

STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR
BETH A. WOOD, CPA

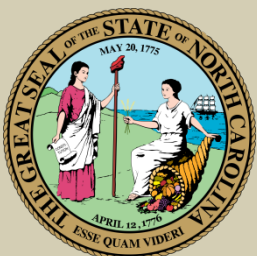


DEPARTMENT OF TRANSPORTATION

RALEIGH, NORTH CAROLINA

STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2018



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Beth A. Wood, CPA
State Auditor

TABLE OF CONTENTS

	PAGE
AUDITOR'S TRANSMITTAL	1
FINDINGS, RECOMMENDATIONS, AND RESPONSES.....	4
ORDERING INFORMATION	13

STATE OF NORTH CAROLINA
Office of the State Auditor



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AUDITOR'S TRANSMITTAL

The Honorable Roy Cooper, Governor
Members of the North Carolina General Assembly
James H. Trogdon, III, Secretary
Department of Transportation

As part of our audit of the State of North Carolina's compliance with the types of requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of its major federal programs, we have completed certain audit procedures at the Department of Transportation for the year ended June 30, 2018.

Our responsibility is to express an opinion on compliance for each of the State of North Carolina's major federal programs based on our audit of the types of compliance requirements referred to above. However, the results included herein are in relation to our audit scope at the Department and not to the State of North Carolina as a whole. The State Auditor expresses an opinion on the State's compliance with requirements applicable to its major federal programs in the State's *Single Audit Report*.

Our federal compliance audit scope at the Department of Transportation included the following:

- CFDA 20.205, 20.219, 20.224, 23.003 – Highway Planning and Construction Cluster
- CFDA 20.106 – Airport Improvement Program
- CFDA 20.319 – High-Speed Rail Corridors and Intercity Passenger Rail Services – Capital Assistance Grants

Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

We conducted our audit of compliance in accordance with the 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 the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with types of compliance requirements referred to above that could have a direct and material effect on

major federal programs occurred. An audit includes examining, on a test basis, evidence about compliance with those requirements and performing such other procedures as we consider necessary in the circumstances.

Other Matters

Compliance

The results of our audit procedures at the Department of Transportation disclosed instances of noncompliance that are required to be reported in accordance with the Uniform Guidance and which are described in findings 1 - 5 in the Findings, Recommendations, and Responses section.

Internal Controls

Management is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered internal control over compliance with the types of requirements that could have a direct and material effect on a major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of internal control over compliance.

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

Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses and significant deficiencies may exist that were not identified. However, as discussed in the Findings, Recommendations, and Responses section, we did identify certain deficiencies in internal control over compliance that we consider to be material weaknesses and significant deficiencies. The deficiencies described in findings 1, 2, and 3 are considered to be material weaknesses in internal control over compliance. Furthermore, the deficiencies described in findings 4 and 5 are considered to be significant deficiencies in internal control over compliance.

Department of Transportation's Response to Findings

The Department's responses to the findings identified in our audit are included in the Findings, Recommendations, and Responses section of this transmittal. The Department's responses were not subjected to the auditing procedures applied in the audit of compliance, and accordingly, we express no opinion on the response.

Purpose of This Transmittal

The purpose of this transmittal is solely to describe the scope of our testing of internal control over compliance and testing of compliance and the results of that testing at the Department of Transportation based on the requirements of the Uniform Guidance. Accordingly, this transmittal is not suitable for any other purpose.

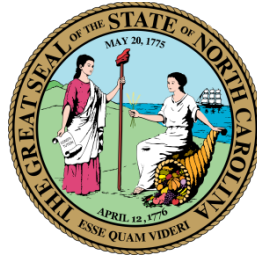
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this transmittal.



Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

March 19, 2019



FINDINGS, RECOMMENDATIONS, AND RESPONSES

Matters Related to Federal Compliance Audit Objectives

The following audit findings were identified during the current audit and describe conditions that represent deficiencies in internal control or noncompliance with laws, regulations, contracts, grant agreements, or other matters.

CFDA 20.106 – AIRPORT IMPROVEMENT PROGRAM

1. NO MONITORING OF \$20.5M IN AIRPORT REVENUE

The Department of Transportation (Department) did not monitor the use of revenue¹ generated by non-commercial airports (airports). The Department has the responsibility to monitor each airport awarded federal funds to ensure that revenue generated by the airport is only used for capital and operating costs of the airport.² According to the Department, the 62 airports generated \$20.5M in revenue during state fiscal year 2018.

