



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

Audit report information can be accessed at:

<http://audgen.michigan.gov>



Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit
Including the Provisions of the Single Audit Act
Department of Environmental Quality
October 1, 2007 through September 30, 2009

Report Number:
761-0100-10

Released:
June 2010

A Single Audit is designed to meet the needs of all financial report users, including an entity's federal grantor agencies. The audit determines if the financial schedules and/or financial statements are fairly presented; considers internal control over financial reporting and internal control over federal program compliance; determines compliance with requirements material to the financial schedules and/or financial statements; and assesses compliance with direct and material requirements of the major federal programs.

**Financial Statements and Financial Schedules:
Auditor's Reports Issued**

We issued unqualified opinions on the Department of Environmental Quality's (DEQ's) financial statements and financial schedules.

~ ~ ~ ~ ~

Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

~ ~ ~ ~ ~

**Noncompliance and Other Matters
Material to the Financial Statements
and/or Financial Schedules**

We did not identify any instances of noncompliance or other matters applicable to the financial statements and/or financial schedules that are required to be reported under *Government Auditing Standards*.

~ ~ ~ ~ ~

Federal Awards:

Auditor's Reports Issued on Compliance

We audited 8 programs (including 3 ARRA related programs) and reported known questioned costs of \$54,860 and known and likely questioned costs totaling \$106,452. DEQ expended a total of \$265.5 million in federal awards during the two-year period that ended September 30, 2009. We issued 4 unqualified opinions and 4 qualified opinions. The opinions issued by major programs are identified on the back of this summary.

~ ~ ~ ~ ~

Internal Control Over Major Programs

We identified significant deficiencies in internal control over federal program compliance (Findings 1 through 6). We consider Findings 2 through 6 to contain material weaknesses. In addition, we identified 8 recommendations (presented as 5 recommendations in Findings 1 and 3 through 6) repeated from our prior report for the two-year period ended September 30, 2007.

~ ~ ~ ~ ~

Required Reporting of Noncompliance

We identified instances of noncompliance that are required to be reported in accordance with

U.S. Office of Management and Budget (OMB)
Circular A-133 (Findings 1 through 6).

~ ~ ~ ~ ~

Systems of Accounting and Internal Control:

We determined that DEQ was in substantial compliance with Sections 18.1483 - 18.1487 of the *Michigan Compiled Laws*.

~ ~ ~ ~ ~

Subsequent Event:

Executive Order No. 2009-45 created the Department of Natural Resources and Environment (DNRE), effective January 17, 2010. It transferred all of the authority, powers, duties, functions, responsibilities, records, personnel, property, equipment, and budgetary resources of the Department of Natural Resources (DNR) and DEQ to DNRE by a Type II transfer and abolished DNR and DEQ. Accordingly, our recommendations in this report are directed to DNRE.

~ ~ ~ ~ ~

We audited the following programs as major programs:

<i>CFDA Number</i>	<i>Program Title</i>	<i>Compliance Opinion</i>
11.419	Coastal Zone Management Administration Awards	Unqualified
66.001	Air Pollution Control Program Support	Qualified
66.458	<u>Capitalization Grants for Clean Water State Revolving Funds</u> <ul style="list-style-type: none"> • Capitalization Grants for Clean Water State Revolving Funds • ARRA - Capitalization Grants for Clean Water State Revolving Funds 	Qualified
66.460	Nonpoint Source Implementation Grants	Qualified
66.468	<u>Capitalization Grants for Drinking Water State Revolving Funds</u> <ul style="list-style-type: none"> • Capitalization Grants for Drinking Water State Revolving Funds • ARRA - Capitalization Grants for Drinking Water State Revolving Funds 	Qualified
66.605	Performance Partnership Grants	Unqualified
66.801	Hazardous Waste Management State Program Support	Unqualified
66.805	<u>Leaking Underground Storage Tank Trust Fund Corrective Action Program</u> <ul style="list-style-type: none"> • Leaking Underground Storage Tank Trust Fund Corrective Action Program • ARRA - Leaking Underground Storage Tank Trust Fund Corrective Action Program 	Unqualified

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 30, 2010

Ms. Rebecca A. Humphries, Director
Department of Natural Resources and Environment
Constitution Hall
Lansing, Michigan

Dear Ms. Humphries:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Department of Environmental Quality (DEQ) for the period October 1, 2007 through September 30, 2009.

This report contains our report summary; our independent auditor's reports on the financial statements and financial schedules; and the DEQ financial statements, financial schedules, and supplemental financial statements and schedule. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters, our independent auditor's report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133, and our schedule of findings and questioned costs. In addition, this report contains DEQ's summary schedule of prior audit findings, its corrective action plan, and a glossary of acronyms and terms.

Our findings and recommendations are contained in Section III of the schedule of findings and questioned costs. The agency preliminary responses are contained in the corrective action plan. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

TABLE OF CONTENTS

DEPARTMENT OF ENVIRONMENTAL QUALITY

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
INDEPENDENT AUDITOR'S REPORTS, FINANCIAL STATEMENTS, AND FINANCIAL SCHEDULES	
Independent Auditor's Report on the Financial Statements	10
Independent Auditor's Report on the Financial Schedules	12
Department of Environmental Quality Financial Statements	
Combined Balance Sheet	14
Combined Statement of Revenues, Expenditures, and Changes in Fund Balances	15
Department of Environmental Quality Financial Schedules	
Schedule of General Fund Revenues and Other Financing Sources	16
Schedule of Sources and Disposition of General Fund Authorizations	17
Notes to the Financial Statements and Financial Schedules	18

SUPPLEMENTAL FINANCIAL STATEMENTS AND SCHEDULE

Special Revenue Funds	
Description of Special Revenue Funds	28
Combining Balance Sheet	30
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances	31
Combining Balance Sheet - Combined Environmental Protection Bond Fund	32
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances - Combined Environmental Protection Bond Fund	33
 Agency Fund	
Description of Agency Fund	35
Statement of Changes in Assets and Liabilities - Environmental Quality Deposits Fund, Fiscal Year Ended September 30, 2009	36
Statement of Changes in Assets and Liabilities - Environmental Quality Deposits Fund, Fiscal Year Ended September 30, 2008	37
 Schedule of Expenditures of Federal Awards	38

INDEPENDENT AUDITOR'S REPORTS ON INTERNAL CONTROL AND COMPLIANCE

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters	46
Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133	48

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results	51
Section II: Findings Related to the Financial Statements and Financial Schedules	53
Section III: Findings and Questioned Costs Related to Federal Awards	53
1. Coastal Zone Management Administration Awards, <i>CFDA</i> 11.419	53
2. Air Pollution Control Program Support, <i>CFDA</i> 66.001	58
3. Capitalization Grants for Clean Water State Revolving Funds, <i>CFDA</i> 66.458	62
4. Nonpoint Source Implementation Grants, <i>CFDA</i> 66.460	71
5. Capitalization Grants for Drinking Water State Revolving Funds, <i>CFDA</i> 66.468	78
6. Performance Partnership Grants, <i>CFDA</i> 66.605	86

OTHER SCHEDULES

Summary Schedule of Prior Audit Findings	91
Corrective Action Plan	95

GLOSSARY

Glossary of Acronyms and Terms	112
--------------------------------	-----

INDEPENDENT AUDITOR'S REPORTS,
FINANCIAL STATEMENTS,
AND FINANCIAL SCHEDULES



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Statements

Ms. Rebecca A. Humphries, Director
Department of Natural Resources and Environment
Constitution Hall
Lansing, Michigan

Dear Ms. Humphries:

We have audited the accompanying financial statements of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2009 and September 30, 2008, as identified in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the Department of Environmental Quality's special revenue and agency funds and do not purport to, and do not, present fairly the financial position of the State of Michigan or its special revenue and agency funds as of September 30, 2009 and September 30, 2008 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Department of Environmental Quality's special revenue and agency funds as of September 30, 2009 and September 30, 2008 and the changes in financial position of the special revenue funds for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 24, 2010 on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and the supplemental financial statements, as identified in the table of contents, are presented for purposes of additional analysis and are not a required part of the Department's financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

AUDITOR GENERAL

June 24, 2010



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Schedules

Ms. Rebecca A. Humphries, Director
Department of Natural Resources and Environment
Constitution Hall
Lansing, Michigan

Dear Ms. Humphries:

We have audited the accompanying financial schedules of the Department of Environmental Quality for the fiscal years ended September 30, 2009 and September 30, 2008, as identified in the table of contents. These financial schedules are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial schedules present only the revenues and other financing sources and the sources and disposition of authorizations for the Department of Environmental Quality's General Fund accounts, presented using the current financial resources measurement focus and the modified accrual basis of accounting. Accordingly, these financial schedules do not purport to, and do not, constitute a complete financial presentation of either the Department or the State's General Fund in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial schedules referred to in the first paragraph present fairly, in all material respects, the revenues and other financing sources and the sources and disposition of authorizations of the Department of Environmental Quality for the fiscal years ended September 30, 2009 and September 30, 2008 on the basis of accounting described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 24, 2010 on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Department's financial schedules referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial schedules and, in our opinion, is fairly stated, in all material respects, in relation to the financial schedules taken as a whole.

AUDITOR GENERAL

June 24, 2010

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combined Balance Sheet
As of September 30
(In Thousands)

	<u>Special Revenue Funds</u>		<u>Agency Fund</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
ASSETS				
Current assets:				
Cash	\$	\$ 3	\$	\$
Equity in common cash (Note 3)	129,056	101,831	2,789	3,288
Amounts due from other funds	12	2		
Amounts due from component units	12	7		
Amounts due from local units	604	339		
Other current assets	1,390	8,599		
Total current assets	<u>\$ 131,074</u>	<u>\$ 110,780</u>	<u>\$ 2,789</u>	<u>\$ 3,288</u>
Amounts due from local units	14,350	13,148		
Other noncurrent assets	1,275	1,543		
Total assets	<u><u>\$ 146,699</u></u>	<u><u>\$ 125,472</u></u>	<u><u>\$ 2,789</u></u>	<u><u>\$ 3,288</u></u>
LIABILITIES AND FUND BALANCES				
Current liabilities:				
Warrants outstanding	\$ 1,407	\$ 93	\$	\$
Accounts payable and other liabilities	13,070	14,040	2,789	3,288
Amounts due to other funds	193	140		
Deferred revenue	568	1,058		
Total current liabilities	<u>\$ 15,238</u>	<u>\$ 15,331</u>	<u>\$ 2,789</u>	<u>\$ 3,288</u>
Deferred revenue	1,275	1,543		
Total liabilities	<u>\$ 16,513</u>	<u>\$ 16,874</u>	<u>\$ 2,789</u>	<u>\$ 3,288</u>
Fund balances (Note 2):				
Reserves for:				
Budgetary carry-forwards:				
Restricted revenues	\$ 49,315	\$ 48,839	\$	\$
Revolving loan programs	31,990	28,453		
Funds held as permanent investments	8,737	7,610		
Total reserved	<u>\$ 90,042</u>	<u>\$ 84,902</u>	<u>\$ 0</u>	<u>\$ 0</u>
Unreserved	40,145	23,696		
Total fund balances	<u>\$ 130,187</u>	<u>\$ 108,598</u>	<u>\$ 0</u>	<u>\$ 0</u>
Total liabilities and fund balances	<u><u>\$ 146,699</u></u>	<u><u>\$ 125,472</u></u>	<u><u>\$ 2,789</u></u>	<u><u>\$ 3,288</u></u>

The accompanying notes are an integral part of the financial statements and financial schedules.

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Combined Statement of Revenues, Expenditures, and Changes in Fund Balances
Fiscal Years Ended September 30
 (In Thousands)

	<u>Special Revenue Funds</u>	
	<u>2009</u>	<u>2008</u>
REVENUES		
Federal	\$ 314	\$ 693
Miscellaneous	22,139	27,453
Total revenues	<u>\$ 22,453</u>	<u>\$ 28,146</u>
EXPENDITURES		
Current:		
General government	\$ 167	\$
Environmental	49,687	60,972
Total expenditures	<u>\$ 49,854</u>	<u>\$ 60,972</u>
Excess of revenues over (under) expenditures	<u>\$ (27,401)</u>	<u>\$ (32,826)</u>
OTHER FINANCING SOURCES (USES)		
Proceeds from bond issues (Note 7)	\$ 49,890	\$ 25,000
Premium on bond issuance	1,272	1,215
Discount on bond issuance	(211)	
Transfers from other funds	3,500	6,463
Transfers to other funds	(5,461)	(6,983)
Total other financing sources (uses)	<u>\$ 48,990</u>	<u>\$ 25,694</u>
Excess of revenues and other sources over (under) expenditures and other uses	<u>\$ 21,589</u>	<u>\$ (7,132)</u>
Fund balances - Beginning of fiscal year	<u>108,598</u>	<u>115,730</u>
Fund balances - End of fiscal year	<u><u>\$ 130,187</u></u>	<u><u>\$ 108,598</u></u>

The accompanying notes are an integral part of the financial statements and financial schedules.

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of General Fund Revenues and Other Financing Sources
Fiscal Years Ended September 30
(In Thousands)

	2009	2008
REVENUES		
Taxes	\$ 32,910	\$ 26,620
From federal agencies (Note 6)	43,127	45,506
From licenses and permits	26,789	28,424
Miscellaneous:		
Gas and oil privilege fees	5,026	14,329
Environmental pollution judgments/settlements	2,937	3,675
Solid waste facility surcharge	3,212	3,889
Other	16,167	20,208
Total revenues	\$ 130,166	\$ 142,651
OTHER FINANCING SOURCES		
Transfers from other funds (Note 8)	\$ 1,497	\$ 131
Total other financing sources	\$ 1,497	\$ 131
Total revenues and other financing sources	\$ 131,665	\$ 142,782

The accompanying notes are an integral part of the financial statements and financial schedules.

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Sources and Disposition of General Fund Authorizations
Fiscal Years Ended September 30
(In Thousands)

	<u>2009</u>	<u>2008</u>
SOURCES OF AUTHORIZATIONS (Note 4)		
General purpose appropriations	\$ 38,580	\$ 42,763
Balances carried forward	108,260	110,513
Restricted financing sources	134,834	153,669
Less: Intrafund expenditure reimbursements	<u>(3,320)</u>	<u>(13,020)</u>
Total	<u>\$ 278,353</u>	<u>\$ 293,925</u>
 DISPOSITION OF AUTHORIZATIONS (Note 4)		
Gross expenditures and transfers out	\$ 186,118	\$ 198,327
Less: Intrafund expenditure reimbursements	<u>(3,320)</u>	<u>(13,020)</u>
Net expenditures and transfers out	<u>\$ 182,797</u>	<u>\$ 185,307</u>
Balances carried forward:		
Encumbrances	\$ 66	\$ 32
Restricted revenues - not authorized or used	90,411	103,227
Revolving loan programs	5,000	5,000
Total balances carried forward	<u>\$ 95,477</u>	<u>\$ 108,260</u>
Balances lapsed	<u>79</u>	<u>359</u>
Total	<u>\$ 278,353</u>	<u>\$ 293,925</u>

The accompanying notes are an integral part of the financial statements and financial schedules.

Notes to the Financial Statements and Financial Schedules

Note 1 Significant Accounting Policies

a. Reporting Entity - Financial Statements

The accompanying financial statements report the financial position and the changes in financial position of the following funds administered by the Department of Environmental Quality (DEQ) as of and for the fiscal years ended September 30, 2009 and September 30, 2008:

Special Revenue Funds

Combined Environmental Protection Bond Fund (includes the Environmental Protection Bond Fund, the Clean Michigan Initiative Bond Fund, and the Great Lakes Water Quality Bond Fund)

Bottle Deposits Fund

Agency Fund

Environmental Quality Deposits Fund

These funds principally account for DEQ's environmental cleanup and grant and loan program activity. They are a part of the State of Michigan's reporting entity and are reported on in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*.

b. Reporting Entity - Financial Schedules

The accompanying financial schedules report the results of DEQ's financial transactions for the fiscal years ended September 30, 2009 and September 30, 2008. The financial transactions of DEQ are accounted for principally in the State's General Fund and are reported on in the *SOMCAFR*.

c. Measurement Focus and Basis of Accounting

The special revenue fund financial statements and the General Fund financial schedules contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting as provided by accounting principles generally accepted in the United States of America (GAAP). Under the modified

accrual basis of accounting, revenues are recognized as they become susceptible to accrual, generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures generally are recorded when a liability is incurred; however, certain expenditures related to long-term obligations are recorded only when payment is due and payable. The agency fund financial statements contained in this report are presented using the economic resources measurement focus and the accrual basis of accounting as provided by GAAP. Under the accrual basis of accounting, additions to and deductions from the agency fund are recorded when incurred, regardless of the timing of cash flows.

d. Basis of Presentation

The accompanying financial statements present only the funds listed in Note 1a. The accompanying financial schedules present only the revenues and other financing sources and the sources and disposition of authorizations for DEQ's General Fund accounts. The *SOMCAFR* provides more extensive disclosures regarding the State's significant accounting policies; budgeting, budgetary control, and legal compliance; common cash; bonded debt; debt service and defeased debt; pension benefits; other postemployment benefits; and interfund receivables and payables.

