Compliance

We have audited the State of Texas's (State) compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that could have a direct and material effect on the Capitalization Grants for Drinking Water State Revolving Funds program for the year ended August 31, 2010. Compliance with the requirements of laws, regulations, contracts, and grants applicable to the Capitalization Grants for Drinking Water State Revolving Funds program is the responsibility of the State's management. Our responsibility is to express an opinion on the State's compliance based on our audit.

Except as discussed in the following paragraph, 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 the Capitalization Grants for Drinking Water State Revolving Funds program occurred. An audit includes examining, on a test basis, evidence about the State's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the State's compliance with those requirements.

This audit was conducted as part of the State of Texas Statewide A-133 Audit for the year ended August 31, 2010. As such, the Capitalization Grants for Drinking Water State Revolving Funds program was selected as a major program based on the State of Texas as a whole for the year ended August 31, 2010. The State does not meet the OMB Circular A-133 requirements for a program-specific audit and the presentation of the Schedule of Program Expenditures does not conform to the OMB Circular A-133 Schedule of Expenditures of Federal Awards. However, this audit was designed to be relied on for the State of Texas opinion on federal compliance, and in our judgment, the audit and this report satisfy the intent of those requirements. In addition, we have chosen not to comply with a reporting standard that specifies the wording that should be used in discussing restrictions on the use of this report. We believe that this wording is not in alignment with our role as a legislative audit function.

In our opinion, the State complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on the Capitalization Grants for Drinking Water State Revolving Funds program for the year ended August 31, 2010. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying Schedule of Findings and Questioned Costs as items:

Agency	Cluster or Program	Compliance Requirement	Finding Number
Water Development Board	CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA	Reporting	11-192
Water Development Board	CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA	Subrecipient Monitoring	11-193

Internal Control Over Compliance

The management of the State is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to the Capitalization Grants for Drinking Water State Revolving Funds program. In planning and performing our audit, we considered the State's internal control over compliance with requirements that could have a direct and material effect on the Capitalization Grants for Drinking Water State Revolving Funds program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the State's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control 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.

Our consideration of 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 the State’s internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies. 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. We consider the following deficiencies in internal control over compliance which are described in the accompanying Schedule of Findings and Questioned Costs to be significant deficiencies:

Agency	Cluster or Program	Compliance Requirement	Finding Number
Water Development Board	CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA	Reporting	11-192
Water Development Board	CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA	Subrecipient Monitoring	11-193

Schedule of Program Expenditures

The accompanying Schedule of Program Expenditures for the Capitalization Grants for Drinking Water State Revolving Funds program (Schedule) of the State for the year ended August 31, 2010, is presented for purposes of additional analysis. This information is the responsibility of the State’s management and has been subjected only to limited auditing procedures and, accordingly, we express no opinion on it. However, we have audited the Statewide Schedule of Expenditures of Federal Awards in a separate audit, and the opinion on the Statewide Schedule of Expenditures of Federal Awards is included in the *State of Texas Federal Portion of the Statewide Single Audit Report for the Fiscal Year Ended August 31, 2010*.

The State’s responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs. We did not audit the State’s responses and, accordingly, we express no opinion on the responses.

This report is intended for the information and use of the Governor, the Members of the Texas Legislature, the Legislative Audit Committee, the management of the State, KPMG LLP, federal awarding agencies, and pass-through entities. However, this report is a matter of public record, and its distribution is not limited.

John Keel, CPA
State Auditor

February 18, 2011

Schedule of Program Expenditures for the
 Capitalization Grants for Drinking Water State Revolving Funds Program
 for the State of Texas
 For the Year Ended August 31, 2010

Schedule of Program Expenditures			
Agency	Pass-through to Non-state Entities	Direct Expenditures	Total
Water Development Board			
Other than American Recovery and Reinvestment Act	\$46,587,221	\$4,322,297	\$ 50,909,518
American Recovery and Reinvestment Act	49,109,012	1,795,892	50,904,904
Total Audited Capitalization Grants for Drinking Water State Revolving Funds Program	\$95,696,233	\$6,118,189	\$101,814,422
Note: Federal expenditures for the Capitalization Grants for Drinking Water State Revolving Funds program at state entities not included in the scope of this audit totaled \$10,710,587 for the year ended August 31, 2010.			