As a result of the Department's failure to monitor, misuse of revenues by the airports could go undetected. If revenues are found to be diverted from capital and operating costs, future Federal Aviation Administration grant funding could be reduced or eliminated.

Per the Department's Division of Aviation Management, the Division was not aware of its requirements to monitor airport revenue use. Management believed that the annual financial audit required by *North Carolina General Statute 159-34* or audits required under the Single Audit Act and Uniform Guidance³ were sufficient to monitor compliance of subrecipient airports. They did not understand that the scope of a financial statement audit would not cover this compliance requirement and that not all airports would not be subject to a single audit.

Federal regulations⁴ require the pass-through entity to:

“Monitor the activities of the subrecipient [airports] as necessary to ensure that the subaward is used for authorized purposes in compliance with Federal statutes, regulations and the terms and conditions of the subaward; and that the subaward performance goals are achieved.”

Federal Award Information: CFDA 20.106 Airport Improvement Program, grant awards 3-37-SBGP-44-2012, 3-37-SBGP-45-2012, 3-37-SBGP-46-2013, 3-37-SBGP-47-2014, 3-37-SBGP-48-2014, 3-37-SBGP-49-2015, 3-37-SBGP-50-2016, and 3-37-SBGP-51-2016 for the federal fiscal years ended September 30, 2012 to 2017.

¹ The Policies and Procedures Concerning the Generation and Use of Airport Revenue, issued February 16, 1999 (64 CFR 7695), defines airport revenues and which revenues are subject to the use requirement to be spent on capital and operating costs. Revenues include items such as state and local aviation fuel taxes, rental income, permits, air carrier fees and receipt from sale of airport property.

² The Airport and Airway Improvement Act of 1982, as amended and codified in Title 49 United States Code Chapter 47107(b)(1), requires all airport sponsors receiving Federal assistance to use airport revenue for the capital and operating costs of the airport, the local airport system, or other facilities that are owned or operated by the airport and are substantially and directly related to the actual transportation of passengers and property. Any other use of airport revenue is considered a revenue diversion.

³ Single Audit Act of 1996 (Public Law 104-156) and Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (2 CFR 200 Subpart F – Audit Requirements).

⁴ 2 CFR Part 200.331(d)

Recommendation: Department management should make sure that staff overseeing grant management has a clear understanding of the requirement to monitor the use of airport revenues.

Agency Response: See page 10 for the Department of Transportation's response to this finding.

2. INADEQUATE MONITORING OF SUBRECIPIENTS

The Department of Transportation (Department) did not adequately monitor subrecipients (airports) to ensure that they disbursed advanced federal funds⁵ within three business days of receiving funds from the Department.⁶ During state fiscal year 2018, the Department paid \$22.1 million to 62 subrecipients for approved airport projects.

Auditors reviewed 64 out of the 264 subrecipient requests for funds and identified eight (12.5%) instances where the subrecipient did not disburse funds until after the three business days allowed. The eight advances totaled \$1.69 million and were disbursed between 4 and 158 days after the subrecipient received the funds.

Inadequate monitoring increased the risk that subrecipients could retain and use federal funds for unapproved costs without being detected. Subrecipients could also fail to pay contractors/vendors which could impact the completion of airport projects.

According to the Department, inadequate monitoring occurred because the checklist instructions did not direct the reviewer to verify that the funds were disbursed within three business days of receipt. The Department's review checklist required payment (disbursement) verification from the subrecipients, but the checklist instructions did not require verification of timeliness.

Federal regulations⁷ require the pass-through entity to:

“Monitor the activities of the subrecipient as necessary to ensure that the subaward is used for authorized purposes in compliance with Federal statutes, regulations and the terms and conditions of the subaward;⁸ and the subaward performance goals are achieved.”

Federal Award Information: CFDA 20.106 – Airport Improvement Program, grant awards 3-37-SBGP-44-2012, 3-37-SBGP-45-2012, 3-37-SBGP-46-2013, 3-37-SBGP-47-2014, 3-37-SBGP-48-2014, 3-37-SBGP-49-2015, 3-37-SBGP-50-2016, and 3-37-SBGP-51-2016 for the federal fiscal years ended September 30, 2012 to 2017.

Recommendation: Department management should ensure that the instructions provided to reviewers include all requirements and that reviewers complete the checklist in its entirety.