Accordingly, these financial statements and financial schedules do not purport to, and do not, present fairly the financial position and changes in financial position or constitute a complete financial presentation of DEQ, the State of Michigan, the State's General Fund, or the State's special revenue and agency funds in conformity with GAAP.

The financial transactions of DEQ are recorded in the General Fund and individual funds in the State's central accounting system. The various environmental quality funds are combined in the *SOMCAFR* into fund types described as follows:

Governmental Fund Types

Special Revenue Funds: This fund group includes operating fund activities financed by specific revenue sources that are legally restricted for specified purposes.

Fiduciary Fund Types

Agency Funds: This fund group includes assets held by DEQ on behalf of outside parties. DEQ's responsibility is custodial in nature, and the asset and liability balances, but not operating results, are included within these statements.

Note 2 Combined Balance Sheet Reserves

The elements of the reserves are defined as follows:

- a. Restricted revenues: Revenues that, by statute, are restricted for use to a particular program or activity. Generally, the expenditure of the restricted revenues is subject to annual legislative appropriation. However, the restricted revenues may also be used in subsequent years to finance expenditures for multi-year appropriations (\$12.9 million and \$16.6 million in fiscal years 2008-09 and 2007-08, respectively) and encumbrances carried forward (\$4.3 million and \$4.9 million in fiscal years 2008-09 and 2007-08, respectively).
- b. Revolving loan programs: Reserves to finance loans to local units of government and brownfield redevelopment authorities for response activities at known or suspected facilities with redevelopment potential. Also, the reserves finance loans to local units of government and to brownfield redevelopment authorities for environmental assessments, demolition, and other remedial actions.

- c. Funds held as permanent investments: Amounts that have been restricted for the purpose of providing a long-term source of investment income. These investments are held as a portion of the fund's share of the State's common cash pool.

Note 3 Equity in Common Cash

Custodial Credit Risk: All of DEQ's deposits are managed by the State Treasurer. "Equity in common cash" represents an interest in the State's common cash pool, which is used by most State funds as a short-term investment vehicle. DEQ's deposits are included in the State of Michigan's equity in common cash.

DEQ's common cash balances were as follows (in thousands):

	As of September 30			
	Special Revenue Funds		Agency Fund	
	2009	2008	2009	2008
Equity in common cash	\$129,056	\$101,831	\$2,789	\$3,288

These amounts do not include common cash for State-restricted subfunds within the General Fund.

The Governmental Accounting Standards Board (GASB) requires certain disclosures related to custodial credit risk for deposits. Custodial credit risk for deposits is the risk that, in the event of a bank failure, DEQ's deposits will not be returned to it. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and are uncollateralized, collateralized with securities held by pledging financial institutions, or collateralized with securities held by the pledging financial institution's trust department or agent but not in DEQ's name. The State Treasurer evaluates each financial institution it deposits common cash funds with and assesses the level of risk of each institution. Only those institutions with an acceptable estimated risk level are used as depositories.

Note 4 Schedule of Sources and Disposition of General Fund Authorizations

The various elements of the schedule of sources and disposition of General Fund authorizations are defined as follows:

- a. General purpose appropriations: Original appropriations and any supplemental appropriations that are financed by General Fund/general purpose revenues.
- b. Balances carried forward: Authorizations for multi-year projects, encumbrances, restricted revenues - authorized, and restricted revenues - not authorized or used that were not spent as of the end of the prior fiscal year. These authorizations are available for expenditure in the current fiscal year for the purpose of the carry-forward without additional legislative authorization, except for the restricted revenues - not authorized or used.
- c. Restricted financing sources: Collections of restricted revenues, restricted transfers, and restricted intrafund expenditure reimbursements used to finance programs as detailed in the appropriations act. These financing sources are authorized for expenditure up to the amount appropriated. Depending upon program statute, any amounts received in excess of the appropriation are, at year-end, either converted to general purpose financing sources and made available for general appropriation in the next fiscal year or carried forward to the next fiscal year as either restricted revenues - authorized or restricted revenues - not authorized or used.
- d. Intrafund expenditure reimbursements: Funding from other General Fund departments to finance a program or a portion of a program that is the responsibility of the receiving department.
- e. Encumbrances: Authorizations carried forward to finance payments for goods or services ordered during the fiscal year but not received by fiscal year-end. These authorizations are generally limited to obligations funded by general purpose appropriations.
- f. Restricted revenues - not authorized or used: Revenues that, by statute, are restricted for use to a particular program or activity. Generally, the expenditure of the restricted revenues is subject to annual legislative

appropriation. However, the restricted revenues may also be used in subsequent years to finance expenditures for multi-year environmental cleanup appropriations (\$20.3 million and \$28.9 million in fiscal years 2008-09 and 2007-08, respectively) and encumbrances carried forward (\$26.3 million and \$22.4 million in fiscal years 2008-09 and 2007-08, respectively).

- g. Balances lapsed: Authorizations that were unexpended and unobligated at the end of the fiscal year. These amounts are available for legislative appropriation in the subsequent fiscal year.

Note 5 Joint Venture

The State, represented by DEQ, is a participant in a joint venture known as the Great Lakes Protection Fund. The joint venture is not reflected within this report because it did not meet GAAP's criteria for inclusion.

The Great Lakes Protection Fund is a not-for-profit corporation located in Evanston, Illinois. Its purpose is to finance and support research with respect to the water quality of the Great Lakes. The eight states bordering on the Great Lakes are eligible to become members if they make a required contribution to the endowment of the Fund. Contribution requirements were established based upon water consumption and usage. Michigan is the largest contributor to the Fund, having made a contribution of \$25 million, constituting approximately 31% of the total. Michigan made its required contribution in fiscal year 1989-90 by issuing the Fund a general obligation bond authorized as part of the State's environmental protection bond program. No additional contributions from Michigan will be required.

Each of the participating seven member states is represented by two members on the Fund's Board of Directors. The Board members are selected by the states' respective governors. The Fund's financing and budgeting operations are controlled by the directors within requirements established by the Articles of Incorporation. Net earnings on total contributions after operating expenses are divided into parts. One-third of the net earnings on total contributions (after operating expenses) are granted to the respective states in proportion to their contributions to the Fund, to be used for the purposes of the Fund. Two-thirds of the net earnings are available to the Fund to make other grants. The State's

equity interest in the Great Lakes Protection Fund of \$25 million is reflected in the *SOMCAFR* in the government-wide statement of net assets.

Complete financial statements may be obtained directly by contacting the Financial Reporting Section within the Office of Financial Management, State Budget Office, Department of Technology, Management & Budget, at (517) 373-3029.

Note 6 Federal Revenues and Expenditures

Federal revenues in the schedule of General Fund revenues and other financing sources differ from the expenditures reported in the schedule of expenditures of federal awards. The schedule of expenditures of federal awards includes payments totaling \$171.3 million made by the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to subrecipients* from its State Revolving Fund* and Drinking Water State Revolving Fund*. These expenditures and related federal revenues are not recorded in DEQ's accounting records. Although DEQ has administrative responsibility for the expenditures, the subrecipient loan disbursements and repayments flow through and are accounted for by the Michigan Municipal Bond Authority.

Note 7 Proceeds From Bond Issues

Article IX, Section 15 of the Michigan Constitution authorizes general obligation long-term borrowing, subject to approval by the Legislature and a majority of voters at a general election. General obligation bonds are backed by the full faith and credit of the State. DEQ-related general obligation bonds issued

* See glossary at end of report for definition.

during fiscal years 2007-08 and 2008-09 as reported in DEQ's special revenue funds were as follows:

General Obligation Bonds Issued	Amounts Issued	Fiscal Year Maturities		Average Interest Rate Percentage
		First Year	Last Year	
Series 2008 A (1)	\$15.0	2011	2019	4.94%
Series 2008 B (1) (2)	\$10.0	2011	2019	4.33%
Series 2009 A (1)	\$46.4	2022	2026	5.65%
Series 2009 B (1)	\$ 3.5	2012	2012	4.60%

- (1) Section 324.95102 of the *Michigan Compiled Laws* authorized the issuance of bonds totaling \$675.0 million. As of September 30, 2009, \$569.4 million of such bond proceeds had been received, leaving remaining authorization of \$105.6 million.
- (2) During November 2002, voters approved a ballot proposal in which the State would issue \$1.0 billion in general obligation bonds to provide capital, which is then loaned to local units of government for water quality improvement projects. As of September 30, 2009, \$145.6 million of such bond proceeds had been recognized as received, leaving remaining authorization of \$854.4 million.

Note 8 Transfer of Surplus Bottle Deposits Funds

Act 79, P.A. 2009, effective August 31, 2009, transferred \$0.9 million of funds, determined to be surplus, from the Community Pollution Prevention Fund, a subfund of the Bottle Deposits Fund, to the Environmental Protection Fund (EPF), a subfund in the General Fund.

Note 9 Contingencies and Litigation

- a. Rexair, Inc.: In 1991, DEQ entered a consent decree with Rexair, Inc., to halt migration of and to remediate trichloroethylene (TCE) released at the Rexair facility. The TCE plume escaped the groundwater capture system, and DEQ filed a motion for dispute resolution through the consent decree to have Rexair address the problem. DEQ tried to withdraw this motion, but the circuit court denied the request. On March 24, 2006, the circuit court ordered a dismissal of the dispute resolution with prejudice and awarded Rexair attorney fees and costs. DEQ filed an application for leave of appeal, which was granted by the Court of Appeals on May 8, 2008. Rexair filed a leave for appeal to the Supreme Court. On October 3, 2008, the Supreme Court reversed the Court of Appeals decision and reinstated the circuit court's order. DEQ filed a motion for reconsideration with the Supreme Court, but the motion was denied on

April 29, 2009. In February 2010, an evidentiary hearing was held at which Rexair was awarded \$3.8 million in attorney fees and costs. DEQ has filed an appeal. As the final outcome is still pending, a liability is not recorded in these financial statements. In accordance with State accounting policy for governmental funds, liabilities are accrued when cases are settled and the amount is due and payable.

- b. Richfield Landfill, Inc.: Richfield Landfill, Inc., filed suit against DEQ in a temporary takings claim based upon the denial of an operating license for a solid waste landfill. Richfield Landfill has claimed damages in excess of \$5 million. In accordance with GAAP and the modified accrual basis of accounting, a liability is not recorded in these financial statements and financial schedules because liabilities are accrued when cases are settled and the amount is due and payable.
- c. AAR Cadillac Manufacturing: AAR Cadillac Manufacturing filed suit against DEQ for costs and attorney fees in excess of \$2 million related to its efforts to comply with an administrative order issued by DEQ to remediate contamination at its facility. An appeal has been filed by DEQ. In accordance with GAAP and the modified accrual basis of accounting, a liability is not recorded in these financial statements and financial schedules because liabilities are accrued when cases are settled and the amount is due and payable. On June 24, 2010, this case was settled. The settlement agreement is prospective in nature and provides for no exchange of money. Under the settlement agreement, both parties are required to perform specific environmental work and monitoring at the site.

Note 10 Subsequent Event

Executive Order No. 2009-45 created the Department of Natural Resources and Environment (DNRE), effective January 17, 2010. It transferred all of the authority, powers, duties, functions, responsibilities, records, personnel, property, equipment, and budgetary resources of the Department of Natural Resources (DNR) and DEQ to DNRE by a Type II transfer and abolished DNR and DEQ.

SUPPLEMENTAL
FINANCIAL STATEMENTS AND
SCHEDULE

Description of Special Revenue Funds

COMBINED ENVIRONMENTAL PROTECTION BOND FUND

This Fund was established by Act 328, P.A. 1988, to account for the proceeds of \$660 million of Environmental Protection general obligation bonds approved by Michigan voters in November 1988. The Act specifies that the proceeds of these bonds be available to clean up sites of toxic and other environmental contamination, for solid waste projects, to capitalize the State Water Pollution Control Loan Fund, and to fund Michigan's participation in a regional Great Lakes Protection Fund. Act 380, P.A. 1996, provides that interest earnings and unappropriated or lapsed solid waste project allocations be transferred to the Cleanup and Redevelopment Subfund (CRF).

Act 284, P.A. 1998, expanded the Combined Environmental Protection Bond Fund to account for the proceeds of \$570 million of Clean Michigan Initiative general obligation bonds approved by Michigan voters in November 1998. The Act directs that bond proceeds be used for environmental response activities at facilities, waterfront improvements, remediation of contaminated lake and river sediments, nonpoint source pollution prevention and control projects or wellhead protection projects, water quality monitoring and water resources protection and pollution control activities, and pollution prevention programs.

Act 397, P.A. 2002, expanded this Fund to account for the proceeds of \$1 billion of Great Lakes Water Quality general obligation bonds approved by Michigan voters in November 2002. The Act directs that bond proceeds be used to finance sewage treatment works projects, storm water projects, and nonpoint source projects that improve the quality of the waters of the State. The Great Lakes Water Quality Bond Fund records the bond proceeds and the administrative costs of the Department of Environmental Quality (DEQ). All programmatic loan and grant payments are reported in the financial statements of the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan.

BOTTLE DEPOSITS FUND

This Fund was created by Act 384, P.A. 1996, to provide for the disposition of unredeemed bottle deposits. The Fund is jointly administered by DEQ and the Department of Treasury. The law mandates that an annual distribution of collections be made as follows: 25% returned to the dealers and 75% to fund several subfunds.

The 75% is initially deposited into the Cleanup and Redevelopment Trust Subfund (CRTF) and, if not further distributed, remains there until the principal amount reaches \$200 million. Of the funds received annually in CRTF, 80% is allocated to CRF and 10% to the Community Pollution Prevention Subfund. The remaining 10% stays in CRTF.

Act 380, P.A. 1996, moved the former Environmental Response Fund to a subfund of CRF. The law mandates that proceeds of all cost recovery actions taken and settlements entered into pursuant to Part 201, Act 451, P.A. 1994, as amended, excluding natural resource damages, by DEQ or the Attorney General, or both, shall be credited to the Environmental Response Fund.

Several DEQ subfunds are administratively housed within the Bottle Deposits Fund, although they receive no bottle deposit revenue. The State Sites Cleanup Subfund, established in accordance with Act 380, P.A. 1996, to provide for response activities at facilities where the State is liable as the owner or operator, is one such subfund. Also included are the following loan programs administered by DEQ: the Brownfield Revolving Loan Fund, created by Act 253, P.A. 2003; the Revitalization Revolving Loan Fund, created by Act 383, P.A. 1996; and the federal Brownfield Cleanup Revolving Loan Fund.

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Balance Sheet
Special Revenue Funds
As of September 30
(In Thousands)

	Combined Environmental Protection Bond Fund		Bottle Deposits Fund		Totals	
	2009	2008	2009	2008	2009	2008
ASSETS						
Current assets:						
Cash	\$	\$	\$	\$ 3	\$ 0	\$ 3
Equity in common cash	52,368	35,977	76,688	65,854	129,056	101,831
Amounts due from other funds	12	2			12	2
Amounts due from component units	12	7			12	7
Amounts due from local units		2	604	338	604	340
Other current assets			1,390	8,599	1,390	8,599
Total current assets	<u>\$ 52,392</u>	<u>\$ 35,987</u>	<u>\$ 78,682</u>	<u>\$ 74,793</u>	<u>\$ 131,074</u>	<u>\$ 110,782</u>
Amounts due from local units			14,350	13,148	14,350	13,148
Other noncurrent assets			1,275	1,543	1,275	1,543
Total assets	<u>\$ 52,392</u>	<u>\$ 35,987</u>	<u>\$ 94,307</u>	<u>\$ 89,485</u>	<u>\$ 146,699</u>	<u>\$ 125,472</u>
LIABILITIES AND FUND BALANCES						
Current liabilities:						
Warrants outstanding	\$ 952	\$ 17	\$ 455	\$ 76	\$ 1,407	\$ 93
Accounts payable and other liabilities	11,282	12,270	1,788	1,770	13,070	14,040
Amounts due to other funds	13	5	180	135	193	140
Deferred revenue			568	1,058	568	1,058
Total current liabilities	<u>\$ 12,247</u>	<u>\$ 12,291</u>	<u>\$ 2,990</u>	<u>\$ 3,040</u>	<u>\$ 15,238</u>	<u>\$ 15,331</u>
Long-term liabilities:						
Deferred revenue			1,275	1,543	1,275	1,543
Total liabilities	<u>\$ 12,247</u>	<u>\$ 12,291</u>	<u>\$ 4,265</u>	<u>\$ 4,582</u>	<u>\$ 16,512</u>	<u>\$ 16,874</u>
Fund balances:						
Reserves for:						
Budgetary carry-forwards:						
Restricted revenues	\$	\$	\$ 49,315	\$ 48,839	\$ 49,315	\$ 48,839
Revolving loan programs			31,990	28,453	31,990	28,453
Funds held as permanent investments			8,737	7,610	8,737	7,610
Total reserved	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 90,042</u>	<u>\$ 84,902</u>	<u>\$ 90,042</u>	<u>\$ 84,902</u>
Unreserved	40,145	23,696			40,145	23,696
Total fund balances	<u>\$ 40,145</u>	<u>\$ 23,696</u>	<u>\$ 90,042</u>	<u>\$ 84,902</u>	<u>\$ 130,187</u>	<u>\$ 108,598</u>
Total liabilities and fund balances	<u>\$ 52,392</u>	<u>\$ 35,987</u>	<u>\$ 94,307</u>	<u>\$ 89,485</u>	<u>\$ 146,699</u>	<u>\$ 125,472</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances
Special Revenue Funds
Fiscal Years Ended September 30
(In Thousands)