Schedule of Findings and Questioned Costs

*State of Texas Compliance with Federal
Requirements for the Capitalization Grants for
Drinking Water State Revolving Funds Program
for the Fiscal Year Ended August 31, 2010*

Summary of Auditors' Results

Financial Statements

Issued under separate cover. See State Auditor's Office report entitled *State of Texas Financial Portion of the Statewide Single Audit Report for the Fiscal Year Ended August 31, 2010*.

Federal Awards

Internal Control over major programs:

Material weakness(es) identified? No

Significant deficiency(ies) identified? Yes

Type of auditor's report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with Section 510(a) of OMB Circular A-133? Yes

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program or Cluster</u>
66.468	Capitalization Grants for Drinking Water State Revolving Funds (with ARRA)

Dollar threshold used to distinguish between type A and type B programs: \$85,612,909

Auditee qualified as low-risk auditee? No

Section 2:

Financial Statement Findings

Issued under separate cover. See State Auditor's Office report entitled *State of Texas Financial Portion of the Statewide Single Audit Report for the Fiscal Year Ended August 31, 2010*.

Section 3:

Federal Award Findings and Questioned Costs

This section identifies significant deficiencies, material weaknesses, and instances of non-compliance, including questioned costs, as required to be reported by Office of Management and Budget Circular A-133, Section 510(a).

Water Development Board

Reference No. 11-192

Reporting

CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA

Award year – February 1, 2009 to August 31, 2014

Award number – 2F-96692301 (ARRA)

Type of finding – Significant Deficiency and Non-Compliance

Section 1512 of the American Recovery and Reinvestment Act (Recovery Act) requires that recipients submit quarterly reports to the federal government. Information required to be submitted includes (1) the amount of Recovery Act funds received; (2) the amount of Recovery Act funds received that were expended; (3) a detailed list of all projects or activities for which Recovery Act funds were expended; (4) an estimate of the number of jobs created or retained; and (5) detailed information on any subcontracts or subgrants awarded by the recipient, including the data elements required to comply with the Federal Funding Accountability and Transparency Act of 2006 (Public Law 109-282) (Recovery Act Section 1512(c)). The prime recipient of Recovery Act funds is responsible for the reporting of all data required by Recovery Act Section 1512 for its subrecipients. As the prime recipient of Recovery Act funds, the Water Development Board (Board) obtains this information from its subrecipients and submits it to the federal government.

Questioned Cost: \$ 0
U.S. Environmental Protection Agency

The report the Board submitted for the quarter ending June 30, 2010, for the Capitalization Grants for Drinking Water State Revolving Funds program did not include all activity in the reporting period and was not supported by the Board's accounting records. Errors related to three subrecipients resulted in the understatement of expenditures by \$624,493, which was 2 percent of the \$29,027,062 expenditures for all subrecipients included in the report. The Board did not detect the errors because it does not have a review process prior to submitting the report.

Quarterly reports are submitted to the federal government to comply with Recovery Act Section 1512 reporting requirements and provide transparency regarding Recovery Act funds spent. When the Board submits an inaccurate report, this decreases the reliability of the information intended for the federal government and the general public.

Recommendation:

The Board should develop and implement controls to ensure that the information it includes in its quarterly Recovery Act reports is accurate. At a minimum, controls should include a review process that reconciles reported information to supporting accounting records.

Management Response and Corrective Action Plan:

TWDB concurs with the finding and has developed a process that reconciles reported information to supporting accounting records. It is noted that the amounts identified as under-reported were included in subsequent submissions thereby realizing complete and accurate reporting.

Implementation Date: February 2011

Responsible Person: John Steib

Reference No. 11-193

Subrecipient Monitoring

CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds

CFDA 66.468 - Capitalization Grants for Drinking Water State Revolving Funds - ARRA

Award years – September 21, 2004 to December 31, 2010, September 27, 2005 to September 15, 2011, and February 1, 2009 to August 31, 2014

Award numbers – FS-996795-08, FS-996795-09, and 2F-96692301 (ARRA)

Type of finding – Significant Deficiency and Non-Compliance

The Water Development Board (Board) is required by Office and Management and Budget (OMB) Circular A-133, Section .400, to monitor subrecipients to ensure compliance with federal rules and regulations, as well as the provisions of the contracts or grant agreements.