⁵ 2 CFR Part 200.305(b) – Non-federal entities other than states, must minimize the time elapsing between the transfer of funds from the pass-through entity and the disbursement by the non-federal entity.

⁶ The Sponsor's (airports) Assurances in Section C-4 of the subaward agreement states, “payments from NCDOT to the Sponsor are made on a reimbursement basis. The Sponsor must pay all contractors/vendors prior to or within 3 business days of receipt of the Department's reimbursement.”

⁷ 2 CFR Part 200.331(d)

⁸ See footnote 6.

Agency Response: See pages 10-11 for the Department of Transportation's response to this finding.

3. FEDERAL FINANCIAL REPORTS INCOMPLETE

The Department of Transportation (Department) did not submit complete annual financial reports for the Airport Improvement Program Grant to the Federal Aviation Administration (FAA). During state fiscal year 2018, the Department had eight open federal grant awards, each of which required an annual report to be submitted for the period ending September 30, 2017.

For all eight reports, the Department did not complete the Federal Cash Section of the SF-425 Federal Financial Report. The Department should have cumulatively reported \$56.5 million for cash disbursements, \$55.5 million for cash receipts, and a negative \$1 million for cash on hand.

Incomplete reporting may prevent the Airport District Office (ADO)⁹ from tracking the financial progress of the airport grants. Tracking ensures the timely use of funds and could impact future funding levels.

According to the Department's Division of Aviation Management, the reporting errors occurred because the preparer and reviewer were not aware of, nor trained on the FAA Airport Improvement Program (AIP) instructions for completing the Federal Financial Report (SF-425).

Federal regulations¹⁰ and the grant award document require the Department to submit the annual SF-425 Federal Financial Report to the Federal Aviation Administration. The report should include all activity of the reporting period and be supported by applicable accounting records to ensure completeness and accuracy.

Federal Award Information: CFDA 20.106 – Airport Improvement Program, grant awards 3-37-SBGP-44-2012, 3-37-SBGP-45-2012, 3-37-SBGP-46-2013, 3-37-SBGP-47-2014, 3-37-SBGP-48-2014, 3-37-SBGP-49-2015, 3-37-SBGP-50-2016, and 3-37-SBGP-51-2016 for the federal fiscal years ended September 30, 2012 to 2017.

Recommendation: Department management should train staff in the proper preparation and review of the Federal Financial Reports to ensure complete reporting.

Agency Response: See page 11 for the Department of Transportation's response to this finding.

⁹ The local FAA Office of Airports that directly works with the state. In regional offices that do not have ADOs, the use of the term ADO refers to the FAA Office of Airports branch within the regional office that deals directly with the state.

¹⁰ U.S. Department of Transportation Federal Aviation Administration Airport Improvement Program Handbook, Order 5100.38D and Advisory Circular 150/5100-21.

CFDA 20.205 – HIGHWAY PLANNING AND CONSTRUCTION CLUSTER

4. EXPENDITURES INCURRED PRIOR TO PROJECT AUTHORIZATION

The Department paid for project expenditures using Highway Planning and Construction Cluster (HPCC) funds that were incurred prior to the project being authorized by the federal government. During fiscal year 2018, the Department received authorization for 314 new projects and the expenditures associated with those projects totaled \$32.8 million.

The Federal Highway Administration (FHWA) must authorize projects prior to expenditures being incurred related to the project. FHWA may provide an exception for expenditures to be incurred prior to the project authorization.

Out of a sample of 40 projects authorized during the period (totaling \$3.4 million), two (5%) projects included expenditures billed to FHWA that were incurred prior to authorization. For both projects, the Department provided no evidence that FHWA provided an exception for these expenditures. The total unauthorized expenditures were \$23,151 (federal share of \$18,801).

Even though the tests identified only \$18,801 in questioned costs, if extended to the entire population, questioned costs could exceed \$25,000.¹¹

As a result, the Department must reimburse the FHWA for the unallowable costs using state or other funding.

According to Department management, the invoice review failed to identify and flag the expenditures incurred prior to project authorization for exclusion from FHWA billings when the invoices were entered and approved in the accounting system.

Federal regulations¹² require “a non-Federal entity to only charge to the Federal award allowable costs incurred during the period of performance and any costs incurred before the Federal awarding agency or pass-through entity made the Federal award that were authorized by the Federal awarding agency or pass-through entity.”