	Combined Environmental Protection Bond Fund		Bottle Deposits Fund		Totals	
	2009	2008	2009	2008	2009	2008
REVENUES						
From federal agencies	\$	\$	\$ 314	\$ 693	\$ 314	\$ 693
Miscellaneous	2,086	1,976	20,053	25,477	22,139	27,453
Total revenues	<u>\$ 2,086</u>	<u>\$ 1,976</u>	<u>\$ 20,367</u>	<u>\$ 26,170</u>	<u>\$ 22,453</u>	<u>\$ 28,146</u>
EXPENDITURES						
Current:						
General government	\$ 167	\$	\$	\$	\$ 167	\$ 0
Environmental	32,920	42,943	16,767	18,029	49,687	60,972
Total expenditures	<u>\$ 33,086</u>	<u>\$ 42,943</u>	<u>\$ 16,767</u>	<u>\$ 18,029</u>	<u>\$ 49,854</u>	<u>\$ 60,972</u>
Excess of revenues over (under) expenditures	<u>\$ (31,001)</u>	<u>\$ (40,967)</u>	<u>\$ 3,600</u>	<u>\$ 8,141</u>	<u>\$ (27,401)</u>	<u>\$ (32,826)</u>
OTHER FINANCING SOURCES (USES)						
Proceeds from bond issues	\$ 49,890	\$ 25,000	\$	\$	\$ 49,890	\$ 25,000
Premium on bond issuance	1,272	1,215			1,272	1,215
Discount on bond issuance	(211)				(211)	0
Transfers from other funds			3,500	6,463	3,500	6,463
Transfers to other funds	(3,501)	(6,464)	(1,960)	(519)	(5,461)	(6,983)
Total other financing sources (uses)	<u>\$ 47,450</u>	<u>\$ 19,751</u>	<u>\$ 1,540</u>	<u>\$ 5,943</u>	<u>\$ 48,990</u>	<u>\$ 25,694</u>
Excess of revenues and other sources over (under) expenditures and other uses	<u>\$ 16,449</u>	<u>\$ (21,217)</u>	<u>\$ 5,140</u>	<u>\$ 14,084</u>	<u>\$ 21,589</u>	<u>\$ (7,132)</u>
Fund balances - Beginning of fiscal year	<u>23,696</u>	<u>44,912</u>	<u>84,902</u>	<u>70,818</u>	<u>108,598</u>	<u>115,730</u>
Fund balances - End of fiscal year	<u><u>\$ 40,145</u></u>	<u><u>\$ 23,696</u></u>	<u><u>\$ 90,042</u></u>	<u><u>\$ 84,902</u></u>	<u><u>\$ 130,187</u></u>	<u><u>\$ 108,598</u></u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Balance Sheet
Combined Environmental Protection Bond Fund
As of September 30
(In Thousands)

	Environmental Protection Bond Fund		Clean Michigan Initiative Bond Fund		Great Lakes Water Quality Bond Fund		Totals	
	2009	2008	2009	2008	2009	2008	2009	2008
ASSETS								
Current assets:								
Equity in common cash	\$ 15,083	\$ 16,935	\$ 37,285	\$ 19,042	\$	\$	\$ 52,368	\$ 35,977
Amounts due from other funds	12	2					12	2
Amounts due from component units					12	7	12	7
Amounts due from local units				2				2
Other current assets								0
Total current assets	<u>\$ 15,095</u>	<u>\$ 16,937</u>	<u>\$ 37,285</u>	<u>\$ 19,044</u>	<u>\$ 12</u>	<u>\$ 7</u>	<u>\$ 52,392</u>	<u>\$ 35,987</u>
Total assets	<u>\$ 15,095</u>	<u>\$ 16,937</u>	<u>\$ 37,285</u>	<u>\$ 19,044</u>	<u>\$ 12</u>	<u>\$ 7</u>	<u>\$ 52,392</u>	<u>\$ 35,987</u>
LIABILITIES AND FUND BALANCES								
Current liabilities:								
Warrants outstanding	\$	\$	\$ 952	\$ 17	\$	\$	\$ 952	\$ 17
Accounts payable and other liabilities	976	1,172	10,306	11,094		4	11,282	12,270
Amounts due to other funds			1	2	12	3	13	5
Total current liabilities	<u>\$ 976</u>	<u>\$ 1,172</u>	<u>\$ 11,259</u>	<u>\$ 11,113</u>	<u>\$ 12</u>	<u>\$ 7</u>	<u>\$ 12,247</u>	<u>\$ 12,291</u>
Total liabilities	\$ 976	\$ 1,172	\$ 11,259	\$ 11,113	\$ 12	\$ 7	\$ 12,247	\$ 12,291
Fund balances:								
Total unreserved fund balances	14,119	15,765	26,026	7,931			40,145	23,696
Total liabilities and fund balances	<u>\$ 15,095</u>	<u>\$ 16,937</u>	<u>\$ 37,285</u>	<u>\$ 19,044</u>	<u>\$ 12</u>	<u>\$ 7</u>	<u>\$ 52,392</u>	<u>\$ 35,987</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Combining Statement of Revenues, Expenditures, and Changes in Fund Balances
 Combined Environmental Protection Bond Fund
Fiscal Years Ended September 30
 (In Thousands)

	Environmental Protection Bond Fund		Clean Michigan Initiative Bond Fund		Great Lakes Water Quality Bond Fund		Totals	
	2009	2008	2009	2008	2009	2008	2009	2008
REVENUES								
Miscellaneous	\$ 387	\$ 246	\$ 1,633	\$ 1,625	\$ 66	\$ 105	\$ 2,086	\$ 1,976
Total revenues	\$ 387	\$ 246	\$ 1,633	\$ 1,625	\$ 66	\$ 105	\$ 2,086	\$ 1,976
EXPENDITURES								
Current:								
General government	\$ 165	\$	\$ 2	\$	\$	\$	\$ 167	\$ 0
Environmental	1,868	1,972	30,987	38,368	65	2,603	32,920	42,943
Total expenditures	\$ 2,033	\$ 1,972	\$ 30,989	\$ 38,368	\$ 65	\$ 2,603	\$ 33,086	\$ 42,943
Excess of revenues over (under) expenditures	\$ (1,646)	\$ (1,726)	\$ (29,356)	\$ (36,743)	\$ 1	\$ (2,498)	\$ (31,001)	\$ (40,967)
OTHER FINANCING SOURCES (USES)								
Proceeds from bond issues	\$	\$	\$ 49,890	\$ 22,500	\$	\$ 2,500	\$ 49,890	\$ 25,000
Premium on bond issues			1,272	1,215			1,272	1,215
Discount on bond issues			(211)				(211)	0
Transfers to other funds			(3,500)	(6,462)	(1)	(2)	(3,501)	(6,464)
Total other financing sources (uses)	\$ 0	\$ 0	\$ 47,451	\$ 17,253	\$ (1)	\$ 2,498	\$ 47,450	\$ 19,751
Excess of revenues and other sources over (under) expenditures and other uses	\$ (1,646)	\$ (1,726)	\$ 18,095	\$ (19,490)	\$	\$	\$ 16,449	\$ (21,217)
Fund balances - Beginning of fiscal year	15,765	17,490	7,931	27,422			23,696	44,912
Fund balances - End of fiscal year	\$ 14,119	\$ 15,765	\$ 26,026	\$ 7,931	\$ 0	\$ 0	\$ 40,145	\$ 23,696

Description of Agency Fund

ENVIRONMENTAL QUALITY DEPOSITS FUND

This Fund was reauthorized by Act 451, P.A. 1994, as amended, to account for cash bonds posted by applicants desiring licenses to operate hazardous and solid waste disposal areas. Because the Scrap Tire Regulatory Fund created by Act 451, P.A. 1994, has similar provisions, both of these activities are accounted for in this Fund. In accordance with Act 451, P.A. 1994, as amended, interest earnings at the rate of interest accrued on the State's common cash pool, not to exceed an annual rate of 6%, are credited to the applicant's account. The receipt of cash bonds and interest earnings are recorded as additions to assets and liabilities.

This Act also specifies the circumstances under which the director of the Department of Environmental Quality is authorized to use the deposits to close and maintain a facility or return the deposit upon the operator's satisfactory closure and maintenance of the facility. The use or return of deposits and interest are recorded as deductions to assets and liabilities.

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Statement of Changes in Assets and Liabilities
 Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2009
 (In Thousands)

	Balance October 1, 2008	Additions	Deductions	Balance September 30, 2009
ASSETS				
Equity in common cash	\$ 3,288	\$ 680	\$ 1,179	\$ 2,789
Total assets	<u>\$ 3,288</u>	<u>\$ 680</u>	<u>\$ 1,179</u>	<u>\$ 2,789</u>
LIABILITIES				
Accounts payable and other liabilities	\$ 3,288	\$ 680	\$ 1,179	\$ 2,789
Total liabilities	<u>\$ 3,288</u>	<u>\$ 680</u>	<u>\$ 1,179</u>	<u>\$ 2,789</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Statement of Changes in Assets and Liabilities
Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2008
(In Thousands)

	Balance October 1, 2007	Additions	Deductions	Balance September 30, 2008
ASSETS				
Equity in common cash	\$ 3,055	\$ 284	\$ 51	\$ 3,288
Total assets	<u>\$ 3,055</u>	<u>\$ 284</u>	<u>\$ 51</u>	<u>\$ 3,288</u>
LIABILITIES				
Accounts payable and other liabilities	\$ 3,055	\$ 284	\$ 51	\$ 3,288
Total liabilities	<u>\$ 3,055</u>	<u>\$ 284</u>	<u>\$ 51</u>	<u>\$ 3,288</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2007 through September 30, 2009

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2008		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
<u>Financial Assistance</u>					
<u>U.S. Department of Commerce</u>					
Direct Program:					
Coastal Zone Management Administration Awards	11.419		\$ 1,386,333	\$ 858,533	\$ 2,244,866
Pass-Through Program:					
University of Michigan Sea Grant Support	11.417	NA05OAR4171067	189		189
Total U.S. Department of Commerce			\$ 1,386,522	\$ 858,533	\$ 2,245,055
<u>U.S. Department of Defense</u>					
Direct Program:					
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113		\$ 1,222,281	\$	\$ 1,222,281
Total U.S. Department of Defense			\$ 1,222,281	\$ 0	\$ 1,222,281
<u>U.S. Department of the Interior</u>					
Direct Programs:					
Fish and Wildlife Management Assistance	15.608		\$ 35,060	\$	\$ 35,060
U.S. Geological Survey - Research and Data Collection	15.808		24,929		24,929
National Geological and Geophysical Data Preservation Program	15.814		4,138		4,138
Total U.S. Department of the Interior			\$ 64,127	\$ 0	\$ 64,127
<u>U.S. Environmental Protection Agency</u>					
Direct Programs:					
Air Pollution Control Program Support	66.001		\$ 3,764,275	\$	\$ 3,764,275
State Indoor Radon Grants	66.032		211,200	77,250	288,450
Surveys, Studies, Research, Investigations, Demonstrations, and Special Purpose Activities Relating to the Clean Air Act	66.034		833,850	205,139	1,038,989
State Clean Diesel Grant Program	66.040		\$	\$	\$
ARRA - State Clean Diesel Grant Program Total State Clean Diesel Grant Program	66.040		\$ 0	\$ 0	\$ 0
Surveys, Studies, Investigations, Demonstrations, and Training Grants and Cooperative Agreements - Section 104(b)(3) of the Clean Water Act	66.436		6,330		6,330
Water Quality Management Planning	66.454		\$ 174,715	\$ 265,959	\$ 440,674
ARRA - Water Quality Management Planning Total Water Quality Management Planning	66.454		\$ 174,715	\$ 265,959	\$ 440,674
Capitalization Grants for Clean Water State Revolving Funds (1)	66.458		\$ 2,439,790	\$ 39,325,473	\$ 41,765,263
ARRA - Capitalization Grants for Clean Water State Revolving Funds Total Capitalization Grants for Clean Water State Revolving Funds	66.458		\$ 2,439,790	\$ 39,325,473	\$ 41,765,263
Nonpoint Source Implementation Grants	66.460		2,145,633	3,191,049	5,336,682
Regional Wetland Program Development Grants	66.461		182,020	84,520	266,540
Water Quality Cooperative Agreements	66.463		27,303	149,423	176,726
Wastewater Operator Training Grant Program	66.467		37,437		37,437
Capitalization Grants for Drinking Water State Revolving Funds (1)	66.468		\$ 2,824,466	\$ 46,960,642	\$ 49,785,108
ARRA - Capitalization Grants for Drinking Water State Revolving Funds Total Capitalization Grants for Drinking Water State Revolving Funds	66.468		\$ 2,824,466	\$ 46,960,642	\$ 49,785,108

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2009

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 1,196,096	\$ 781,012	\$ 1,977,108	\$ 4,221,974
			189
\$ 1,196,096	\$ 781,012	\$ 1,977,108	\$ 4,222,163
\$ 1,115,622	\$	\$ 1,115,622	\$ 2,337,903
\$ 1,115,622	\$ 0	\$ 1,115,622	\$ 2,337,903
\$ 54,021	\$	\$ 54,021	\$ 89,081
51,232		51,232	76,161
30,336		30,336	34,474
\$ 135,589	\$ 0	\$ 135,589	\$ 199,716
\$ 3,869,778	\$	\$ 3,869,778	\$ 7,634,053
283,400		283,400	571,850
730,075	123,577	853,652	1,892,641
\$ 45,589	\$	\$ 45,589	\$ 45,589
36,348		36,348	36,348
\$ 81,937	\$ 0	\$ 81,937	\$ 81,937
			6,330
\$ 177,027	\$ 130,240	\$ 307,267	\$ 747,941
174,095		174,095	174,095
\$ 351,122	\$ 130,240	\$ 481,362	\$ 922,036
\$ 2,463,084	\$ 38,968,758	\$ 41,431,842	\$ 83,197,105
	16,091,925	16,091,925	16,091,925
\$ 2,463,084	\$ 55,060,683	\$ 57,523,767	\$ 99,289,030
2,436,581	3,484,457	5,921,038	11,257,720
33,068	38,548	71,616	338,156
32,798	(1,191)	31,607	208,333
		0	37,437
\$ 3,432,434	\$ 25,531,183	\$ 28,963,617	\$ 78,748,725
	5,167,696	5,167,696	5,167,696
\$ 3,432,434	\$ 30,698,879	\$ 34,131,313	\$ 83,916,421

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2007 through September 30, 2009
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2008		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Great Lakes Program	66.469		\$ 599,721	\$ 114,414	\$ 714,135
State Grants to Reimburse Operators of Small Water Systems for Training and Certification Costs	66.471		403,271	326,350	729,621
Beach Monitoring and Notification Program Implementation Grants	66.472		71,899	250,984	322,883
Water Protection Grants to the States	66.474		223,169		223,169
Wetland Program Grants - State/Tribal Environmental Outcome Wetland Demonstration Program	66.479		376,688	29,060	405,748
Performance Partnership Grants	66.605		12,842,700		12,842,700
Environmental Information Exchange Network Grant Program and Related Assistance	66.608		571,424	33,480	604,904
Environmental Policy and Innovation Grants	66.611		984		984
Pollution Prevention Grants Program	66.708		80,010		80,010
Multi-Media Capacity Building Grants for States and Tribes	66.709				
Hazardous Waste Management State Program Support	66.801		3,425,943		3,425,943
Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements	66.802		1,017,302		1,017,302
Underground Storage Tanks Prevention, Detection and Compliance Program	66.804		516,000		516,000
Leaking Underground Storage Tank Trust Fund Corrective Action Program	66.805		\$ 1,550,000	\$	\$ 1,550,000
ARRA - Leaking Underground Storage Tank Trust Fund Corrective Action Program	66.805				
Total Leaking Underground Storage Tank Trust Fund Corrective Action Program			\$ 1,550,000	\$ 0	\$ 1,550,000
Superfund State and Indian Tribe Core Program Cooperative Agreements	66.809		347,266		347,266
State and Tribal Response Program Grants	66.817		1,137,317		1,137,317
Brownfields Assessment and Cleanup Cooperative Agreements	66.818			264,337	264,337
Total Direct Programs			\$ 35,810,713	\$ 91,278,080	\$ 127,088,793
Pass-Through Programs:					
Great Lakes Commission					
Surveys, Studies, Research, Investigations, Demonstrations, and Special Purpose Activities Relating to the Clean Air Act	66.034	XA00E008-01	\$ 15,830	\$	\$ 15,830
Grand Traverse Band of Ottawa and Chippewa Indians					
Training, Investigations, and Special Purpose Activities of Federally- Recognized Indian Tribes Consistent With the Clean Air Act (CAA), Tribal Sovereignty and the Protection and Management of Air Quality	66.038	XA965856-01	\$ 688	\$	\$ 688
Little River Band of Ottawa Indians					
Training, Investigations, and Special Purpose Activities of Federally- Recognized Indian Tribes Consistent With the Clean Air Act (CAA), Tribal Sovereignty and the Protection and Management of Air Quality	66.038	XA965859-01	377		377
Total Training, Investigations, and Special Purpose Activities of Federally-Recognized Indian Tribes Consistent With the Clean Air Act (CAA), Tribal Sovereignty and the Protection and Management of Air Quality			\$ 1,065	\$ 0	\$ 1,065