Questioned Cost: \$ 0
U.S. Environmental Protection Agency

Pre-award Monitoring

Recipients of American Recovery and Reinvestment Act (Recovery Act) awards are required to ensure that the subrecipients that receive Recovery Act funds maintain active registrations in the Central Contractor Registration (CCR) and obtain a Dun and Bradstreet Data Universal Numbering System (DUNS) number (Title 2, Code of Federal Regulations, Section 176.50, and Recovery Act, Section 1512(h)). This information is needed to allow the recipient to properly monitor subrecipient expenditures of Recovery Act funds and for oversight by the federal awarding agencies, offices of inspector general, and the U.S. Government Accountability Office.

The Board must review and perform periodic checks to confirm that subrecipients receiving Recovery Act funds have current CCR registrations before and during the award period. To accomplish this, the Board requests CCR information as part of the subrecipient application process and uses a checklist to ensure that the subrecipient provided that information. **For 6 (24 percent) of 25 subrecipients tested, the subrecipient did not include CCR information on the application or the Board did not complete a checklist.** In addition, there was no evidence that the Board (1) verified CCR registrations upon the receipt of the application and prior to the first award disbursement or (2) monitored the registration throughout the year. Although the Board indicated that it made those checks, it had no procedures to document that it made those checks.

A-133 Single Audit Compliance Monitoring

According to OMB Circular A-133, the Board must ensure that each subrecipient that expends more than \$500,000 in federal funds obtain an OMB Circular A-133 Single Audit and provide a copy of the audit report to the Board within 9 months of the end of the subrecipient’s fiscal year (OMB Circular A-133, Sections 320 and 400). In addition, the Board must issue a management decision on audit findings within six months after receipt of a subrecipient’s audit report (OMB Circular A-133, Section 400). In cases of continued inability or unwillingness of a subrecipient to obtain the required audits, the Board must take appropriate action using sanctions (OMB Circular A-133 Sections 225).

For 2 (12 percent) of 17 subrecipients originally tested, the Board did not ensure that the subrecipient either obtained a Single Audit or provided a certification that it was exempt from Single Audit requirements. Further analysis of the subrecipient population identified one more subrecipient that did not obtain a Single Audit or provide a certification that it was exempt. The Board provided documentation indicating that it made some effort to collect that information. **In addition, the Board did not ensure that 9 (8 percent) of 109 subrecipients submitted audit reports within nine months of the end of their fiscal year.**

These issues increase the risk that the Board will not be aware of instances in which subrecipients fail to comply with federal requirements and increase the potential of program funds not being spent as intended.

Recommendations:

The Board should:

- Develop and implement a procedure to ensure that it verifies CCR registration information for every Recovery Act applicant at the time of application, prior to the first disbursement of funds, and periodically throughout the life of the project. The Board also should maintain documentation of these verifications.
- Streamline and simplify the process for tracking its receipt of audit reports from subrecipients' Single Audits and confirmations from subrecipients. The Board also should use available tools, including sanctions, to encourage subrecipients to comply with the requirement to submit an audit report or a certification of exemption.

Management Response and Corrective Action Plan:

The Board should develop and implement a procedure to ensure that it verifies CCR registration information for every Recovery Act applicant at the time of application, prior to the first disbursement of funds, and periodically throughout the life of the project. The Board also should maintain documentation of these verifications.

TWDB concurs with the finding and has developed an operating procedure to ensure the CCR is verified on receipt of the application, at the point of initial disbursement of funds, and ensure the CCR is renewed at the appropriate times thereafter. This verification will be documented in a tracking spreadsheet that will be included in each sub-recipient file for reference.

Implementation Date: February 2011

Responsible Person: John Steib

The Board should streamline and simplify the process for tracking its receipt of audit reports from subrecipients' Single Audits and confirmations from subrecipients. The Board also should use available tools, including sanctions, to encourage subrecipient to comply with the requirement to submit an audit report or a certification of exemption.

Management concurs that the process for tracking the receipt of Single Audit reports could be streamlined. There should be continuous improvement in efficiency, and management has identified both short-term and long-term improvements. Management will also identify tools and procedures for working with subrecipients to further improve the receipt of Single Audits.

Implementation Date: June 2011

Responsible Persons: Piper Montemayor and Carleton Wilkes

Summary Schedule of Prior Year Audit Findings

Federal regulations (Office of Management and Budget Circular OMB Circular A-133) state, “the auditee is responsible for follow-up and corrective action on all audit findings.” As part of this responsibility, the auditee reports the corrective action it has taken for the following:

- Each finding in the 2009 Schedule of Findings and Questioned Costs.
- Each finding in the 2009 Summary Schedule of Prior Audit Findings that was not identified as implemented or reissued as a current year finding.