Federal Award Information: CFDA 20.205 Highway Planning and Construction Cluster 2018

Recommendation: Department management should ensure that invoice review is sufficient to determine if any expenditures were incurred prior to authorization and that those expenditures are properly recorded in the system for exclusion from FHWA billings.

Additionally, the Department should review all authorized projects to determine whether any additional costs were incurred prior to FHWA authorization.

Agency Response: See page 11 for the Department of Transportation’s response to this finding.

¹¹ 2 CFR 200.516(a)(3) requires auditors to report known questioned costs when likely questioned costs are greater than \$25,000.

¹² 2 CFR 200.309

5. REVIEW PROCEDURES FAILED TO ENSURE CONTRACTOR COMPLIANCE WITH FEDERAL PAY RATES

The Department did not consistently obtain and review contractor payrolls for construction projects funded by the Highway Planning and Construction Cluster. During the audit period, the Department paid \$734.9 million in construction project expenditures subject to this requirement.

Payroll reviews help ensure contractors comply with the federal minimum pay rates for laborers and mechanics.

A test of 77 out of 3,136 construction expenditure payments and the related project files revealed that nine (12%) project files were missing the required payrolls.

Because the payrolls were not consistently obtained and reviewed, there was an increased risk that the Department would fail to identify contractor noncompliance and take appropriate corrective action. Corrective action could include suspension of payments, termination of the contract, and debarment from future contracting opportunities.

According to the Department, the payrolls were not obtained for two reasons.

First, the Department did not obtain five of the nine missing payrolls because the contractors would not provide them.¹³ In these instances, Department staff requested the payrolls and followed-up when they were not received. However, the Department did not implement alternative corrective actions when it did not receive the payrolls after requesting them for months. Available alternative corrective actions included terminating contractor funding.

Second, the Department did not obtain four of the nine missing payrolls because of inaccurate monitoring documentation. The Department uses form FAP-1¹⁴ to identify active contractors for the week and ensure that all payrolls are obtained. In these four instances, the FAP-1 inaccurately documented that some contractors did not work, although the daily project diaries maintained by the Department's onsite inspector indicated the contractors worked on site during the week. As a result, the payrolls were not requested.

Federal regulations¹⁵ require contractors and subcontractors that work on construction contracts in excess of \$2,000 to submit to the awarding agency a copy of their weekly payroll and a statement of compliance (certified payroll) for any week where contract work was performed.

Additionally, per the Federal Highway Administration Davis-Bacon and Related Acts Questions and Answers, the Department is responsible for properly applying and enforcing wage rate requirements in construction contracts, which includes reviewing certified payrolls in a timely manner to ensure all laborers and mechanics are paid wages

¹³ Four of the five errors were related to the same contractor.

¹⁴ The FAP-1 is the internal report used to identify the contractors that were active during the week and the payrolls that should be received.

¹⁵ 29 CFR section 5.5(3)(ii)(A)

not less than those established by the U.S. Department of Labor for the locality of the project.

Federal Award Information: CFDA 20.205 Highway Planning and Construction Cluster 2018

Recommendation: Department management should ensure that staff properly execute the necessary follow-up procedures to obtain certified payrolls and takes alternative corrective actions when the contractor does not provide the payrolls.

Additionally, Department management should ensure that the FAP-1 is reviewed for completeness and accuracy by comparing to the daily project diaries.

Agency Response: See pages 11-12 for the Department of Transportation's response to this finding.



STATE OF NORTH CAROLINA
DEPARTMENT OF TRANSPORTATION

ROY COOPER
GOVERNOR

JAMES H. TROGDON, III
SECRETARY

January 14, 2019

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 Auditor Wood,

We have reviewed the audit findings from the federal compliance portion of the audit for the year that ended June 30, 2018. We are providing the following responses and corrective actions to address the issues identified.

1. NO MONITORING OF \$20.5M IN AIRPORT REVENUE

Audit Response: The Department agrees with the finding and is taking the below corrective actions.

The Division immediately acted to address the deficiency through statewide training and improved communications with airport auditors, sponsors and finance staff. The Division developed airport revenue use training as part of the North Carolina Airport Technical Assistance Program (NCAirTAP) and conducted this training for Division staff managing grants as well as for airport sponsors at three regional meetings of the North Carolina Airports Association between August 17, 2018 and September 7, 2018. The Aviation Division is also implementing compliance monitoring to address the deficiency. In July 2018, the Division started developing a risk-based subrecipient compliance monitoring plan. The plan is under development. It will assign a risk level to each airport sponsor and appropriately test for compliance with airport revenue use and other grant requirements. This compliance monitoring plan will provide a comprehensive method for the Division to regularly review airport procedures and controls, act to address deficiencies, promote the use of best practices, and ensure that subject revenue generated by the airport is only used for allowable purposes.