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2009

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 666,940	\$ 103,640	\$ 770,580	\$ 1,484,715
166,125	86,305	252,430	982,051
132,669	168,246	300,915	623,798
201,753		201,753	424,922
440,757	53,360	494,117	899,865
12,418,101	20,499	12,438,600	25,281,300
563,466	10,800	574,266	1,179,170
48,005		48,005	48,989
46,617		46,617	126,627
15,539		15,539	15,539
3,476,990		3,476,990	6,902,933
951,964		951,964	1,969,266
518,647		518,647	1,034,647
\$ 1,574,262	\$	\$ 1,574,262	\$ 3,124,262
18,624		18,624	18,624
\$ 1,592,886	\$ 0	\$ 1,592,886	\$ 3,142,886
201,284		201,284	548,550
1,263,106		1,263,106	2,400,423
30,165		30,165	294,502
\$ 36,449,291	\$ 89,978,043	\$ 126,427,334	\$ 253,516,127
\$	\$	\$ 0	\$ 15,830
\$ 434	\$	\$ 434	\$ 1,122
2,968		2,968	3,345
\$ 3,402	\$ 0	\$ 3,402	\$ 4,467

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2007 through September 30, 2009
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2008		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Gun Lake Tribe Targeted Watersheds Grants	66.439	WS-9656901	\$ 182	\$	\$ 182
Michigan Department of Community Health Science To Achieve Results (STAR) Fellowship Program	66.514	RD833628-01	854		854
State of Minnesota Performance Partnership Grants	66.605	BG985688-09	101		101
Environmental Council of the States Environmental Information Exchange Network Grant Program and Related Assistance	66.608	OS833457-01	79,099		79,099
Total Pass-Through Programs			\$ 97,131	\$ 0	\$ 97,131
Total U.S. Environmental Protection Agency			\$ 35,907,844	\$ 91,278,080	\$ 127,185,924
<u>U.S. Department of Homeland Security</u>					
Direct Programs:					
State Access to the Oil Spill Liability Trust Fund (3)	97.013		\$	\$	\$ 0
Community Assistance Program State Support Services Element (CAP-SSSE)	97.023		199,432		199,432
National Dam Safety Program	97.041		46,658		46,658
Cooperating Technical Partners	97.045		313,499		313,499
Map Modernization Management Support	97.070		101,139		101,139
Homeland Security Biowatch Program	97.091		1,065,775		1,065,775
Total U.S. Department of Homeland Security			\$ 1,726,503	\$ 0	\$ 1,726,503
Total Financial Assistance			\$ 40,307,277	\$ 92,136,613	\$ 132,443,890
<u>Nonfinancial Assistance</u>					
<u>U.S. Environmental Protection Agency</u>					
Direct Programs:					
Air Pollution Control Program Support	66.001		\$ 84,422	\$	\$ 84,422
Surveys, Studies, Research, Investigations, Demonstrations, and Special Purpose Activities Relating to the Clean Air Act	66.034		371,825		371,825
Water Pollution Control, State, Interstate, and Tribal Program Support	66.419		315,652		315,652
Performance Partnership Grants	66.605				
Hazardous Waste Management State Program Support	66.801		270,626		270,626
Total U.S. Environmental Protection Agency			\$ 1,042,525	\$ 0	\$ 1,042,525
Total Nonfinancial Assistance			\$ 1,042,525	\$ 0	\$ 1,042,525
Total Expenditures of Federal Awards			\$ 41,349,802	\$ 92,136,613	\$ 133,486,415

(1) Basis of Presentation: This schedule presents the federal grant activity of the Department of Environmental Quality (DEQ) on the modified accrual basis of accounting and in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statements and financial schedules. In addition, this schedule includes payments totaling \$171.3 million made by the Michigan Municipal Bond Authority to subrecipients in the State Revolving Fund. These expenditures and related federal revenues are not recorded in DEQ's accounting records.

(2) CFDA is defined as *Catalog of Federal Domestic Assistance*.

(3) The State Access to the Oil Spill Liability Trust Fund grant represents funding from the Oil Spill Liability Trust Fund that is being used to reimburse DEQ for cleanup at the Michigan Petroleum Technologies, White Division site.

For the Fiscal Year Ended September 30, 2009

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$	\$	\$ 0	\$ 182
5,346		5,346	6,200
		0	101
26,991		26,991	106,090
<u>\$ 35,739</u>	<u>\$ 0</u>	<u>\$ 35,739</u>	<u>\$ 132,870</u>
\$ 36,485,030	\$ 89,978,043	\$ 126,463,073	\$ 253,648,997
\$ 3,471	\$	\$ 3,471	\$ 3,471
216,701		216,701	416,133
46,669		46,669	93,327
181,009		181,009	494,508
98,931		98,931	200,070
1,118,391		1,118,391	2,184,166
<u>\$ 1,665,172</u>	<u>\$ 0</u>	<u>\$ 1,665,172</u>	<u>\$ 3,391,675</u>
<u>\$ 40,597,509</u>	<u>\$ 90,759,055</u>	<u>\$ 131,356,564</u>	<u>\$ 263,800,454</u>
\$ 87,613	\$	\$ 87,613	\$ 172,035
		0	371,825
133,788		133,788	449,440
200,630		200,630	200,630
283,424		283,424	554,050
<u>\$ 705,455</u>	<u>\$ 0</u>	<u>\$ 705,455</u>	<u>\$ 1,747,980</u>
<u>\$ 705,455</u>	<u>\$ 0</u>	<u>\$ 705,455</u>	<u>\$ 1,747,980</u>
<u>\$ 41,302,964</u>	<u>\$ 90,759,055</u>	<u>\$ 132,062,019</u>	<u>\$ 265,548,434</u>

INDEPENDENT AUDITOR'S REPORTS ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Ms. Rebecca A. Humphries, Director
Department of Natural Resources and Environment
Constitution Hall
Lansing, Michigan

Dear Ms. Humphries:

We have audited the financial statements and financial schedules of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2009 and September 30, 2008, as identified in the table of contents, and have issued our report thereon dated June 24, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements and financial schedules, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements and/or financial schedules that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements and/or financial schedules will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined in the preceding paragraph.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements and financial schedules are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement and financial schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Governor, the Legislature, management, others within the Department, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

June 24, 2010



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance With
Requirements Applicable to Each Major Program
and on Internal Control Over Compliance in
Accordance With OMB Circular A-133

Ms. Rebecca A. Humphries, Director
Department of Natural Resources and Environment
Constitution Hall
Lansing, Michigan

Dear Ms. Humphries:

Compliance

We have audited the compliance of the Department of Environmental Quality with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each major federal program for the two-year period ended September 30, 2009. The Department's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Department's management. Our responsibility is to express an opinion on the Department'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 in the preceding paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Department'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 Department's compliance with those requirements.

The Department could not provide sufficient documentation supporting its compliance with Air Pollution Control Program Support and Nonpoint Source Implementation Grants regarding the matching, level of effort, and earmarking requirement nor were we able to satisfy ourselves as to the Department's compliance with the requirement by other auditing procedures.

As described in Findings 3 through 5 in the accompanying schedule of findings and questioned costs, the Department did not comply with requirements regarding subrecipient monitoring and special tests and provisions that are applicable to its Capitalization Grants for Clean Water State Revolving Funds; Nonpoint Source Implementation Grants; and Capitalization Grants for Drinking Water State Revolving Funds. Compliance with such requirements is necessary, in our opinion, for the Department to comply with the requirements applicable to those programs.

In our opinion, except for the effects of noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the Department of Environmental Quality's compliance with the requirements of Air Pollution Control Program Support and Nonpoint Source Implementation Grants regarding matching, level of effort, and earmarking and except for the noncompliance described in the preceding paragraph, the Department of Environmental Quality complied, in all material respects, with the requirements referred to in the first paragraph that are applicable to each of its other major federal programs for the two-year period ended September 30, 2009. The results of our auditing procedures also disclosed other 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 questions costs as Findings 1 through 6.

Internal Control Over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, 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 Department's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the Department's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A control deficiency in an entity's 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 noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as Findings 1 through 6 to be significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies described in the preceding paragraph, we consider Findings 2 through 6 to contain material weaknesses.

The Department's response to the findings identified in our audit are described in the accompanying corrective action plan. We did not audit the Department's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Governor, the Legislature, management, others within the Department, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

June 24, 2010

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results

Financial Statements and Financial Schedules

Type of auditor's report issued:	Unqualified*
Internal control* over financial reporting:	
Material weaknesses* identified?	No
Significant deficiencies* identified that are not considered to be material weaknesses?	None reported
Noncompliance or other matters material to the financial statements and/or financial schedules?	No

Federal Awards

Internal control over major programs:	
Material weaknesses* identified?	Yes
Significant deficiencies* identified that are not considered to be material weaknesses?	Yes

Type of auditor's report issued on compliance for major programs:
 Unqualified for all major federal programs except Air Pollution Control Program Support, Capitalization Grants for Clean Water State Revolving Funds, Nonpoint Source Implementation Grants, and Capitalization Grants for Drinking Water State Revolving Funds, which are qualified*.

Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	Yes
---	-----

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
11.419	Coastal Zone Management Administration Awards
66.001	Air Pollution Control Program Support

* See glossary at end of report for definition.

66.458	<u>Capitalization Grants for Clean Water State Revolving Funds</u> <ul style="list-style-type: none"> • Capitalization Grants for Clean Water State Revolving Funds • ARRA - Capitalization Grants for Clean Water State Revolving Funds
66.460	Nonpoint Source Implementation Grants
66.468	<u>Capitalization Grants for Drinking Water State Revolving Funds</u> <ul style="list-style-type: none"> • Capitalization Grants for Drinking Water State Revolving Funds • ARRA - Capitalization Grants for Drinking Water State Revolving Funds
66.605	Performance Partnership Grants
66.801	Hazardous Waste Management State Program Support
66.805	<u>Leaking Underground Storage Tank Trust Fund Program</u> <ul style="list-style-type: none"> • Leaking Underground Storage Tank Trust Fund Corrective Action Program • ARRA - Leaking Underground Storage Tank Trust Fund Corrective Action Program

Dollar threshold used to distinguish between type A and type B programs: \$3,000,000

Auditee qualified as a low-risk auditee*? No

* See glossary at end of report for definition.

Section II: Findings Related to the Financial Statements and Financial Schedules

We did not report any findings related to the financial statements and financial schedules.

Section III: Findings and Questioned Costs* Related to Federal Awards

FINDING (7611001)

1. Coastal Zone Management Administration Awards, CFDA 11.419

U.S. Department of Commerce	CFDA 11.419: Coastal Zone Management Administration Awards
Award Number: NA06NOS4190250 NA07NOS4190184 NA07NOS4190241 NA08NOS4190465	Award Period: 10/01/2006 - 09/30/2009 10/01/2007 - 09/30/2010 10/01/2007 - 09/30/2010 10/01/2008 - 03/31/2010
	Known Questioned Costs: \$0

The Department of Environmental Quality's (DEQ's) internal control over the Coastal Zone Management Administration Awards (CZM) Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and subrecipient monitoring.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of CZM Program awards.

Federal expenditures for the CZM Program totaled \$4.2 million for the two-year period ended September 30, 2009.

* See glossary at end of report for definition.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that CZM Program expenditures met the allowable cost principles of OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (Title 2, Part 225 of the *Code of Federal Regulations (CFR)*). Our review disclosed:

- (1) DEQ did not have a process in place to ensure that it did not overcharge administrative payroll costs to CZM Program awards. These included expenditures charged to the CZM Program and State-funded expenditures that DEQ used to match CZM Program awards. DEQ compared budget to actual administrative costs for all open grants during each fiscal year as a whole rather than on an individual grant award basis as required. As a result, DEQ determined that the budgeted administrative payroll expenditures did not exceed actual expenditures for the CZM Program in total. However, by grant award, the budgeted expenditures did exceed actual expenditures and DEQ therefore should have adjusted the expenditures to actual. In addition, DEQ did not complete a quarterly review for one quarter during fiscal year 2008-09. Subsequent to our review, DEQ completed the missing quarterly review and made corrections to the fiscal year 2008-09 administrative payroll costs applied to the grants.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires DEQ to adjust costs charged to federal awards to reflect actual activity performed at least quarterly unless the difference between actual and budgeted costs is less than 10%, in which case the adjustment can be made annually. Appendix A, section C.3.a. of OMB Circular A-87 (federal regulation 2 *CFR* 225) states that a cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objectives in accordance with relative benefits received.

We reported a similar condition in our prior Single Audit*. DEQ indicated in its June 2008 corrective action plan that the amount of administrative

* See glossary at end of report for definition.

time charged to the grant would be minimized and that the procedure for allocating these costs to federal grants would be posted on the DEQ Intranet.

- (2) DEQ did not have a process in place to document that employees agreed to changes made to their time sheets by others after they were submitted. As a result, DEQ did not document for 1 (4%) of 28 sampled payroll expenditures that the employee agreed to where the expenditures were charged. DEQ split these payroll expenditures between the federal grant and State funds used to match the federal grant award. DEQ was able to provide support that the employee worked on activities related to the CZM Program and, as a result, we did not report any questioned costs.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires that where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation. The personnel activity report or equivalent documentation is required to be signed by the employee charging time to the program.

b. Matching, Level of Effort, and Earmarking

DEQ's internal control did not ensure that it complied with federal requirements for matching, level of effort, and earmarking. Our review disclosed:

- (1) DEQ's internal control did not ensure that expenditures used to match CZM Program expenditures met allowable cost requirements. A portion of the payroll expenditures for the CZM Program are funded by the federal grant awards and the remaining expenditures are State-funded and used to match the federal grant awards. We noted:
 - (a) As discussed in the Allowable Costs/Cost Principles section (part a.(1)) of this finding, DEQ did not have a process in place to ensure that it did not overcharge administrative payroll costs to CZM Program awards.

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching

requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

- (b) As discussed in the Allowable Costs/Cost Principles section (part a.(2)) of this finding, DEQ did not have a process in place to document that employees agreed to changes made to their time sheets by others after they were submitted. As a result, DEQ did not document that an employee agreed to where his/her payroll expenditures that were State-funded and used to match the federal grant award were charged.

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

- (2) DEQ did not consistently require subrecipients to submit supporting documentation of matching expenditures used to satisfy the CZM Program matching requirements.

Our review disclosed that DEQ did not obtain invoices, receipts, or other detailed documentation to adequately support matching expenditures reported in 4 (27%) of 15 subrecipient financial reports. These matching expenditures included personnel costs, contractual services, travel, equipment, and supplies.

Federal regulation 15 *CFR* 24.24(b)(6) requires that costs and third party in-kind contributions counting toward satisfying a cost sharing or matching requirement must be verifiable from the records of grantees and subgrantees. Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) and Appendix B, section 8.m(4) of OMB Circular A-122, *Cost Principles for Non-Profit Organizations* (federal regulation 2 *CFR* 230), require payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed for reimbursement under federal awards.

c. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity* responsibilities as established by OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

We reviewed 12 subrecipients to assess DEQ's efforts to inform subrecipients of the required federal award information and to monitor subrecipients' activities. Also, we reviewed 47 subrecipients, of which 7 received CZM Program funding, to assess DEQ's efforts to obtain and review subrecipients' Single Audit reports and to issue management decisions.

Our review of DEQ's subrecipient monitoring efforts disclosed:

- (1) DEQ did not consistently monitor the activities of subrecipients to ensure that they used federal awards for authorized purposes. If DEQ does not sufficiently monitor the activities of subrecipients, it cannot ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements.

Because, in most instances, the amount of funds that DEQ passed through to its CZM subrecipients would not be significant enough for the CZM Program to be considered a major program in a Single Audit, DEQ's main process to monitor its subrecipients was to review project narratives, progress reports, and summary level financial reports that are submitted by the subrecipients with limited supporting documentation. Our review disclosed that DEQ did not obtain invoices, receipts, or other detailed documentation of costs incurred for 4 (27%) of 15 payments to subrecipients. In addition, as discussed in the Matching, Level of Effort, and Earmarking section (part b.(2)) of this finding, DEQ did not obtain detailed documentation to adequately support matching expenditures reported in 4 (27%) of 15 subrecipient financial reports.

OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws, regulations, and the provisions of contracts or grant agreements.

* See glossary at end of report for definition.

- (2) DEQ did not receive a Single Audit report or verify that an audit report was not required for 1 (14%) of the 7 subrecipients. DEQ received a statement from the subrecipient indicating that an audit report was not required; however, the statement covered the incorrect fiscal year.

OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the Single Audit requirements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would continue its effort to obtain 100% of the required audit reports and that it had established additional procedures to help determine whether an audit report is required.

RECOMMENDATIONS

FOR THE SECOND CONSECUTIVE AUDIT, WE RECOMMEND THAT DNRE IMPROVE ITS INTERNAL CONTROL OVER THE CZM PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING ALLOWABLE COSTS/COST PRINCIPLES AND SUBRECIPIENT MONITORING.

We also recommend that DNRE establish internal control over the CZM Program to ensure compliance with federal laws and regulations regarding matching, level of effort, and earmarking.

FINDING (7611002)

2. Air Pollution Control Program Support, CFDA 66.001

U.S. Environmental Protection Agency	CFDA 66.001: Air Pollution Control Program Support
Award Number: A00571106	Award Period: 10/01/2007 - 09/30/2009
	Known Questioned Costs: \$450

DEQ's internal control over Air Pollution Control Program Support did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and reporting. Our review disclosed material weaknesses in internal control with the matching, level of effort,

and earmarking compliance requirement. DEQ could not provide sufficient documentation supporting its compliance with the matching, level of effort, and earmarking requirement nor were we able to satisfy ourselves that DEQ complied with the requirement by other auditing procedures. As a result, we issued a qualified opinion on compliance with federal laws and regulations for Air Pollution Control Program Support.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Air Pollution Control Program Support awards.

Federal expenditures for Air Pollution Control Program Support totaled \$7.8 million for the two-year period ended September 30, 2009. We reported known questioned costs totaling \$450 and known and likely questioned costs totaling \$29,271.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ did not have a process in place to ensure that, when an employee's time and attendance was submitted by the supervisor, the employee later signed that he/she agreed to the time and attendance information that was processed. As a result, DEQ did not document an employee signature for 1 (3%) of 34 sampled payroll expenditures. DEQ split these payroll expenditures between the federal grant and State funds used to match the federal grant award. As a result, we identified known questioned costs of \$450.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires that where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports that are signed by the employee.

b. Matching, Level of Effort, and Earmarking

DEQ's internal control did not ensure that it complied with federal requirements for matching, level of effort, and earmarking. Our review disclosed:

- (1) DEQ's internal control did not ensure that its State-funded air pollution expenditures were recorded in the accounting records in a way that separately identified activities required by the grant award from activities not required under the federal grant award.

DEQ is required to include in its calculation of required maintenance of effort all State-funded expenditures for the core federal grant activities contained in the grant work plan and, if used to meet the minimum required match for the program, DEQ is required to include any State-funded activities that were not required by the grant work plan but that were for activities included in the spectrum of Air Pollution Control Program Support. DEQ overmatched the federal grant award in both fiscal years of the audit period; however, DEQ could not provide sufficient documentation to support how much of the match and overmatch was for core activities contained in the work plan and how much was for activities that were not required by the grant work plan. As a result, we could not determine the required maintenance of effort level for either fiscal year or if DEQ complied with the maintenance of effort requirements.

Federal regulation 40 *CFR* 35.146 requires DEQ to expend annually on recurrent activities an amount of non-federal funds at least equal to such expenditures during the preceding fiscal year. It also provides that if the expenditure data for the preceding fiscal year shows that DEQ did not meet the requirements of federal regulation 40 *CFR* 35.146, the regional administrator will take action to recover the grant funds for the year in which the agency did not maintain its level of effort.

- (2) As discussed in the Allowable Costs/Cost Principles section (part a.) of this finding, DEQ did not have a process in place to ensure that, when an employee's time and attendance was submitted by the supervisor, the employee later signed that he/she agreed to the time and attendance information that was processed. As a result, DEQ did not document an employee signature for payroll expenditures that were State-funded and

used to match the federal grant award. We determined that \$550 of the payroll expenditures we took exception to in part a. of this finding were State-funded and used as matching and level of effort expenditures for the Program.

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

c. Reporting

DEQ's internal control did not ensure that its federal reports were accurate and supported by its accounting records. As discussed in the Matching, Level of Effort, and Earmarking section (part b.) of this finding, DEQ's internal control did not ensure that its State-funded air pollution expenditures were recorded in the accounting records in a way that separately identified activities required by the grant award from activities not required under the federal grant award. Although DEQ met its matching requirements during our audit period, DEQ did not accurately report all matching expenditures on the financial report. Our review of the fiscal year 2008-09 federal financial report disclosed that DEQ understated recipient match by up to \$1,497,958.

RECOMMENDATION

We recommend that DNRE improve its internal control over Air Pollution Control Program Support to ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and reporting.

FINDING (7611003)

3. Capitalization Grants for Clean Water State Revolving Funds, CFDA 66.458

U.S. Environmental Protection Agency	CFDA 66.458: Capitalization Grants for Clean Water State Revolving Funds CFDA 66.458: ARRA - Capitalization Grants for Clean Water State Revolving Funds
Award Number: CS-260001-06 CS-260001-07 CS-260001-08 2W-00E75201	Award Period: 10/01/2005 - 09/30/2008 10/01/2006 - 09/30/2009 10/01/2007 - 09/30/2010 10/01/2008 - 12/31/2013
	Known Questioned Costs: \$13,042

DEQ's internal control over the Capitalization Grants for Clean Water State Revolving Funds (SRF) Program* did not ensure compliance with federal laws and regulations regarding activities allowed or unallowed; allowable costs/cost principles; matching, level of effort, and earmarking; procurement and suspension and debarment; reporting; subrecipient monitoring, and special tests and provisions. Our review disclosed material weaknesses in internal control and material noncompliance with requirements related to subrecipient monitoring and special tests and provisions for American Recovery and Reinvestment Act of 2009 (ARRA) funded expenditures. As a result of DEQ's lack of monitoring over subrecipients' compliance with the Davis-Bacon Act and Buy American requirements and lack of informing subrecipients of the federal award number, the amount of ARRA funds at the time of disbursement, and the requirement to specifically identify ARRA funding on the schedule of expenditures of federal awards (SEFA) and the data collection form, we issued a qualified opinion on compliance with federal laws and regulations for the SRF Program.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of SRF Program awards.

Federal expenditures for the SRF Program totaled \$99.3 million for the two-year period ended September 30, 2009. During fiscal year 2008-09, DEQ received a \$168.5 million SRF award of ARRA funds and incurred ARRA related expenditures of \$16.1 million.

* See glossary at end of report for definition.

Our exceptions, by compliance area, are as follows:

a. Activities Allowed or Unallowed

DEQ needs to improve its internal control over reimbursement requests to ensure that expenditures are for allowable activities. Our review disclosed that DEQ project managers did not approve 3 (12%) of 25 reimbursements. One of these 3 reimbursements was funded by ARRA.

OMB Circular A-133, Section 300(b) requires DEQ to maintain internal control over federal programs that provides reasonable assurance that DEQ is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its programs. To provide reasonable assurance that expenditure reimbursements are for allowable activities, DEQ's internal control process required the project manager to approve select expenditure reimbursements.

b. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that SRF Program expenditures met the allowable cost principles of OMB Circular A-87 (federal regulation 2 *CFR* 225). Our review disclosed:

- (1) DEQ did not have a process in place to ensure that it did not overcharge administrative payroll costs to SRF Program awards. These included expenditures charged to the SRF Program and State-funded expenditures that DEQ used to match SRF Program awards. DEQ compared budget to actual administrative costs for all open grants during each fiscal year as a whole rather than on an individual grant award basis as required. As a result, DEQ determined that the budgeted administrative payroll expenditures did not exceed actual expenditures for the SRF Program in total. However, by grant award, the budgeted expenditures did exceed actual expenditures and DEQ therefore should have adjusted the expenditures to actual. Also, DEQ included excess staff payroll costs in the allocation base used to determine the percentage of administrative payroll costs allocable to the grants. In addition, DEQ did not complete a quarterly review for one quarter during fiscal year 2008-09. Subsequent to our review, DEQ completed the missing quarterly review and made corrections to the fiscal year 2008-09 administrative payroll costs applied to the grants. As a result, we

identified known questioned costs of \$13,042 related to fiscal year 2007-08 administrative costs.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires DEQ to adjust costs charged to federal awards to reflect actual activity performed at least quarterly unless the difference between actual and budgeted costs is less than 10%, in which case the adjustment can be made annually. Appendix A, section C.3.a. of OMB Circular A-87 (federal regulation 2 *CFR* 225) states that a cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objectives in accordance with relative benefits received.

- (2) As discussed in the Activities Allowed or Unallowed section (part a.) of this finding, DEQ project managers did not approve 3 (12%) of 25 reimbursements.

OMB Circular A-133, Section 300(b) requires DEQ to maintain internal control over federal programs that provides reasonable assurance that DEQ is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its programs. To provide reasonable assurance that expenditure reimbursements met the allowable cost principles, DEQ's internal control process required the project manager to approve select expenditure reimbursements.

c. Matching, Level of Effort, and Earmarking

As discussed in the Allowable Costs/Cost Principles section (part b.(1)) of this finding, DEQ did not have a process in place to ensure that it did not overcharge administrative payroll costs to SRF Program awards. We determined that \$2,671 of the payroll expenditures we took exception to were State-funded and provided as match for the \$13,042 of federal payroll expenditures questioned in part b.(1).

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

d. Procurement and Suspension and Debarment

DEQ's internal control did not ensure that it contracted with or made grant awards to parties that had not been suspended or debarred. To provide reasonable assurance that subrecipients were not suspended or debarred, DEQ's internal control process required that an application checklist be completed, which included ensuring that the contractor was not suspended or debarred. However, our review of 33 subrecipients disclosed that DEQ did not complete an application checklist for 11 (33%) of 33 subrecipients. Two of these 11 projects were funded by ARRA. DEQ did obtain certifications for 10 of the 11 subrecipient files that did not have an application checklist completed; however, DEQ did not obtain a certification, add a clause or condition to the covered transaction, or document in the application checklist that it checked the federal Excluded Parties List System for 1 (3%) of 33 subrecipients.

Although our review of 33 SRF subrecipients disclosed that none of the subrecipients were suspended or debarred, DEQ's failure to follow its internal control procedures and complete an application checklist increases that risk that other, or future, subrecipients could be suspended or debarred.

Federal regulation 2 *CFR* 180.300 requires DEQ to verify that an entity is not suspended or debarred by checking the federal Excluded Parties List System, collecting a certification from that entity, or adding a clause or condition to the covered transaction with that entity.

e. Reporting

DEQ's internal control did not ensure that its federal reports were accurate and supported by its financial records. As a result, DEQ did not report accurate SRF data. Our review disclosed:

- (1) DEQ's methodology to calculate the jobs created or retained in the ARRA Section 1512 report for the period ended September 30, 2009 was not in accordance with the OMB June 2009 Guidance (M-09-21). As a result, DEQ overstated the number of jobs created or retained.

The OMB June 2009 Guidance (M-09-21) provides that the formula for reporting the jobs created or retained is to divide the cumulative ARRA funded hours worked by the cumulative hours in a full-time schedule for

the same time period. Instead of calculating one cumulative full-time equivalent number for the time period covered by the first ARRA Section 1512 report (February 17, 2009 through September 30, 2009), DEQ's process was to add the monthly full-time equivalent jobs reported by the subrecipients for each month in the period. In effect, DEQ divided the ARRA funded hours worked for the quarter by the number of full-time hours for only one month instead of dividing by the cumulative full-time hours for the period reported. DEQ used the same methodology for prior quarters and then added the quarters together. This resulted in the jobs that were created or retained in prior months being recounted in subsequent months.

- (2) DEQ did not have a process in place to verify the accuracy of the information contained in the ARRA Section 1512 report. Without adequate internal control, DEQ cannot ensure the completeness and accuracy of the ARRA Section 1512 reports.

OMB implementing guidance for ARRA provides that prime recipients, as owners of the data submitted, have principal responsibility for the quality of the information submitted.

f. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity responsibilities as established by OMB Circular A-133 and the grant award.

We reviewed 39 supplemental agreements and related projects, 10 of which related to projects funded with ARRA funds, to assess DEQ's efforts to inform subrecipients of the required federal award information and to monitor subrecipients' activities. Also, we reviewed 47 subrecipients, of which 21 received SRF funding, to assess DEQ's efforts to obtain and review subrecipients' Single Audit reports and to issue management decisions.

Our review of DEQ's subrecipient monitoring efforts disclosed:

- (1) DEQ did not have a process in place to adequately monitor the activities of the subrecipients expending ARRA funds for construction activities to ensure that the subrecipients complied with the Davis-Bacon Act. DEQ accepted the SRF Program ARRA award in April 2009 and started

expending ARRA funds on the Program in May 2009. DEQ did ensure that the required Davis-Bacon Act contract clauses were included in the supplemental agreements and in the contracts initiated by its subrecipients; however, this does not provide assurance that subrecipients used funds in accordance with the Davis-Bacon Act requirements.

DEQ indicated that, starting in May 2010, it implemented a process to conduct site visits of subrecipients to monitor for the Davis-Bacon Act requirements. As of June 11, 2010, DEQ indicated that 4 of these monitoring visits, which covered 9 supplemental agreements, had been conducted and that DEQ did not note any noncompliance with the requirements.

DEQ's federal grant award terms and conditions, as well as Section 1606 of ARRA and the OMB implementing guidance for ARRA, require the application of Davis-Bacon Act wage requirements to all federally assisted construction projects receiving ARRA funds.

- (2) DEQ did not have a process in place to adequately monitor the subrecipients expending ARRA funds for construction, alteration, maintenance, or repair of a public building or public work to ensure that the subrecipients complied with the Buy American requirements. DEQ accepted the SRF Program ARRA award in April 2009 and started expending ARRA funds on the Program in May 2009. DEQ did ensure that the required Buy American contract clauses were included in the supplemental agreements and in the contracts initiated by its subrecipients; however, this does not provide assurance that the subrecipients used funds in accordance with the Buy American requirements.

DEQ indicated that, starting in May 2010, it implemented a process to conduct site visits of subrecipients to monitor for the Buy American requirements. As of June 11, 2010, DEQ indicated that 4 of these monitoring visits, which covered 9 supplemental agreements, had been conducted and that DEQ did not note any noncompliance with the requirements.

DEQ's federal grant award terms and conditions, as well as Section 1605 of ARRA and the OMB implementing guidance for ARRA, prohibit the use of ARRA funds for a project for construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States.

- (3) DEQ did not consistently monitor the activities of subrecipients to ensure that they used federal awards in compliance with other federal laws and regulations. Our review disclosed that DEQ did not maintain evidence that it adequately monitored 1 (3%) of 39 projects. In addition, as discussed in the Activities Allowed or Unallowed section (part a.) of this finding, DEQ project managers did not approve 3 (12%) of 25 reimbursements.

OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws, regulations, and the provisions of contracts or grant agreements. To provide reasonable assurance that subrecipients used federal awards in compliance with federal laws and regulations, DEQ's internal control process required the project manager to approve select expenditure reimbursements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would perform an evaluation and develop a plan to improve consistency and documentation of monitoring.

- (4) DEQ did not receive a Single Audit report or verify that an audit report was not required for 2 (10%) of 21 subrecipients. For one of the subrecipients, DEQ received a statement from the subrecipient indicating that an audit report was not required; however, the statement covered the incorrect fiscal year. For the other subrecipient, DEQ obtained a statement from the related county indicating that the subrecipient was a component unit of the county and that the component unit would have its own Single Audit. However, DEQ did not follow through and obtain the component unit's Single Audit. In addition, for 1 (6%) of 17 subrecipients that were required to submit a Single Audit report, DEQ did not

adequately follow up with the subrecipient when the subrecipient's Single Audit report did not include the same *CFDA* number as the federal awards that DEQ passed through to the subrecipient.

OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the Single Audit requirements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would continue its effort to obtain 100% of the required audit reports and that it had established additional procedures to help determine whether an audit report is required.

g. Special Tests and Provisions

DEQ's internal control did not ensure that it complied with federal laws and regulations regarding special test and provision requirements. Our review disclosed:

- (1) DEQ did not have a process in place to inform the subrecipients of the federal award number at the time of subaward and did not inform the subrecipients of the federal award number and the amount of ARRA funds at the time of disbursement of funds for the 10 supplemental agreements funded with ARRA funds.

DEQ's federal grant award terms and conditions provide that the grant award is subject to all applicable provisions of implementing guidance for ARRA issued by OMB. OMB implementing guidance requires DEQ to separately identify to each subrecipient, at the time of subaward and disbursement of funds, the federal award number, the *CFDA* number, and the amount of ARRA funds.

- (2) DEQ did not have a process in place to inform the subrecipients of the requirement to include information to specifically identify ARRA funding on their SEFAs and data collection forms in the 10 supplemental agreements reviewed.

DEQ's federal grant award terms and conditions provide that the grant award is subject to all applicable provisions of implementing guidance for ARRA issued by OMB. OMB implementing guidance requires DEQ to have its subrecipients separately identify the expenditures for federal awards under ARRA on their SEFAs and data collection forms.