The Summary Schedule of Prior Audit Findings (year ended August 31, 2009) has been prepared to address these responsibilities.

Water Development Board

Reference No. 10-136

Reporting

CFDA 66.458 - Capitalization Grants for Clean Water State Revolving Funds
Award years - October 1, 2007 to September 30, 2009 and October 1, 2008 to September 30, 2010
Award numbers - CS-48000208 and CS-48000209
Type of finding - Significant Deficiency and Non-Compliance

The State must provide an annual report to the U.S. Environmental Protection Agency (EPA) beginning the first fiscal year after it receives payments under Title VI of the Clean Water Act. The State should submit this report to the EPA according to the schedule established in the grant agreement (Title 40, Code of Federal Regulations, Section 35.3165).

Initial Year Written: 2009
 Status: Implemented
 U.S. Environmental
 Protection Agency

The grant agreements for the Capitalization Grants for Clean Water State Revolving Funds require that an annual report must be provided within 90 days after the end of the state fiscal year. The annual report must describe how the state has met the goals and objectives as identified in its Intended Use Plan. The information in the report must include the following items: (1) identification of the assistance recipients; (2) the assistance amounts by category; (3) the terms for financial assistance; (4) the communities served; (5) verification of Title II requirements of the capitalization grant funds; (6) verification that first use of the funds was to meet the enforceable requirements of the Clean Water Act; and (7) any other information the regional administrator or designated representative reasonably requires to review and determine compliance with the Clean Water Act.

The clean water annual report the Water Development Board (Board) submitted for fiscal year 2009 included information on binding commitments for Tier II loans (state funded loans) and Tier III loans (federally funded loans). However, in that report the binding commitments for federally funded loans were understated by \$2,960,000. The Board inadvertently identified the City of Seminole’s loan as a state-funded loan commitment; however, supporting documentation showed that this was a federally funded loan commitment. Although the Board reviewed the report internally prior to submitting it, that review did not detect the error. As a result, the \$46,345,000 amount reported as committed for federally funded loans in 2009 was understated by 6 percent.

In addition, the Board drew down federal funds based on expenditures related to seven Tier II loans. As a result, those seven Tier II subrecipients must comply with federal requirements. However, the Board did not include those seven Tier II subrecipients in the “Cross Cutters” section of its clean water annual report. As a result, the report understated Cross Cutters by \$142,310,000 associated with Tier II subrecipients. The Board omitted the Tier II subrecipients from the Cross Cutter section of the Clean Water Annual Report as a result of the Board’s interpretation of prior guidance it received from the EPA. Specifically, the Board’s interpretation was that the group of subrecipients designated as Tier II did not have to comply with federal requirements, even when the Board drew down federal funds based on expenditures at those subrecipients.

Corrective Action:

Corrective action was taken.

Reference No. 10-137

Subrecipient Monitoring

CFDA 66.458 - Capitalization Grants for Clean Water State Revolving Funds

Award years - Multiple

Award numbers - Multiple

Type of finding - Non-Compliance

As a pass-through entity, the Water Development Board (Board) is required by Office of Management and Budget (OMB) Circular A-133, March 2009 Compliance Supplement Part 3, Section M Subrecipient Monitoring, to monitor subrecipients’ use of federal awards through reporting, site visits, regular contact, or other means to provide reasonable assurance that subrecipients administer federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

Initial Year Written:	2009
Status:	Implemented

U.S. Environmental Protection Agency

The Board used its Intended Use Plan (IUP) to show commitments for the Capitalization Grants for Clean Water State Revolving Funds Program. These commitments consist of loans funded with state funds (Tier II) and loans funded with federal funds (Tier III). The Board requires loans that it designates as state-funded to comply with only state requirements, and it requires loans that it designates as federally funded to comply with federal requirements. The U.S. Environmental Protection Agency (EPA) allows the Board to draw down funds based on expenditures incurred at either Tier II subrecipients or Tier III subrecipients. However, it requires the Board to ensure that, if the Board draws down federal funds for expenditures for the Tier II group, the Board must ensure that those subrecipients comply with federal requirements, without regard to the fact that Tier II subrecipients were designated as state-funded. Auditors tested the applicable Tier II and Tier III subrecipients separately and noted no reportable errors related to the Tier III group. However, the Board did not comply with some subrecipient monitoring compliance requirements for Tier II subrecipients when the Board drew down federal funds based on expenditures incurred at those subrecipients. During fiscal year 2009, all of the Board’s program drawdowns were based on expenditures in the Tier II group. These draws totaled \$13,600,214 and were based on expenditures at five subrecipients.