2. INADEQUATE MONITORING OF SUBRECIPIENTS

Audit Response: The Department agrees with the finding and is taking the below corrective actions.

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1 S. WILMINGTON ST.
RALEIGH, NC 27601

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The Aviation Division will ensure that advanced funds are disbursed by the recipient within three business days of payment and that appropriate follow-up action is taken by the Division if a recipient is not in compliance. The Division will update its online claim form so sponsors must indicate whether the claim is a request for reimbursement or advanced funds. If the advanced funds option is selected, the sponsor will be required to certify that it needs advanced funds for an approved project expense. The sponsor's certification statement will explain that advanced funds must be disbursed within three business days of the advance. The disbursement will be verified on the next payment verification by the Division. If the Division determines that a sponsor did not disburse the advance funds within three business days after certifying that it had, the sponsor will receive a letter of non-compliance. If the sponsor continues to be in non-compliance, the Division could require immediate repayment of the advance funding. This will be factored into the risk level assessment and may affect future funding. The Division is developing this process in close communication with staff and airport sponsors.

3. FEDERAL FINANCIAL REPORTS INCOMPLETE

Audit Response: The Department agrees with the finding and is taking the below corrective actions.

The Division immediately acted to address the deficiency. The Division obtained instructions for completing the SF-425 and the preparer received training. The role of reviewer was reassigned to a manager with experience for completing and submitting the form. Before submitting the final version of its FFY18 SF-425, the Division emailed a draft of the form to its FAA Program Manager and requested that it be reviewed for accuracy and completeness. The Program Manager verified that the form was filled out correctly. The Division finalized its SF-425 and submitted it to the FAA, retaining the form and instructions for future reference.

4. EXPENDITURES INCURRED PRIOR TO PROJECT AUTHORIZATION

Audit Response: The Department agrees with the finding and is taking the below corrective actions.

The Federal Funds manager contacted the two units that approved invoices for payment and informed them of the error. NCDOT reimbursed the Federal Highway Administration (FHWA) for the two projects in which expenditures occurred prior to the authorization date. The first reimbursement of \$20,373 was given to FHWA on November 16, 2018 and the second reimbursement of \$1,404 was provided on January 4, 2019. The Federal Funds manager sent a memo on January 7, 2019 to remind invoice approvers to check for expenditure dates and attended the Division of Highways Operations meeting to discuss period of performance on January 8, 2019.

5. REVIEW PROCEDURES FAILED TO ENSURE CONTRACTOR COMPLIANCE WITH FEDERAL PAY RATES

Audit Response: The Department agrees with the finding and is taking the below corrective actions.

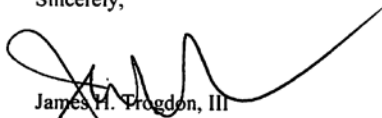
A review of project records revealed several times when the contractor failed to provide the requested documentation. Since the audit findings were released, two of the nine payrolls have been provided and the Department will correct the remaining payrolls by March 1, 2019, except for those records that may have expired because they were old. This includes two of the nine

payrolls that were completed prior to the end of 2012, which was also prior to previous findings and implementation of a corrective action plan.

The corrective action plan for this audit will include the following:

The audit findings will be addressed with NCDOT contract administration staff at regional workshops before April 30, 2019. In addition, for the offices where audit findings occurred, the specific findings will be reviewed with the contract administrator and the office staff responsible for reviewing Davis-Bacon payroll data by January 31, 2019. Procedures will be updated to provide clarity on review of the project diaries and completion of the FAP-1 and providing instructions on alternative corrective actions to be taken to ensure receipt of payrolls.

Sincerely,



James H. Proddon, III

cc: Robert W. Lewis, COO
Evan Rodewald, CFO
Mary Morton, OIG
Tim Little, Chief Engineer
Ron Hancock, Deputy Chief Engineer
Julie White, Deputy Secretary for Multi-Modal Transportation

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For additional information contact:
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This audit was conducted in 4,695 hours at an approximate cost of \$483,585.