

STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

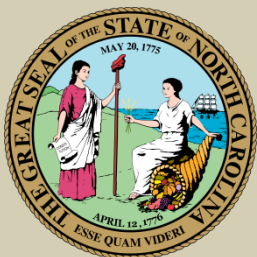


DEPARTMENT OF ENVIRONMENTAL QUALITY

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	7

Article V, Chapter 147 of the *North Carolina General Statutes*, gives the Auditor broad powers to examine all books, records, files, papers, documents, and financial affairs of every state agency and any organization that receives public funding. The Auditor also has the power to summon people to produce records and to answer questions under oath.

STATE OF NORTH CAROLINA
Office of the State Auditor



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State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Roy Cooper, Governor
Members of the North Carolina General Assembly
Michael S. Regan, Secretary
Department of Environmental Quality

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 Environmental Quality 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 Environmental Quality included the following:

- 14.228 – Community Development Block Grants/State's Program and Non-Entitlement Grants in Hawaii
- 93.568 – Low-Income Home Energy Assistance

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 Environmental Quality disclosed no instances of noncompliance that are required to be reported in accordance with the Uniform Guidance.

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. We did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we consider the deficiency described in the finding in the Findings, Recommendations, and Responses section to be a significant deficiency in internal control over compliance.

Department of Environmental Quality's Response to Findings

The Department's response to the finding identified in our audit is included in the Findings, Recommendations, and Responses section of this transmittal. The Department's response was 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 Environmental Quality based on the requirements of the Uniform Guidance. Accordingly, this transmittal is not suitable for any other purpose.

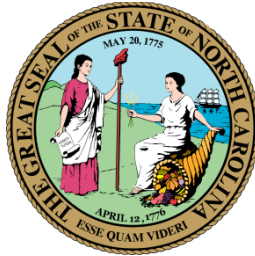
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this transmittal.



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 finding was 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.

1. INADEQUATE SUBRECIPIENT MONITORING

The Department did not adequately monitor \$35.6 million in federal funds passed through to subrecipients¹ of the Community Development Block Grant/State's Program and Non-Entitlement Grants in Hawaii (CDBG).

Specifically, the Department did not:

- Review subrecipient annual audit reports for problems and communicate expected corrective actions to subrecipients.
- Notify subrecipients of all required federal award information.

Auditors reviewed the monitoring process for all 11 subrecipients that were required to have an audit in accordance with the Uniform Guidance.² There was no evidence that the Department reviewed any of the 11 audit reports issued during the audit period. Because the audit reports were not reviewed, the Department did not issue timely management decisions³ for two subrecipients who had audit findings related to the Community Development Block Grant.

Additionally, the Department made subawards to 17 subrecipients during the audit period and used contracts to communicate the federal award information. However, none of the 17 contracts included the following required federal award information:

- Federal Award Identification Number (FAIN)
- Federal Award Date
- CFDA Number and Name
- Identification of whether the award is research and development
- Indirect Cost Rate for the federal award

The Department did not communicate the omitted federal award information to subrecipients until auditors raised the issue.

The lack of adequate and timely monitoring increased the risk that CDBG funds would not be used in accordance with the federal requirements. For example, the audit reports that required follow-up by the Department reported deficiencies such as:

- Incomplete accounting records related to grant revenues and expenses.

¹ Subrecipients are counties, cities, and towns that use CDBG funds for public water and wastewater infrastructure projects.

² 2 CFR section 200.331(f) & 2 CFR section 200.501

³ 2 CFR section 200.521(a) – Management decisions must clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee actions (i.e. repay disallowed costs, make financial adjustments, or take other actions).

- Lack of internal control procedures to monitor the timely disbursement of federal funds.

According to the Department, the lack of adequate monitoring happened for two reasons.

First, the Department did not review subrecipient audit reports that were issued during the audit period or issue timely management decisions because the procedures for reviewing the audit reports did not clearly describe the steps to follow.

Second, the Department did not communicate all of the required federal award information to its subrecipients because they did not obtain the information from the N.C. Department of Commerce (Commerce) in a timely manner. Commerce is the primary recipient of the CDBG grant from the U.S. Department of Housing and Urban Development (HUD) and receives the grant award notification which contains all of the federal award information that must be communicated to subrecipients. The Department did not obtain the information from Commerce until after the subrecipient contracts were signed.

Federal regulations⁴ require the Department to monitor the activities of its subrecipients by reviewing audit reports. Specifically, the Department is required to:

- Review financial and performance reports.
- Follow-up and ensure that the subrecipient takes timely and appropriate action on all deficiencies pertaining to the federal award.
- Issue management decisions⁵ for audit findings that relate to federal awards it makes to subrecipients within six months of acceptance of the audit report by the Federal Audit Clearinghouse.

Further, federal regulations⁶ require the Department to clearly identify the award as a subaward and include specific federal award information at the time of the award.

Federal Award Information: Federal Awarding Agency: U.S. Department of Housing and Urban Development; CFDA Number (title): 14.228 (Community Development Block Grants/State's Program and Non-Entitlement Grants in Hawaii); Federal Award Number (award period): B-17-DC-37-0001 (July 1, 2017).

Recommendation: The Department should revise the audit report review procedures so that they clearly describe the steps to follow to ensure that audit reports are reviewed, follow-up is completed, and management decisions are issued timely.

The Department should obtain the CDBG grant award notification from the Department of Commerce in a timely manner to ensure that they include all required federal award information in the contracts with their subrecipients.

Agency Response: See page six for the Department of Environmental Quality's response to this finding.

⁴ 2 CFR section 200.331(d)

⁵ 2 CFR section 200.521(c) and 2 CFR section 200.521(d)

⁶ 2 CFR section 200.331(a)(1) – provides the complete list of the required information that should be identified to the subrecipient at the time of the award.



ROY COOPER
Governor
MICHAEL S. REGAN
Secretary

Date: November 1, 2018

To: Beth Wood, CPA, State Auditor
State of North Carolina
20601 Mail Service Center
Raleigh, NC 27699-0600

From: Michael S. Regan
Secretary, DEQ

Subject: Federal Compliance Audit at the Department of Environmental Quality SFY18

Ms. Wood,

We are responding to the department's federal compliance audit for the year ending June 30, 2018. We have reviewed the audit finding and recommendation and are pleased to provide our response as follows:

Finding – INADEQUATE SUBRECIPIENT MONITORING

Department Response

The Department agrees with the finding.

The Department has taken corrective actions and is working closer with the Department of Commerce to obtain federal award information in a timely manner. Commerce is the primary recipient of the CDBG grant from the U.S. Department of Housing and Urban Development. The Federal Award Identification Number (FAIN), Federal Award Date, CDFR Number and Name, Identification of whether the award is research and development and Indirect Cost Rate for the federal award will be included in the contracts to our subrecipients as required by 2 CFR 200.331(a)(1). The Department has revised the audit report review procedures to review audit reports in a timely manner and to communicate expected corrective actions to subrecipients. Management decision letters, will be issued within six months from the date the audit report was accepted by the federal audit clearinghouse, when subrecipients have audit findings on audit reports. This will comply with 2 CFR 200.521(d).

Thank you for the time and opportunity to review and respond to these findings. Please contact me if you have any questions regarding the department's response to any of the findings and recommendations.

Sincerely,

A handwritten signature in blue ink that reads "Michael S. Regan".

Michael S. Regan
Secretary, DEQ

cc: John Nicholson, DEQ
Rex Whaley, DEQ
Jennifer Mundt, DEQ
Kim Colson, DEQ
Landon Perry, DEQ

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