Pre-award and During-the-Award Monitoring

The Board did not verify suspension and debarment for state subrecipients (Tier II) for which it drew down federal funds in fiscal year 2009. Specifically, for 3 (60 percent) of 5 subrecipients files tested, the Board did not verify that the subrecipients were not suspended or debarred. The Board did not comply with this requirement because of its interpretation of EPA guidance. In addition, the Board did not conduct during-the-award monitoring of processes that verified suspension and debarment status for these subrecipients

during the award period. Not verifying the suspension and debarment status of its subrecipients increases the risk that the Board will enter into agreements with entities that are suspended or debarred from entering into contractual agreements involving federal funds. However, auditors verified that none of the subrecipients were suspended or debarred.

In addition, the Board was unable to provide evidence that it communicated the Catalog of Federal Domestic Assistance (CFDA) number to 4 (80 percent) of 5 subrecipients tested. This could result in subrecipients not being informed of compliance requirements that are specific to the program, which increases the risk of non-compliance.

A-133 Single Audit Compliance Monitoring

The Board must ensure that subrecipients that spend \$500,000 or more in federal funds obtain an OMB Circular A-133 Single Audit and provide a copy of the audit report to the Board. The Board is required to review the audit report and to issue a management decision, if applicable. OMB Circular A-133, March 2009 Compliance Supplement Part 3, Section M, requires the Board to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report. In cases of continued inability or unwillingness of a subrecipient to obtain the required audits, the Department must take appropriate action using sanctions.

For 3 (60 percent) of 5 subrecipients tested, the Board did not verify that the subrecipients obtained either a Single Audit or a certification from the subrecipient that it was exempt from Single Audit requirements. This diminishes oversight and increases the potential of program funds not being spent as intended.

All of the issues discussed above are related to the group of subrecipients the Department has designated as Tier II subrecipients and resulted from the Board's interpretation of prior guidance it received from the EPA. Specifically, the Board's interpretation was that the group of subrecipients designated at Tier II did not have to comply with federal requirements, even when the Board drew down federal funds based on expenditures at those subrecipients.

Corrective Action:

Corrective action was taken.

Appendix

Objectives, Scope, and Methodology

Objectives

With respect to the Capitalization Grants for Drinking Water State Revolving Funds Program (Drinking Water Program), the objectives of this audit were to (1) obtain an understanding of internal controls, assess control risk, and perform tests of controls unless the controls were deemed to be ineffective and (2) provide an opinion on whether the State complied with the provisions of laws, regulations, and contracts or grants that have a direct and material effect on the Drinking Water Program.

Scope

The audit scope covered federal funds that the State spent for the Drinking Water Program from September 1, 2009, through August 31, 2010. Audit work included control and compliance work at the Water Development Board (Board).

Methodology

The audit methodology included developing an understanding of controls over each compliance area that was direct and material to the Drinking Water Program at the Board. Auditors conducted tests of compliance and of the controls identified for each compliance area and performed analytical procedures when appropriate.

Information collected and reviewed included the following:

- Board expenditure, reporting, cash revenue, required matching, and subrecipient data.
- Federal notices of award and award proposals.
- Transactional support related to expenditures and revenues.
- Board-generated reports and data used to support reports, revenues, and other compliance areas.
- Information system support for Board assertions related to general controls over information systems that support the control structure related to federal compliance.

Procedures and tests conducted included the following:

- Analytical procedures of expenditure data to identify instances of non-compliance.
- Compliance testing for samples of transactions for each direct and material compliance area.

- Tests of design and effectiveness of key controls and tests of design of controls to assess the sufficiency of the Department’s control structure.
- Tests of design and effectiveness of general controls over information systems that support the control structure related to federal compliance.

Criteria used included the following:

- The Code of Federal Regulations.
- Office of Management and Budget Circulars A-87, A-102, and A-133.
- The American Recovery and Reinvestment Act.
- Federal notices of award and award proposals.
- Board policies and procedures.

Project Information

Audit fieldwork was conducted from June 2010 through January 2011. Except as discussed above in the *Independent Auditor’s 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 Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

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