- (3) DEQ needs to improve its internal control related to ensuring that environmental reviews are completed. DEQ's process to ensure that environmental reviews were completed was to have staff complete a crosscutter checklist that documents they considered all the environmental factors. Our review of 16 project files disclosed that DEQ did not complete a crosscutter checklist for 4 (25%) of the 16 projects.

Although our review of 33 project files disclosed that an environmental review had been performed for each of the projects, DEQ's failure to follow its internal control procedures and complete the crosscutter checklist increases the risks that environmental reviews for other projects may not be completed.

RECOMMENDATIONS

We recommend that DNRE improve its internal control over the SRF Program to ensure compliance with federal laws and regulations regarding activities allowed or unallowed; allowable costs/cost principles; matching, level of effort, and earmarking; procurement and suspension and debarment; reporting; and special tests and provisions.

FOR THE SECOND CONSECUTIVE AUDIT, WE RECOMMEND THAT DNRE IMPROVE ITS INTERNAL CONTROL OVER THE SRF PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING SUBRECIPIENT MONITORING.

FINDING (7611004)

4. Nonpoint Source Implementation Grants, CFDA 66.460

U.S. Environmental Protection Agency	CFDA 66.460: Nonpoint Source Implementation Grants
Award Number: C9975474-04	Award Period: 10/01/2003 - 09/30/2008
C9975474-05	10/01/2004 - 09/30/2009
C9975474-06	10/01/2005 - 09/30/2010
C9975474-07	10/01/2006 - 09/30/2011
C9975474-08	10/01/2007 - 09/30/2012
C9975474-09	10/01/2008 - 09/30/2013
	Known Questioned Costs: \$41,368

DEQ's internal control over the Nonpoint Source Implementation Grants (NPS) Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and subrecipient monitoring. Our review disclosed material weaknesses in internal control with matching, level of effort, and earmarking and subrecipient monitoring and material noncompliance with federal laws and regulations regarding subrecipient monitoring. DEQ could not provide sufficient documentation supporting its compliance with the matching, level of effort, and earmarking requirement nor were we able to satisfy ourselves that DEQ complied with the requirement by other auditing procedures. As a result, we issued a qualified opinion on compliance with federal laws and regulations for the NPS Program.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of NPS awards.

Federal expenditures for the NPS Program totaled \$11.3 million for the two-year period ended September 30, 2009. We identified known questioned costs of \$41,368 and known and likely questioned costs totaling \$64,139.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that NPS Program expenditures met the allowable cost principles of OMB Circular A-87 (federal regulation 2 *CFR* 225).

Our review disclosed:

- (1) DEQ did not ensure that 1 (3%) of 40 NPS Program expenditures were paid based on an actual billing. In this instance, the expenditure was paid based on a draft billing. The project administrator did not notice that a draft billing was submitted.

Appendix A of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires that costs charged to federal awards be adequately documented and be necessary and reasonable for the administration of the federal award.

- (2) DEQ did not have a process in place to ensure that, when an employee's time and attendance was submitted by the supervisor, the employee later signed that he/she agreed to the time and attendance information that was processed. As a result, DEQ did not document an employee signature for 1 (6%) of the 17 sampled payroll expenditures. A portion of these expenditures were charged to the NPS federal grant and another portion were charged as State funds used to match the federal grant. As a result, we questioned costs of \$207.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires that where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports that are signed by the employee.

- (3) DEQ did not have a process in place to adjust budgeted payroll costs to actual payroll costs for one employee reported as match for the NPS Program.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires DEQ to adjust payroll costs charged to federal awards to reflect actual activity performed at least quarterly unless the difference

between actual and budgeted costs is less than 10%, in which case the adjustment can be made annually.

b. Matching, Level of Effort, and Earmarking

DEQ's internal control did not ensure compliance with federal laws and regulations regarding matching and earmarking. Our review disclosed:

(1) DEQ did not ensure the propriety of NPS Program matching expenditures. As a result, we estimated that DEQ did not initially meet the required level of match by \$829,571 and by \$610,990 for the 2004 and 2005 grant awards, respectively, which ended during the audit period. Subsequent to our review, DEQ identified additional eligible matching expenditures to replace the unallowable match expenditures discussed in parts b.(1)(a) and b.(1)(b) of this finding. Therefore, we did not question the costs of the related federal expenditures. Our review disclosed:

(a) DEQ needs to improve its internal control over grantees' matching expenditures to ensure that the expenditures are adequately documented.

DEQ awarded federal NPS funds and State Clean Michigan Initiative funds to grantees to carry out NPS Program activities. The grantees are required to provide match from local sources. DEQ required the grantees to submit quarterly financial reports but only required limited supporting documentation of match expenditures.

We noted during our review of NPS Program expenditures that 53 (88%) of 60 grantee expenditures had State Clean Michigan Initiative funded and/or local match expenditures that were not documented as required by federal regulations. We noted that match expenditures were from the grantees' salaries and wages; contractual services; purchased conservation easements; or third party donated match, such as volunteer time, services, supplies, loaned equipment, space, or conservation easements.

Federal regulation 40 *CFR* 35.265 requires that DEQ provide at least a 40% match. Federal regulation 40 *CFR* 31.24 defines how third

party in-kind contributions are to be valued and how matching costs are to be documented. In addition, OMB Cost Principle Circulars outline the documentation that is required for direct expenditures and donated third party in-kind contributions.

- (b) As discussed in the Allowable Costs/Cost Principles section (parts a.(2) and a.(3)) of this finding, DEQ needs to improve its internal control to ensure that payroll costs that are State-funded and used to match the federal grant award are properly documented. We determined that \$1,819 of the payroll expenditures we took exception to in parts a.(2) and a.(3) of this finding were State-funded and inappropriately used as matching expenditures for the Program.

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

- (c) DEQ did not have a comprehensive process in place to include and monitor matching expenditures from all sources during the grant award to ensure that DEQ would meet the 40% required match at the close of the grant award.

DEQ's Financial and Business Services Division (FBSD) is responsible for reporting NPS Program expenditures to the U.S. Environmental Protection Agency (EPA) on the required annual financial report. We noted that NPS Program administrative staff did not include and report to FBSD all local match from grantees and that FBSD did not include all local match that was reported from NPS Program administrative staff in its monitoring of the required match.

- (2) DEQ's process to identify administrative expenditures did not identify all administrative expenditures charged to the NPS Program. As a result, we could not determine if DEQ complied with the NPS administrative earmark requirement and questioned costs of \$41,161.

Title 33, section 1329(h)(12) of the *United States Code* states that administrative costs in the form of salaries, overhead, or indirect costs for

services shall not exceed in any fiscal year 10% of the amount of the grant in such year. The costs of implementing enforcement or regulatory activities, education, training, technical assistance, demonstration projects, and technology transfers are not subject to this limitation.

Our review disclosed:

- (a) DEQ's process to identify administrative expenditures excluded the program manager, program specialist, and other individuals from the calculation of the administrative expenditures based on DEQ's position that these individuals worked 100% on programmatic activities that are not subject to the 10% administrative limitation. DEQ indicated that its process for identifying administrative expenditures was verbally approved by the EPA.

The excluded program personnel perform some administrative functions, such as approving time sheets, performing evaluations of staff, and developing policies and procedures. However, because of DEQ's position that the activities of these individuals are programmatic and not subject to the 10% administrative limitation, DEQ did not identify expenditures related to these types of activities as administrative in its accounting records.

- (b) DEQ did not include all indirect costs allocated to the NPS Program as administrative expenditures. Departmental indirect costs are allocated to the NPS Program based on payroll expenditures. DEQ further allocated these indirect costs using the percentage of NPS payroll costs it identified as administrative. Therefore, only a small portion of the indirect costs were identified by DEQ as being administrative in nature. DEQ indicated that its process for further allocating the indirect costs based on identified administrative expenditures was verbally approved by the EPA.

When we included the administrative costs that were identified by DEQ and added the full indirect costs charged to the grant, we noted that expenditures for the 2007 grant award exceeded the 10% administrative earmark limitation by \$41,161 during fiscal year 2007-08. Due to disagreement regarding what activities were subject to the 10%

administrative limitation and because DEQ did not identify potential administrative expenditures related to program managers and specialists, we could not determine if the remaining open grant awards during our audit period exceeded the 10% administrative earmark limitation or the extent to which the 2007 grant award exceeded the 10% administrative earmark limitation in fiscal year 2007-08 (see item b.(2)(a)).

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that a process had been developed to ensure that the 10% statutory limitation had not been exceeded at the program level.

c. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity responsibilities as established by OMB Circular A-133.

We reviewed 14 subawards to assess DEQ's efforts to inform subrecipients of the required federal award information and to monitor subrecipients' activities. Also, we reviewed 47 subrecipients, of which 6 received NPS funding, to assess DEQ's efforts to obtain and review subrecipients' Single Audit reports and to issue management decisions.

Our review of DEQ's subrecipient monitoring efforts disclosed:

- (1) DEQ did not have a process in place to adequately monitor the activities of subrecipients to ensure that they complied with NPS requirements. DEQ distributed \$6.7 million of the total \$11.3 million in NPS Program expenditures to subrecipients during fiscal years 2007-08 and 2008-09.

DEQ conducted desk reviews of quarterly expenditure reports submitted by the subrecipients during our audit period. However, we noted that the documentation obtained to support the federal and/or local match expenditures in 14 (93%) of 15 quarterly expenditure reports we reviewed was not adequate to ensure compliance with federal requirements. Ten of these 14 quarterly expenditure reports had NPS-funded staff salaries and wages not supported as required by applicable OMB Cost Principle Circulars. All 14 of these quarterly expenditure reports included local match expenditures for subrecipient staff salaries and wages and/or third

party in-kind contributions that were not adequately supported as required by federal regulations and are therefore also included in part b.(1)(a) of this finding.

During our audit period, DEQ's only other financial monitoring of subrecipient activities was to request and obtain the subrecipients' Single Audit reports. However, we noted that only 3 of the 14 subrecipients were required by OMB Circular A-133 to have a Single Audit report.

OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws and regulations. Federal regulation 40 *CFR* 31.40(a) also requires DEQ to monitor subrecipient activities to ensure compliance with federal laws, regulations, and the provisions of contracts or grant agreements.

- (2) DEQ did not receive a Single Audit report in 1 (25%) of the 4 instances that a Single Audit report was required. This subrecipient was another State department. DEQ developed a tracking spreadsheet based on established subrecipient coding in the accounting records to help ensure that all required Single Audit reports were received. However, the tracking sheet did not include subrecipients that were other State departments.

OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the Single Audit requirements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would continue its effort to obtain 100% of the required audit reports and that it had established additional procedures to help determine whether an audit report is required.

RECOMMENDATION

FOR THE SECOND CONSECUTIVE AUDIT, WE RECOMMEND THAT DNRE IMPROVE INTERNAL CONTROL OVER THE NPS PROGRAM TO ENSURE

COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING ALLOWABLE COSTS/COST PRINCIPLES; MATCHING, LEVEL OF EFFORT, AND EARMARKING; AND SUBRECIPIENT MONITORING.

FINDING (7611005)

5. Capitalization Grants for Drinking Water State Revolving Funds, CFDA 66.468

U.S. Environmental Protection Agency	CFDA 66.468: Capitalization Grants for Drinking Water State Revolving Funds CFDA 66.468: ARRA - Capitalization Grants for Drinking Water State Revolving Funds
Award Number: FS-975487-04 FS-975487-05 FS-975487-06 FS-975487-07 FS-975487-08 FS-975487-09 2F-00E75101	Award Period: 10/01/2003 - 09/30/2008 10/01/2004 - 09/30/2009 10/01/2005 - 09/30/2010 10/01/2006 - 09/30/2011 10/01/2007 - 09/30/2010 10/01/2008 - 09/30/2013 10/01/2008 - 12/31/2013
	Known Questioned Costs: \$0

DEQ's internal control over the Capitalization Grants for Drinking Water State Revolving Funds (DWSRF) Program* did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles, procurement and suspension and debarment, reporting, subrecipient monitoring, and special tests and provisions. Our review disclosed material weaknesses in internal control and material noncompliance with requirements related to subrecipient monitoring and special tests and provisions for ARRA funded expenditures. As a result of DEQ's lack of monitoring over subrecipients' compliance with the Davis-Bacon Act and Buy American requirements and lack of informing subrecipients of the federal award number, the amount of ARRA funds at the time of disbursement, and the requirement to specifically identify ARRA funding on the SEFA and the data collection form, we issued a qualified opinion on compliance with federal laws and regulations for the DWSRF Program.

* See glossary at end of report for definition.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of DWSRF Program awards.

Federal expenditures for the DWSRF Program totaled \$83.9 million for the two-year period ended September 30, 2009. During fiscal year 2008-09, DEQ received a \$67.5 million DWSRF award of ARRA funds and incurred ARRA related expenditures of \$5.2 million.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that DWSRF Program expenditures met the allowable cost principles of OMB Circular A-87 (federal regulation 2 *CFR* 225).

DEQ did not have a process in place to ensure that it did not overcharge administrative payroll costs to the DWSRF Program awards. DEQ compared budgeted to actual administrative costs for all grants open during each fiscal year as a whole rather than on an individual grant award basis as required. As a result, DEQ determined that the budgeted administrative payroll expenditures did not exceed actual expenditures for the DWSRF Program. However, by grant award, the budgeted expenditures did exceed actual expenditures and DEQ therefore should have adjusted the expenditures to actual. In addition, DEQ did not complete a quarterly review for one quarter during fiscal year 2008-09. Subsequent to our review, DEQ completed the missing quarterly review and made corrections to the fiscal year 2008-09 administrative payroll costs applied to the grants.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires DEQ to adjust costs charged to federal awards to reflect actual activity performed at least quarterly unless the difference between actual and budgeted costs is less than 10%, in which case the adjustment can be made annually. Appendix A, section C.3.a. of OMB Circular A-87 (federal regulation 2 *CFR* 225) states that a cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objectives in accordance with relative benefits received.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would seek clarification from the federal awarding agency on the acceptability of regarding these grants as a total program in terms of administrative costs and that the amount of administrative time charged to the grant would be minimized. DEQ also indicated that the procedure for allocating costs to federal grants would be posted on the DEQ Intranet.

b. Procurement and Suspension and Debarment

DEQ's internal control to did not ensure that contracts and grant awards were not made to parties that have been suspended or debarred. To provide reasonable assurance that subrecipients were not suspended or debarred, DEQ's internal control process required that an application checklist be completed, which included ensuring that the contractor was not suspended or debarred. However, our review of 33 subrecipients disclosed that DEQ did not complete an application checklist for 4 (12%) of 33 subrecipients.

Although our review of 33 DWSRF subrecipients disclosed that none of the subrecipients were suspended or debarred, DEQ's failure to follow its internal control procedures by completing an application checklist increases the risk that other, or future, subrecipients could be suspended or debarred.

Federal regulation 2 *CFR* 180.300 requires DEQ to verify that an entity is not suspended or debarred by checking the federal Excluded Parties List System, collecting a certification from that entity, or adding a clause or condition to the covered transaction with that entity.

c. Reporting

DEQ's internal control did not ensure that its federal reports were accurate and supported by its financial records. As a result, DEQ did not report accurate DWSRF data. Our review disclosed:

- (1) DEQ overstated the total outlays and the recipient share of expenditures by \$1,695,709 on the fiscal year 2007-08 financial status report (SF-269) for one grant award. Federal regulation 40 *CFR* 35.3535(d)(2)(ii) allows DEQ to use State funds expended on its Public Water System Supervision (PWSS) Program in fiscal year 1992-93 as match, up to 50% of the amount required for the set-aside match for the current DWSRF grant

award. The majority of the reason for the overstatement was because DEQ included the entire State amount expended on the PWSS Program in fiscal year 1992-93 as set-aside match. The 50% limitation restricted the use of these expenditures to \$587,500. DEQ's key internal control to ensure the accuracy of the SF-269 reports was to have the supervisor review and approve the reports. This control was implemented but did not operate effectively.

- (2) DEQ presented the expenditures for the wrong grant award on the fiscal year 2008-09 federal financial report (SF-425) for one grant award. After we notified DEQ, it submitted a revised report to the EPA. We reviewed the revised report and noted that DEQ overstated the federal cash receipts, federal disbursements, and federal share of expenditures lines by \$25,265. DEQ also understated the total recipient share required line by \$114,215 and understated the recipient share of expenditures line by \$52,263. DEQ's key internal control to ensure the accuracy of the SF-425 reports was to have the supervisor review and approve the reports. However, the supervisor did not approve this report.
- (3) DEQ's methodology to calculate the jobs created or retained in the ARRA Section 1512 report for the period ended September 30, 2009 was not in accordance with the OMB June 2009 Guidance (M-09-21). As a result, DEQ overstated the number of jobs created or retained.

The OMB June 2009 Guidance (M-09-21) provides that the formula for reporting the jobs created or retained is to divide the cumulative ARRA funded hours worked by the cumulative hours in a full-time schedule for the same time period. Instead of calculating one cumulative full-time equivalent number for the time period covered by the first ARRA Section 1512 report (February 17, 2009 through September 30, 2009), DEQ's process was to add the monthly full-time equivalent jobs reported by the subrecipients for each month in the period. In effect, DEQ divided the ARRA funded hours worked for the quarter by the number of full-time hours for only one month instead of dividing by the cumulative full-time hours for the period reported. DEQ used the same methodology for prior quarters and then added the quarters together. This resulted in the jobs that were created or retained in prior months being recounted in subsequent months.

- (4) DEQ did not have a process in place to verify the accuracy of the information contained in the ARRA Section 1512 report. As a result, our review of subrecipients included in the ARRA Section 1512 report for the period ended September 30, 2009 noted that DEQ reported inaccurate and/or incomplete information related to 4 (100%) of 4 subrecipients reviewed. DEQ overstated expenditures by \$98,368 for one subrecipient, understated expenditures by \$98,368 for one subrecipient, did not include one required vendor for two subrecipients, and reported the wrong date of award for one subrecipient.

OMB implementing guidance for ARRA provides the required data elements that must be included in the ARRA Section 1512 report. The identity of any vendor receiving payments of at least \$25,000 is one of the required elements. In addition, the guidance also provides that prime recipients, as owners of the data submitted, have principal responsibility for the quality of the information submitted.

d. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity responsibilities as established by OMB Circular A-133 and the grant award.

We reviewed 33 supplemental agreements and related projects, 8 of which related to projects funded with ARRA funds, to assess DEQ's efforts to inform subrecipients of the required federal award information and to monitor subrecipients' activities. Also, we reviewed 47 subrecipients, of which 26 received DWSRF funding, to assess DEQ's efforts to obtain and review subrecipients' Single Audit reports and to issue management decisions.

Our review of DEQ subrecipient monitoring efforts disclosed:

- (1) DEQ did not have a process in place to adequately monitor the activities of the subrecipients expending ARRA funds for construction activities to ensure that the subrecipients complied with the Davis-Bacon Act. DEQ accepted the DWSRF Program ARRA award in April 2009 and started expending ARRA funds on the Program in May 2009. DEQ did ensure that the required Davis-Bacon Act contract clauses were included in the supplemental agreements and in the contracts initiated by its subrecipients; however, this does not provide assurance that

subrecipients used funds in accordance with the Davis-Bacon Act requirements.

DEQ indicated that, starting in May 2010, it implemented a process to conduct site visits of subrecipients to monitor for the Davis-Bacon Act requirements. As of June 11, 2010, DEQ indicated that 1 of these monitoring visits, which covered 2 supplemental agreements, had been conducted and that DEQ did not note any noncompliance with the requirements.

DEQ's federal grant award terms and conditions, as well as Section 1606 of ARRA and the OMB implementing guidance for ARRA, require the application of Davis-Bacon Act wage requirements to all federally assisted construction projects receiving ARRA funds.

- (2) DEQ did not have a process in place to adequately monitor the subrecipients expending ARRA funds for construction, alteration, maintenance, or repair of a public building or public work to ensure that the subrecipients complied with the Buy American requirements. DEQ accepted the DWSRF Program ARRA award in April 2009 and started expending ARRA funds on the Program in May 2009. DEQ did ensure that the required Buy American contract clauses were included in the supplemental agreements and in the contracts initiated by its subrecipients; however, this does not provide assurance that the subrecipients used funds in accordance with the Buy American requirements.

DEQ indicated that, starting in May 2010, it implemented a process to conduct site visits of subrecipients to monitor for the Buy American requirements. As of June 11, 2010, DEQ indicated that 1 of these monitoring visits, which covered 2 supplemental agreements, had been conducted and that DEQ did not note any noncompliance with the requirements.

DEQ's federal grant award terms and conditions, as well as Section 1605 of ARRA and the OMB implementing guidance for ARRA, prohibit the use of ARRA funds for a project for construction, alteration, maintenance, or repair of a public building or public work unless all the iron, steel, and

manufactured goods used in the project are produced in the United States.

- (3) DEQ did not consistently monitor the activities of subrecipients to ensure that they used federal awards in compliance with other federal laws and regulations. Our review disclosed that DEQ did not maintain evidence that it adequately monitored 4 (12%) of the 33 projects. Adequate monitoring of subrecipients by DEQ can be accomplished through such things as regular discussions with the subrecipients and on-site inspections.

OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws, regulations, and the provisions of contracts or grant agreements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would perform an evaluation and develop a plan to improve consistency and documentation of monitoring.

- (4) DEQ did not receive a Single Audit report or verify that an audit report was not required for 2 (8%) of 25 subrecipients. In both instances, DEQ obtained the Single Audit of the related county; however, DEQ's subrecipient was a component unit of the county. DEQ did not follow up with the component unit to determine if a Single Audit report was required.

OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the Single Audit requirements.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would continue its effort to obtain 100% of the required audit reports and that it had established additional procedures to help determine whether an audit report is required.

e. Special Tests and Provisions

DEQ's internal control did not ensure that it complied with federal laws and regulations regarding special test and provision requirements. Our review disclosed:

- (1) DEQ did not have a process in place to inform the subrecipients of the federal award number at the time of subaward and did not inform the subrecipients of the federal award number and the amount of ARRA funds at the time of disbursement of funds for the 8 supplemental agreements funded with ARRA funds.

DEQ's federal grant award terms and conditions provide that the grant award is subject to all applicable provisions of implementing guidance for ARRA issued by OMB. OMB implementing guidance requires DEQ to separately identify to each subrecipient, at the time of subaward and disbursement of funds, the federal award number, the *CFDA* number, and the amount of ARRA funds.

- (2) DEQ did not have a process in place to inform the subrecipients of the requirement to include information to specifically identify ARRA funding on their SEFAs and data collection forms, in the 8 supplemental agreements reviewed.

DEQ's federal grant award terms and conditions provide that the grant award is subject to all applicable provisions of implementing guidance for ARRA issued by OMB. OMB implementing guidance requires DEQ to have its subrecipients separately identify the expenditures for federal awards under ARRA on their SEFAs and data collection forms.

RECOMMENDATIONS

FOR THE SECOND CONSECUTIVE AUDIT, WE RECOMMEND THAT DNRE IMPROVE ITS INTERNAL CONTROL OVER THE DWSRF PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING ALLOWABLE COSTS/COST PRINCIPLES AND SUBRECIPIENT MONITORING.

We also recommend that DNRE improve its internal control over the DWSRF Program to ensure compliance with federal laws and regulations regarding procurement and suspension and debarment, reporting, and special tests and provisions.

FINDING (7611006)

6. Performance Partnership Grants, CFDA 66.605

U.S. Environmental Protection Agency	CFDA 66.605: Performance Partnership Grants
Award Number: BG985023-08 BG985023-09	Award Period: 10/01/2007 - 09/30/2008 10/01/1008 - 09/30/2009
	Known Questioned Costs: \$0

DEQ's internal control over the Performance Partnership Grants (PPG) Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and reporting. Our review disclosed material weaknesses in internal control with compliance requirements related to reporting.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of PPG awards.

Federal expenditures for the PPG Program totaled \$25.5 million for the two-year period ended September 30, 2009.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that PPG Program expenditures met the allowable cost principles of OMB Circular A-87 (federal regulation 2 CFR 225).

DEQ did not maintain the required payroll certifications for 1 (3%) of 34 sampled payroll expenditures. DEQ charged these payroll expenditures to the Program or they were State-funded and used to match the federal grant awards for the Program.

Appendix B, section 8.h. of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires employees who are expected to work solely on a single federal award to certify, at least semiannually, that they worked solely on that program. Because DEQ did not document that this employee worked solely on the PPG Program, we could not verify that the payroll costs charged to the Program were appropriate.

Subsequent to our review, DEQ completed the required payroll certification.

We reported a similar condition in our prior Single Audit. DEQ indicated in its June 2008 corrective action plan that it would continue to work to ensure certification of all employees who work 100% of their time on federal grants, giving greater scrutiny to grants that are shared across divisions.

b. Matching, Level of Effort, and Earmarking

DEQ's internal control did not ensure that it complied with federal requirements for matching, level of effort, and earmarking. Our review disclosed:

- (1) DEQ did not initially identify sufficient State expenditures to meet its matching requirement for the fiscal year 2008-09 PPG Program. DEQ's identified match amount was \$93,467 short of meeting the \$2,743,628 of required match. Subsequent to our review, DEQ identified sufficient additional matching expenditures to meet its required match.

DEQ's process was to split most expenditures in its accounting system so that a portion of the expenditures were charged against the federal program and a portion were recorded as State-funded match. This gets DEQ close to the required match amount. When the annual financial report is completed, DEQ's process is to review the available match and, if more is needed, it identifies additional eligible matching expenditures that can be used as match. However, as noted in part c. of this finding, DEQ did not initially include any match expenditures on the annual financial report and, therefore, did not identify that additional match expenditures were needed.

Federal regulation 40 *CFR* 35.136 requires DEQ to provide a non-federal cost share that is not less than the sum of the minimum non-federal cost

share required under each of the environmental programs that are combined in the PPG Program.

- (2) As discussed in the Allowable Costs/Cost Principles section (part a.) of this finding, DEQ did not maintain the required payroll certifications to support payroll expenditures that were State-funded and used to match the PPG award. We determined that \$10,290 of the payroll expenditures we took exception to in part a. of this finding were State-funded and used as matching expenditures for the PPG Program.

Appendix B, section 8.h.(7) of OMB Circular A-87 (federal regulation 2 *CFR* 225) requires payroll costs used in meeting matching requirements of federal awards to be supported in the same manner as those claimed as allowable costs under federal awards.

Subsequent to our review, DEQ completed the required payroll certification.

c. Reporting

DEQ's internal control did not ensure that its federal reports were accurate and supported by its accounting records. DEQ's key internal control to ensure the accuracy of the federal reports was to have the supervisor review and approve the reports. This control was implemented but did not operate effectively.

Our review of the fiscal year 2008-09 federal financial report disclosed that DEQ overstated federal authorization and federal expenditures by \$4,196,800, understated the recipient match requirement and recipient match expenditures by \$2,743,628, understated its indirect cost base by \$2,098,744, and understated total indirect costs charged by \$341,885.

Subsequent to our review, DEQ submitted a revised federal financial report to the EPA.

RECOMMENDATIONS

FOR THE SECOND CONSECUTIVE AUDIT, WE RECOMMEND THAT DNRE IMPROVE ITS INTERNAL CONTROL OVER THE PPG PROGRAM TO ENSURE

COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING
ALLOWABLE COSTS/COST PRINCIPLES.

We also recommend that DNRE improve its internal control over the PPG Program to ensure compliance with federal laws and regulations regarding matching, level of effort, and earmarking and reporting.

The status of the findings related to federal awards that were reported in prior Single Audits is disclosed in the summary schedule of prior audit findings.

OTHER SCHEDULES

DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT*
Summary Schedule of Prior Audit Findings
As of June 24, 2010

PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

There were no findings related to the financial statements and financial schedules in the prior Single Audit.

PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS

Audit Findings That Have Been Fully Corrected:

Audit Period: October 1, 2003 through September 30, 2005

Finding Number: 760601

Finding Title: Suspension and Debarment

Finding: The Department of Environmental Quality (DEQ) had not established internal control in its Coastal Zone Management Administration Awards (CZM) Program to ensure that it did not contract with or make grant awards to parties that had been suspended or debarred.

Agency Comments: The Department of Natural Resources and Environment (DNRE) has corrected the deficiency.

Audit Period: October 1, 2003 through September 30, 2005

Finding Number: 760602

Finding Title: Subrecipient Monitoring

Finding: DEQ should establish additional internal control to ensure that it complies with the pass-through entity responsibilities as established by U.S. Office of Management and Budget (OMB) Circular A-133.

Agency Comments: DNRE has corrected the deficiencies.

Audit Findings Not Corrected or Partially Corrected:

Audit Period: October 1, 2005 through September 30, 2007

Finding Number: 7610801

Finding Title: Coastal Zone Management Administration Awards (CZM),
CFDA 11.419

Finding: DEQ's internal control over the CZM Program did not ensure compliance with federal laws and regulations regarding activities allowed or unallowed; allowable costs/cost principles; subrecipient monitoring; and procurement and suspension and debarment.

Agency Comments: DNRE has corrected the majority of the deficiencies. DNRE removed the grant coding from employees' standard coding for all employees except those who are assigned to work 100% of their time on grant-related activities. In fiscal year 2008-09, a new process was established to monitor administrative costs allocated to the federal grant. In fiscal year 2007-08, a centralized process was established to identify employees who charged 100% of their time to federal grants and obtain the required certifications. Processes have been established to document the date of receipt of subrecipients' A-133 Single Audits and to issue management decisions on a timely basis. DNRE also established procedures to document that subrecipients were not suspended or debarred from receiving federal funds.

DNRE is refining the process for identifying and securing required A-133 Single Audits from subrecipients. An additional staff member has been assigned to assist in the process, and a supervisory review has been added.

Audit Period: October 1, 2005 through September 30, 2007
Finding Number: 7610802
Finding Title: Capitalization Grants for Clean Water State Revolving Funds (SRF), *CFDA* 66.458

Finding: DEQ's internal control over the SRF Program did not ensure compliance with federal laws and regulations regarding subrecipient monitoring.

Agency Comments: Supplemental agreements have been modified to better inform subrecipients of the required *CFDA* and federal award information. Procedure manuals and external guidance document instructions were reviewed and found to be adequate. Training was provided to staff to improve compliance with existing procedures.

Audit Period: October 1, 2005 through September 30, 2007
Finding Number: 7610803
Finding Title: Nonpoint Source Implementation Grants (NPS), *CFDA* 66.460

Finding: DEQ's internal control over the NPS Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and subrecipient monitoring.

Agency Comments: The process of allocating administrative costs to the NPS grant has been discontinued as the grant dollars can be fully earned through direct charges. DNRE is awaiting written guidance from the U.S. Environmental Protection Agency on the calculation of the 10% limitation on administrative costs.

Audit Period: October 1, 2005 through September 30, 2007
Finding Number: 7610804
Finding Title: Capitalization Grants for Drinking Water State Revolving Funds (DWSRF), *CFDA* 66.468

Finding: DEQ's internal control over the DWSRF Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles and subrecipient monitoring.

Agency Comments: Supplemental agreements have been modified to better inform subrecipients of the required *CFDA* and federal award information. Procedure manuals and external guidance document instructions were reviewed and found to be adequate. Training was provided to staff to improve compliance with existing procedures.

The process of allocating administrative costs to the DWSRF Program has been discontinued as the grant can be fully earned through direct charges.

Audit Period: October 1, 2005 through September 30, 2007

Finding Number: 7610805

Finding Title: Performance Partnership Grants (PPG), *CFDA* 66.605

Finding: DEQ's internal control over the PPG Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles.

Agency Comments: The process of allocating administrative costs to the PPG Program has been discontinued. As DNRE spends more on the program than what the grant provides, DNRE will earn the federal grant through direct charges. DNRE has requested that the U.S. Environmental Protection Agency offset the eligible grant costs paid with State funds against the questioned costs identified in the audit.

- * Executive Order No. 2009-45 created DNRE, effective January 17, 2010. It transferred all of the authority, powers, duties, functions, responsibilities, records, personnel, property, equipment, and budgetary resources of the Department of Natural Resources (DNR) and DEQ to DNRE by a Type II transfer and abolished DNR and DEQ.

DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT

Corrective Action Plan

As of June 17, 2010

FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

There were no findings related to the financial statements and financial schedules for fiscal years 2007-08 and 2008-09.

FINDINGS RELATED TO FEDERAL AWARDS

Finding Number: 7611001

Finding Title: Coastal Zone Management Administration Awards,
CFDA 11.419

Management Views: a. (1) The Department of Natural Resources and Environment (DNRE) agrees with the finding.

(2) DNRE agrees in part with the finding. The Land and Water Management Division of DNRE has a process in place that requires employees to agree to changes made to time sheets by others after they were submitted. In this case, the supporting documentation was lost during a system conversion and alternate documentation was located.

b. (1) (a) DNRE agrees with the finding.

(b) DNRE agrees in part with the finding. See part a.(2).

(2) DNRE agrees with the finding.

- c. (1) DNRE agrees with the finding.
- (2) DNRE agrees with the finding.

Planned Corrective Action:

- a. (1) As of June 14, 2010, DNRE is no longer performing administrative justifications for the CZM Program as staff are required to record their time in the Statewide Data Collection and Distribution System (DCDS) as eligible hours are worked on the grant.
- (2) DNRE has submitted a request for an enhancement to the Statewide DCDS, which is used to record employees' time and process payroll to address this issue.
- b. (1) (a) As discussed in part a.(1), DNRE discontinued allocating administrative costs.
- (b) As discussed in part a.(2), DNRE will work with the Department of Technology, Management & Budget (DTMB) to modify DCDS.
- (2) DNRE implemented revised reporting requirements with the 2009 award cycle. Detailed documentation is now required for payroll, travel, equipment, supplies, and other contractual expenses.
- c. (1) DNRE will work to develop an improved monitoring process to ensure compliance with federal regulations.
- (2) DNRE continues to make efforts to obtain 100% of the required audit reports and will establish additional procedures to help determine whether

an audit report is required. This includes a review of the required audit reports and the checklists used to document the review by the federal aid coordinator.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Sharon Maher and Kathy Tetzlaff

Finding Number: 7611002

Finding Title: Air Pollution Control Program Support, *CFDA* 66.001

Management Views:

- a. DNRE agrees with the finding.
- b. (1) DNRE disagrees with the finding. The finding is contrary to the interpretation and guidance provided by the U.S. Environmental Protection Agency (EPA).

(2) DNRE agrees with the finding.
- c. As discussed in part b.(1), DNRE disagrees with the finding.

Planned Corrective Action:

- a. DNRE submitted a request for an enhancement to the Statewide DCDS, which is used to record employees' time and process payroll to address this issue. Until DCDS is modified, DNRE will implement a process to require manual documentation of the employee's approval.
- b. (1) DNRE will implement an accounting solution to separately identify activities required by the grant award.

(2) As discussed in part a., DNRE will work with DTMB to modify DCDS. In the meantime, DNRE will implement a manual process to require documentation of the employee's approval.

c. As discussed in part b.(1), DNRE will implement an accounting solution to improve reporting.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Sharon Maher and Marion Hart

Finding Number: 7611003

Finding Title: Capitalization Grants for Clean Water State Revolving Funds, *CFDA* 66.458

Management Views:

a. DNRE agrees with the finding.

b. (1) DNRE agrees in part. The EPA agreed with the methodology that DNRE used until December 3, 2009, when it reviewed it in relation to the same finding in the previous audit. At that time, it agreed with the auditors' assessment. After numerous requests, the EPA has not issued written guidance. DNRE stopped using an allocation method to charge administrative costs to EPA grants at the end of fiscal year 2008-09. All payroll costs, including the administrative costs, are charged to the grants by the employee when working on grant eligible activity.

(2) DNRE agrees with the finding.

c. See part b.(1).

- d. DNRE agrees in part. DNRE complied with the federal regulation but did not document the compliance through the use of a checklist.
- e. (1) DNRE agrees that the job reporting process by the loan recipients can be improved.

(2) DNRE agrees in part. Given the tight reporting schedule, there is not adequate time to extensively review and validate all of the information submitted by the subrecipients prior to the due dates. DNRE established a process to review as many of the data elements as possible before the submission date. Errors discovered after the due date are corrected during the next reporting cycle.
- f. (1) DNRE agrees in part. DNRE received the award for American Recovery and Reinvestment Act of 2009 (ARRA) funding on April 13, 2009. It included a condition that stipulated that all laborers and mechanics employed by contractors and subcontractors funded with the grant should be paid prevailing wages. On August 28, 2009, one month before the end of the audit period and four months after the application process for subrecipients began, an amendment was issued that contained the first guidance from the EPA regarding the requirements of the Davis-Bacon condition. It did not include any guidance regarding the EPA's expectation for monitoring. In response to the amendment, DNRE updated the Web site to include the required terms and included the terms in the agreements with subrecipients. On March 25, 2010, the EPA issued a State ARRA Inspection Checklist and provided training in

which DNRE participated. DNRE adopted the checklist and began to use it to assist in monitoring subrecipients.

(2) DNRE agrees in part. The circumstances surrounding the Buy American requirements are identical to those outlined in part f.(1).

(3) As discussed in part a., DNRE agrees with the finding.

(4) DNRE agrees with the finding.

g. (1) DNRE agrees with the finding.

(2) DNRE agrees with the finding.

(3) DNRE agrees with the finding.

Planned Corrective Action:

a. During fiscal year 2007-08, DNRE implemented a new process for project managers to follow when reviewing reimbursement requests and will work to ensure that project managers follow the new process.

b. (1) No additional corrective action is necessary.

(2) As discussed in part a., DNRE implemented a new review process in fiscal year 2007-08. No additional corrective action is necessary.

c. No additional corrective action is necessary.

d. DNRE will continue to verify that subrecipients are not suspended or debarred and will document the verification on the checklist.

- e. (1) DNRE will revise the instructions to subrecipients to reflect the change in the methodology used to calculate jobs created for the ARRA Section 1512 reports.
- (2) DNRE will work to improve its validation process of Section 1512 reporting elements to the extent possible.
- f. (1) DNRE will continue to use the checklist as a basis for monitoring ARRA subrecipients' compliance with the Davis-Bacon Act.
- (2) DNRE will continue to monitor compliance with the Buy American Act, using the checklist identified in part f.(1).
- (3) As discussed in part a., DNRE implemented a new monitoring process in fiscal year 2007-08 and will work to ensure that project managers follow the new process.
- (4) DNRE continues to make efforts to obtain 100% of the required audit reports and will establish additional procedures to help determine whether an audit report is required.
- g. (1) DNRE modified the letters to subrecipients to include the required *CFDA* number.
- (2) DNRE modified the letters to subrecipients to include the information regarding the requirement to specifically identify ARRA funding on the schedules of expenditures of federal awards (SEFAs) and data collection forms.

(3) DNRE will continue to complete the crosscutter checklist to document the environmental reviews.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Sharon Maher and Sonya Butler

Finding Number: 7611004

Finding Title: Nonpoint Source Implementation Grants, *CFDA* 66.460

Management Views:

a. (1) DNRE disagrees with the finding. The expenditure was approved for payment after staff reviewed a number of supporting documents submitted by the subrecipient. These included a cover letter, financial status report, proof of payment to the contractor, a summary of time sheets provided by the contractor indicating the number of hours worked by each person, their rate of pay, and travel costs, along with a narrative description of each task, including the time and cost associated with each task. The invoices that were submitted with this documentation were marked "Draft." The subrecipient subsequently provided final invoices that were initialed and dated to reflect receipt prior to payment.

(2) DNRE agrees with the finding but disagrees with the questioned costs. Subsequent to the auditor's identification of this error, the employee was contacted. He confirmed the activity and certified that the time sheet was accurate.

(3) DNRE agrees with the finding.

b. (1) (a) DNRE disagrees with the finding. Subrecipients and grantees are required to submit quarterly financial reports that include documentation of salaries and wages on a budget form, invoices for contractual services, and easements. Subrecipients and grantees are required to maintain additional documentation and to provide it upon request. The project administrator assesses the reasonableness of the value of third party donated supplies, equipment, and space. Volunteer time is documented using a match documentation form along with agenda or meeting minutes.

(b) DNRE agrees with the finding.

(c) DNRE agrees with the finding.

(2) (a) DNRE disagrees with the finding. The activities of the individuals noted in the finding are programmatic in nature and are not subject to the 10% administrative limitation. In addition, DNRE's process to identify administrative expenditures was verbally approved by the EPA.

(b) DNRE disagrees with the finding. As the auditors stated, a similar condition was reported in the prior audit. DNRE consulted with the EPA regarding the process of including the indirect costs allocated on the basis of programmatic salaries as program costs. The EPA agreed verbally that the process was correct.

c. (1) As discussed in part b.(1)(a), DNRE disagrees with the finding.

(2) DNRE agrees with the finding.

Planned Corrective Action:

a. (1) DNRE will continue to be diligent in securing appropriate documentation prior to authorizing payments.

(2) DNRE will work with DTMB to modify DCDS. In the meantime, DNRE will implement a manual process to require documentation of the employee's approval.

(3) DNRE requires that employees charge actual time worked to the grant. No additional corrective action is necessary.

b. (1) (a) DNRE will develop additional guidance for grantees to ensure compliance with federal regulations.

(b) As described in part a.(2), DNRE will work with DTMB to modify DCDS. In the meantime, DNRE will implement a manual process to require documentation of the employee's approval.

(c) Financial and Business Services Division (FBSD) and Nonpoint Source Implementation Grants staff will devise a process for reporting local match on a quarterly basis. FBSD will include all match reported in the workpapers but will continue to follow EPA guidance and only report match up to the level required by the grant agreement.

- (2) (a) DNRE will continue to seek written guidance from the EPA.
- (b) DNRE will continue to seek written guidance regarding the classification of indirect costs allocated to programmatic activities from the EPA.
- c. (1) DNRE will develop a monitoring plan to ensure compliance with federal regulations.
- (2) DNRE continues to make efforts to obtain 100% of the required audit reports and will establish additional procedures to help determine whether an audit report is required. This includes a review of the required audit reports and the checklists used to document the review by the federal aid coordinator.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Cindy Masterson and Sharon Maher

Finding Number: 7611005

Finding Title: Capitalization Grants for Drinking Water State Revolving Funds, *CFDA* 66.468

Management Views: a. DNRE agrees in part. The EPA agreed with the methodology that DNRE used until December 3, 2009, when it reviewed it in relation to the same finding in the previous audit. At that time, it agreed with the auditors' assessment. After numerous requests, the EPA has not issued written guidance. DNRE stopped using an allocation method to charge administrative costs to EPA grants at the end of fiscal year 2008-09. All payroll costs, including the administrative costs, are charged to

the grants by the employee when working on grant eligible activities.

- b. DNRE agrees in part. DNRE complied with the federal regulation but did not document the compliance through the use of a checklist.
- c. (1) DNRE agrees with the finding.

(2) DNRE agrees with the finding.

(3) DNRE agrees that the jobs reporting process can be improved by the loan recipients.

(4) DNRE agrees in part. Given the tight reporting schedule, there is not adequate time to extensively review and validate all of the information submitted by the subrecipients prior to the due dates. DNRE established a process to review as many of the data elements as possible before the submission date. Errors discovered after the due date are corrected during the next reporting cycle.
- d. (1) DNRE agrees in part. DNRE received the award for ARRA funding on April 13, 2009. It included a condition that stipulated that all laborers and mechanics employed by contractors and subcontractors funded with the grant should be paid prevailing wages. On August 28, 2009, one month before the end of the audit period and four months after the application process for subrecipients began, an amendment was issued that contained the first guidance from the EPA regarding the requirements of the Davis-Bacon condition. It did not include any guidance regarding the

EPA's expectation for monitoring. In response to the amendment, DNRE updated the Web site to include the required terms and included the terms in the agreements with subrecipients. On March 25, 2010, the EPA issued a State ARRA Inspection Checklist and provided training in which DNRE participated. DNRE adopted the checklist and began to use it to assist in monitoring subrecipients.

(2) DNRE agrees in part. The circumstances surrounding the Buy American requirements are identical to those outlined in part d.(1).

(3) DNRE agrees with the finding.

(4) DNRE agrees with the finding.

e. (1) DNRE agrees with the finding.

(2) DNRE agrees with the finding.

Planned Corrective Action:

a. No additional corrective action is necessary.

b. DNRE will continue to verify that subrecipients are not suspended or debarred and will document the verification on the checklist.

c. (1) This finding was the result of significant turnover in staff combined with a large increase in work load due to the ARRA grant requirements. DNRE clarified the 50% limitation on Public Water System Supervision Program match with the EPA and will conduct training with employees preparing the financial status reports.

- (2) As noted in part c.(1), this finding was the result of significant turnover in staff combined with a large increase in work load due to the ARRA grant requirements. DNRE will conduct training with employees preparing the financial status reports and emphasize the importance of supervisory review.
 - (3) DNRE will revise the instructions to subrecipients to reflect the change in the methodology used to calculate jobs created for the ARRA Section 1512 reports.
 - (4) DNRE will work to improve its validation process of Section 1512 reporting elements to the extent possible.
- d. (1) DNRE will continue to use the checklist as a basis for monitoring ARRA subrecipients' compliance with the Davis-Bacon Act.
- (2) DNRE will continue to monitor compliance with the Buy American Act, using the checklist identified in part d. (1).
 - (3) DNRE will continue to work on improving consistency and documentation of monitoring.
 - (4) DNRE continues to make efforts to obtain 100% of the required audit reports and will establish additional procedures to help determine whether an audit report is required.
- e. (1) DNRE modified the letters to subrecipients to include the required *CFDA* number.

- (2) DNRE modified the letters to subrecipients to include the information regarding the requirement to specifically identify ARRA funding on the SEFAs and data collection forms.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Sonya Butler and Sharon Maher

Finding Number: 7611006

Finding Title: Performance Partnership Grants, *CFDA* 66.605

Management Views:

- a. DNRE agrees with the finding.
- b. (1) DNRE agrees with the finding.

(2) DNRE agrees with the finding.
- c. DNRE agrees with the finding.

Planned Corrective Action:

- a. DNRE implemented a new process during the audit period that improved internal control over the payroll certification process. Due to human error in implementing the process, one certification was omitted during the quarterly review process. DNRE has implemented an additional review procedure to provide additional assurance that all required certifications are obtained.
- b. (1) This finding was the result of significant turnover in staff combined with a large increase in work load due to the ARRA grant requirements. The underlying financial data was correct; an error was made in preparing the federal financial report. DNRE will conduct training with employees preparing the federal financial

reports and emphasize the importance of supervisory review.

- (2) As discussed in part a., DNRE has implemented an additional review procedure to provide additional assurance that all required certifications are obtained.
- c. As discussed in part b.(1), this finding was the result of significant turnover in staff combined with a large increase in work load due to the ARRA grant requirements. The underlying financial data was correct; an error was made in preparing the federal financial report. DNRE will conduct training with employees preparing the federal financial reports and emphasize the importance of supervisory review.

Anticipated Completion Date: September 30, 2011

Responsible Individuals: Cindy Masterson and Sharon Maher

GLOSSARY

Glossary of Acronyms and Terms

ARRA	American Recovery and Reinvestment Act of 2009.
Capitalization Grants for Clean Water State Revolving Funds (SRF) Program	The federal grant program that provides capitalization grants to states for establishing revolving funds to be used for the construction of municipal wastewater treatment projects or for the development and implementation of nonpoint source or estuary conservation management programs and plans in compliance with the Clean Water Act.
Capitalization Grants for Drinking Water State Revolving Funds (DWSRF) Program	The federal grant program that provides capitalization grants to states for establishing revolving funds to be used to assist public water suppliers in financing the costs of infrastructure needed to achieve or maintain compliance with Safe Drinking Water Act requirements. States may also set aside certain percentages of their capitalization grant for various activities that promote source water protection and enhanced water systems management.
<i>CFDA</i>	<i>Catalog of Federal Domestic Assistance.</i>
<i>CFR</i>	<i>Code of Federal Regulations.</i>
control deficiency in internal control over federal program compliance	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect on a timely basis noncompliance with a type of compliance requirement of a federal program.
control deficiency in internal control over financial reporting	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
CRF	Cleanup and Redevelopment Subfund.

CRTF	Cleanup and Redevelopment Trust Subfund.
CZM	Coastal Zone Management Administration Awards.
DCDS	Data Collection and Distribution System.
DEQ	Department of Environmental Quality.
DNR	Department of Natural Resources.
DNRE	Department of Natural Resources and Environment.
Drinking Water State Revolving Fund	A fund established within the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to provide low-interest loans to public water suppliers to finance the costs of infrastructure needed to comply with requirements of the Safe Drinking Water Act.
DTMB	Department of Technology, Management & Budget.
EPA	U.S. Environmental Protection Agency.
FBSD	Financial and Business Services Division.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.
GAAP	accounting principles generally accepted in the United States of America.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting,

effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material noncompliance	Violations of laws, regulations, contracts, and grants that could have a direct and material effect on major federal programs or on financial schedule and/or financial statement amounts.
material weakness in internal control over federal program compliance	A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected.
material weakness in internal control over financial reporting	A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial schedules and/or financial statements will not be prevented or detected.
NPS	Nonpoint Source Implementation Grants.
OMB	U.S. Office of Management and Budget.
pass-through entity	A nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.

PPG	Performance Partnership Grants.
PWSS Program	Public Water System Supervision Program.
qualified opinion	<p data-bbox="552 336 1446 378">An auditor's opinion in which the auditor:</p> <ul style="list-style-type: none"> <li data-bbox="552 420 1446 1197">a. Identifies a scope limitation or one or more instances of misstatements that impact the fair presentation of the financial schedules and/or financial statements presenting the basic financial information of the audited agency in conformity with the disclosed basis of accounting or the financial schedules and/or financial statements presenting supplemental financial information in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules and/or financial statements taken by themselves; or <li data-bbox="552 1239 1446 1428">b. Expresses reservations about the audited agency's compliance, in all material respects, with the cited requirements that are applicable to each major federal program.
questioned cost	<p data-bbox="552 1470 1446 1824">A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not</p>

	reflect the actions a prudent person would take in the circumstances.
SEFA	schedule of expenditures of federal awards.
SF-425 report	federal financial report.
SF-269 report	financial status report.
significant deficiency in internal control over federal program compliance	A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected.
significant deficiency in internal control over financial reporting	A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial schedules and/or financial statements that is more than inconsequential will not be prevented or detected.
Single Audit	A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in <i>Government Auditing Standards</i> issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.

<i>SOMCAFR</i>	<i>State of Michigan Comprehensive Annual Financial Report.</i>
State Revolving Fund	A fund established within the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to provide low-interest loans to municipalities for the construction of publicly owned water pollution control facilities.
subrecipient	A nonfederal entity that expends federal awards received from another nonfederal entity to carry out a federal program.
TCE	trichloroethylene.
unqualified opinion	<p>An auditor's opinion in which the auditor states that:</p> <ol style="list-style-type: none"> a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules and/or financial statements taken by themselves; or c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.

